Australian Government

The Board of Taxation

A Post-implementation Review of the Quality and Effectiveness of the Small Business Capital Gains Tax Concessions in Division 152 of the *Income Tax Assessment Act 1997*

A Report to the Treasurer

the board of taxation
www.taxboard.gov.au

The Board of Taxation
October 2005

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FOREWORD

In March 2002, the Board of Taxation provided the Treasurer with a report, *Government Consultation with the Community on the Development of Taxation Legislation*. The report included a recommendation that the Board conduct post-implementation reviews of significant tax legislation initiatives, consistent with one of the functions set out in its Charter: to advise on the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design.

The Government's response[1] to the Board's report accepted that recommendation, agreeing to the Board conducting post-implementation reviews of major pieces of tax legislation to ensure that Government policy intent has been effectively translated consequent upon consultations undertaken.

The Board's first post-implementation review was of the non-commercial losses legislation in Division 35 of the *Income Tax Assessment Act 1997*. The Board's report and the Government's response to this review were publicly released on 27 April 2005.

The Treasurer agreed that the Board's second post-implementation review would be conducted on the small business capital gains tax (CGT) concessions in Division 152 of the *Income Tax Assessment Act 1997*. Division 152 applies to all assessments for the income year including 21 September 1999 and all later income years, but only for CGT events that happen after 11:45 am on 21 September 1999. A number of small amendments have been made to the provisions since their introduction. Therefore, a review at this stage is timely and based on reasonable experience of its operation.

The Board commenced substantive work on the review in November 2004 and formed a Working Group of three of its members to take day to day carriage of this work.

Consistent with its Charter function referred to above, the Board has carried out this review essentially with a forward looking perspective, although where appropriate it has referred to past events with the aim of promoting future improvements in the tax system.

In accordance with the Board's practice to require members who have a material personal interest in a matter before the Board to disclose that interest, several members disclosed that, as part of their normal business activities, they had provided advice to clients on the operation of the small business CGT concessions. The Board noted that the possible recommendations would not financially advantage the members concerned in their roles as private sector advisers. The Board considered that there was no actual conflict of interest and that the members concerned could continue to participate in Board discussions and decisions on the review, after receiving their assurance that they would continue to judge the issues as Board members rather than as practitioners.

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1 Treasurer's Press Release No. 22 of 2 May 2002: 'Reforms to Community Consultation Processes and Agency Accountabilities in Tax Design'.

The Board would like to thank the Treasury and the ATO for their cooperation in conducting this review. The recommendations in this report reflect the Board's independent judgements and do not necessarily reflect the views of the Treasury or the ATO.

The Board would also like to thank the various individuals and organisations that made submissions to the Board on the operation of the small business CGT concessions. Many of the issues raised in these submissions have been taken into account in framing the Board's recommendations. However, the submissions also raised a number of policy issues which are outside the scope of the review. Consistent with the Board's broader Charter, the main policy issues raised are summarised in Chapter 4 of the report for the Treasurer's information.

The *ex officio* members of the Board — the Secretary to the Treasury, Dr Ken Henry, the Commissioner of Taxation, Mr Michael Carmody AO, and the First Parliamentary Counsel, Mr Peter Quiggin — reserved their final views on the issues canvassed in this report for advice to Government.

PART A

OVERVIEW, RECOMMENDATIONS AND BACKGROUND TO THE REVIEW

CHAPTER 1: EXECUTIVE SUMMARY

INTRODUCTION

1.1 The review of the small business capital gains tax (CGT) concessions in Division 152 of the *Income Tax Assessment Act 1997* (ITAA 1997) is the second post-implementation review conducted by the Board of Taxation. The Board's first post-implementation review was of the non-commercial losses legislation in Division 35 of the ITAA 1997. The Board's report and the Government's response to its first review were publicly released on 27 April 2005.

1.2 Conducting post-implementation reviews is consistent with one of the Board's functions, namely to advise the Treasurer on 'the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design'.[2] In undertaking these reviews, the Board assesses the legislation against criteria based on its Consultation Report[3] to determine the extent to which the legislation:

- gives effect to the Government's policy intent, with compliance and administrative costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure;
- is expressed in a clear, simple, comprehensible and workable manner;
- avoids unintended consequences of a substantive nature;
- takes account of actual taxpayer circumstances and commercial practices;
- is consistent with other tax legislation; and
- provides certainty.[4]

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2 The Charter of the Board of Taxation — see Appendix C.

3 Board of Taxation Report to the Treasurer and the Minister for Revenue and Assistant Treasurer 'Government Consultation with the Community on the Development of Taxation Legislation', March 2002.

4 Board of Taxation Consultation Plan for the post-implementation review of the Small Business CGT concessions.

1.3 The Board's intention in undertaking post-implementation reviews is not to reopen debates about the merits of the policy underlying the legislation. Rather, the intention is to gauge how effective the legislation has been in delivering that policy intent and to find out whether its implementation can be improved.

