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The Board of Taxation
C/- Treasury
Langton Crescent
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Dear Sirs

Post-implementation review of the quality and effectiveness of the small business capital gains tax concessions.

We thank the Board of Taxation for this opportunity to express our views on the current operation of the small business capital gains tax concessions (the "Concessions").

It is our belief that there will be abundant submissions from representative bodies in respect of the basic conditions set out in Subdivision 152-A of the *Income Tax Assessment Act 1997*. Consequently this submission will be limited to specific examples that, from our experience, have rendered the Concessions impracticable in actuality.

Company shares as active assets

For a taxpayer to secure the Concessions for a sale of a share[1], they must first satisfy the basic conditions for relief in accordance with Section 152-10.

One condition[2] is that the share satisfies the active assets test.

A share satisfies the active asset test if it meets the conditions set out in Section 152-35. To meet this test, generally the share must be an active asset during at least half of the period from the acquisition of the share to the time just before a CGT event happens to that share. [3]

A share in a company is an active asset, at a given time, should it satisfy Subsection 152-40(3). In summary, for a share in a company to be an active asset, the active assets in that company must be at least 80% of the market value of all the assets of that company.

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[1] The same underlying theory can be attributed to a CGT event happening to a unit in a unit trust.
[2] Paragraph 152-10(1)(d).
[3] The period for which the share needs to be an active asset during at least half the time thereof, is modified in accordance with Section 152-35 should the relevant business ceased or the CGT asset having been owned for more than 15 years.

The construction of Section 152-35 effectively means that for the share to satisfy the active asset test, it must satisfy Subsection 152-40(3) for at least half of the period determined in Subsection 152-35. In practice, it is impracticable (most likely impossible) to determine whether the test in Subsection 152-40(3) is passed at any time other than at discrete intervals (e.g. 30 June 2005).

For the reasons of revenue integrity, it is understandable why the provisions were constructed in such a manner. If discrete time frames were to be used, there is the possibility that transactions may be entered into for no reason other than to satisfy the active assets test.

Notwithstanding the above, we believe that the provisions should allow for testing at discrete intervals. Preferably, the testing time would be on an annual or 6-monthly basis, or given the changes to reporting brought about by *A New Tax System*, a quarterly basis may still be acceptable.

One method that may be used to improve integrity of the provisions in this situation is to introduce a provision similar to Subsection 109R(2) of the *Income Tax Assessment Act 1936*. Whilst this subsection is used to disregard certain payments made in respect of a loan where it is effectively engineering a required outcome in respect of Division 7A, the same premise may be used for the active asset test. That is, where a reasonable person would conclude that a transaction was entered into with the sole or dominant purpose to satisfy Subsection 152-40(3), then that transaction will be disregarded for the purposes of determining that subsection.

Whilst the above may be a method in which to reduce the possibility of deliberate transactions being used to satisfy the subsection, the normal course of operations may result in the subsection not being passed as the provisions are currently drafted purely because of the timing of a transaction. This is clearly illustrated by the timing of the receipt of monies owed by trade debtors.

There is debate over whether cash at bank and trade debtors are active assets. Consideration is given to whether a trade debtor is an active asset in ATO ID 2002/1003. It was determined that trade debtors are *"intangible assets inherently connected with [a] business"* and therefore satisfy Paragraph 152-140(1)(b). The determination went further and opined that trade debtors were not excluded from being an active asset by Paragraph 152-40(4)(d) as they were *"…not financial instruments but rather a business facilitation mechanism that assists in the conduct of [a] business"*. Whether a bank account could be an active asset was reviewed in ATO ID 2003/167. It was determined that it could not be an active asset as it would be excluded by Paragraph 152-40(4)(d), being a financial instrument (we are of the opinion that it is unlikely that a trading account would be excluded under Paragraph 152-40(4)(e) as the main use for a trading account is generally to fund working capital and not to derive interest).

If it is taken that trade debtors is an active asset and cash at bank (being a trading account) is not an active asset then the following scenario is possible:

Shares sold on 30 June 2005 with the company's Statement of Financial Position (Balance Sheet) immediately before the shares' disposal represented as:

Cash at Bank	*$100,000*
Trade Debtors	*$500,000*
Issued Capital	*$300,000*
Unappropriated Profit	*$300,000*

The active assets of the company are $500 000 being trade debtors. This represents approximately 83% of the market value of all the assets owned by the company. To the extent that the shares were active assets for at least half of the prescribed period, the shares would satisfy the active assets test as they were an active asset just before the CGT event.

Shares sold on 1 July 2005 with the company's Statement of Financial Position (Balance Sheet) immediately before the shares' disposal represented as:

Cash at Bank	*$300,000*
Trade Debtors	*$300,000*
Issued Capital	*$300,000*
Unappropriated Profit	*$300,000*

Prior to further shares being sold, $200 000 of debtors has been received as part of normal commercial operations. The active assets of the company are now $300 000. This represents 50% of the market value of all the assets of the company. The $200 000 are not capital proceeds and are therefore not included through Paragraph 152-40(3)(b)(ii). The shares sold on 1 July 2005 cannot satisfy the active assets test.

Whilst this is a simple example, variations on this theme are occurring in practice. The issue at point is the treatment of the trading bank account. Due to the cyclical nature of business, there will be times that a company's trading account will be treated as an asset (rather than a liability when in overdraft). It is noted above that as a general rule we do not believe that the trading account would be excluded from being an active asset by Paragraph 152-40(4)(e) (main use to derive interest etc.) In practice we do not believe that the trading account would be included under Paragraph 152-40(3)(b)(ii). It is therefore argued that ensuring a trading account is not in overdraft, whilst being commercially prudent, is detrimental for small business when endeavouring to access the small business concessions. This would appear to be totally at odds with government policy of having a strong small business sector.

We believe that there are two potential methods to resolve this situation. Firstly, the trading account is to be treated as an active asset when it is reasonable to determine that it will be used for the dominant purpose of funding a business. The reason for funding the business and not merely funding active assets is funds are required to pay employees and creditors etc. to enable the business to continue. The second method is to totally exclude the trading account from the market value of the active assets and the market value of all the assets. Our preference is for the first method due to its nature of supporting business rather than an artificial exclusion to support public policy.

Company shares and small business 15-year exemption

Amendments made by the *First Corporate Law Simplification Act 1995* allowed for single member companies (to the extent that the respective company's constitution also allowed).

Prior to this time, if an individual wished to beneficially own 100% of the shares in a company, they required another entity to legally own one share of that company (held on trust for the individual).

Presently, there are individual shareholders that have beneficially owned shares in a company for fifteen (15) years (or will do in the near future) and upon their disposal satisfy all the requirements of Subdivision 152-B "*Small business 15-year exemption"* except for Paragraph 152-105(b) being the individual must have "…continuously owned the CGT asset for the 15-year period ending just before the event…"

It is our understanding that the construction of this provision requires the beneficial and legal ownership to be continuously owned. At the 28 February 2005, notwithstanding an individual shareholder has beneficially owned 100% of the shares in a company for fifteen (15) years and immediately upon the changes to the *Corporations Act,* obtained the legal ownership of the shares that they were not permitted to hold previously, those shares that the individual did not have the legal ownership of pre-*First Corporate Law Simplification Act 1995* cannot immediately access the small business 15-year exemption.

We are of the opinion that paragraph 152-105(b) should be redrafted to add the word beneficially after "you continuously" and before "owned the *CGT asset…" There is a basis for this view in so far as the Capital gains and losses provisions set out in Parts 3-1 and 3-3 use beneficial ownership and not legal ownership as a determining factor in a number of CGT events[4].

Your plan as we understand is to assess the "quality and effectiveness" of the small business CGT concessions. To this extent you will have regard for, in part, "actual taxpayer circumstances and commercial practices". The above are but two of a number of areas where the "black letter law" does not follow commercial practice. We welcome this review and trust that through this and other submissions, the Board of Taxation will recommend, and the Government accept and implement changes, a more practicable construction of this area of legislation whilst maintaining the integrity of the Government's revenue stream.

We would welcome the opportunity to discuss any of the issues raised in this submission should you require. Please address all correspondence in respect of this submission to the undersigned.

Yours faithfully

Guy Brandon
Tax Advisor

[4] Most notably paragraph 104-10(2)(a) where a disposal for CGT purposes has not occurred when ceasing to be the legal owner but still being the beneficial owner.