1.4 The Board notes that Division 152 was developed prior to the Reforms to Community Consultation Processes and Agency Accountabilities in Tax Design announced by the Treasurer on 2 May 2002.[5] In addition, Division 152 evolved through consolidating and extending a number of prior small business CGT concessions. As such, it was apparent from submissions received by the Board that there was some uncertainty regarding the policy intent behind aspects of Division 152. This has highlighted for the Board the importance of the Treasurer's May 2002 announcement that for the development of new tax measures the Government will be working from an in-principle position of 'ensuring policy intent for each new measure is clearly established and described by public announcement'.

1.5 The uncertainty mainly concerned the controlling individual test that was carried forward from earlier legislation (Divisions 17A and 17B of the *Income Tax Assessment Act 1936* (ITAA 1936) and Division 123 of the ITAA 1997) which previously provided the small business CGT concessions. The controlling individual test was continued through into Division 152 and has been treated as part of the policy intent by the Board in conducting this review and preparing this report. Issues raised in submissions relating to the controlling individual test and other policy issues are identified in Chapter 4 for the Treasurer's information.

What does Division 152 do?

1.6 Division 152 provides significant CGT concessions for eligible small business entities.[6] A copy of Division 152 is at Appendix A. The basic eligibility criteria that must be met to access the concessions are:

- a limit of $5 million on the net value of assets that the business and related entities own;
- the CGT asset must be an active asset;
- if the asset is a share in a company or an interest in a trust, there must be a controlling individual just before the CGT event and the entity claiming the concession must be a CGT concession stakeholder in the company or trust.

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5 Treasurer's Press Release No. 22 of 2002.

6 The term 'eligible small business entity' in this report means a small business taxpayer (whether individual, company or trust) that qualifies for the small business CGT concessions in Division 152.

Some of the concessions have additional, specific conditions that also must be satisfied.

1.7 The concessions are provided in four different forms:

- a 15 year exemption which treats a capital gain as totally tax-free, provided the asset was held continuously for 15 years and the relevant person is over 55 and retiring (or permanently incapacitated) at the time of the CGT event happening;
- a 50 per cent reduction in the taxable amount of the gain;
- the ability to use up to a life time limit of $500,000 towards the retirement funding of the relevant individual; and
- the ability to defer paying tax on the gain where it is used to acquire replacement business assets. In this case, the gain is not recognised until the replacement business asset ceases to be an active business asset in its own right.

1.8 These concessions apply successively, allowing taxpayers access to multiple concessions. They also apply in addition to any general CGT discount for which the taxpayer may qualify.

1.9 Division 152 applies to CGT events that happen from 21 September 1999. Although it has its genesis in earlier small business CGT concessions,[7] Division 152 contains much wider and more generous CGT concessions than had previously been available to small business.

How the review was conducted

1.10 On 3 December 2004, the Board of Taxation invited stakeholders to make submissions to the review. A total of 20 submissions were received from a range of stakeholders by 30 June 2005 (listed at Appendix B to this report). The Board met with a number of organisations that made submissions to the review to discuss their submissions.

1.11 The Board appointed two consultants to assist with the review. Webb Martin Pty Ltd (Webb Martin) was engaged to conduct a general evaluation of Division 152. Atax (the Australian Taxation Studies Program), part of the Law Faculty of The University of New South Wales, was engaged to conduct an evaluation of the compliance and administrative costs of Division 152. Both consultants consulted widely with taxpayers

7 See Divisions 17A and 17B of the ITAA 1936 and Division 123 and Subdivision 118-F of the ITAA 1997.

and tax professionals through focus groups and surveys to obtain input for their evaluations.

1.12 The Board also consulted extensively with the Treasury and the Australian Taxation Office (ATO). The Board would like to extend its appreciation to both the Treasury and the ATO for their cooperation with the Board in conducting this review.

1.13 Consultation, both direct and indirect, was therefore very important for the Board of Taxation to understand the context in which Division 152 operates, the benefits of the provisions and the areas that may be able to be fine-tuned.

1.14 The Board decided to treat suggestions concerning the core eligibility criteria as policy issues and therefore beyond the scope of the review but to consider other suggestions as potentially within the scope of the review. Chapter 4 outlines those issues the review treated as policy matters and therefore out of scope. Further information on how the Board conducted the review is contained in Chapter 2.

1.15 The majority of the Board's recommendations are aimed at addressing what it judged to be unintended consequences in Division 152.

Assessment of the legislation against the Board's criteria

1.16 In assessing the provisions of Division 152 against the review criteria, the Board concluded that, on the whole, the Division is well received by small business. However, some amendments would ensure the Division operates to better fulfil its objectives of providing significant CGT concessions to eligible small business entities.

Does Division 152 give effect to the policy intent, with compliance and administrative costs commensurate with those foreshadowed in the regulation impact statement?

Policy intent

1.17 Division 152 gives effect to the overall policy to provide significant relief from the CGT system for eligible small business entities. It provides a choice of concessions based on the same underlying criteria, permits multiple application of concessions to the one transaction so that their benefit is maximised, and allows eligible small business entities to use significant amounts of their capital gains towards funding their retirement in a largely tax-free manner or towards investing in more business assets.

1.18 The application of the rules to straightforward situations is clear and easily applied and is viewed by tax advisers and taxpayers alike as providing a range of significant and relatively easily accessed benefits for eligible small business entities.

1.19 Some amendments to Division 152 are recommended where the current provisions do not adequately give effect to the policy. Recommendations are made to improve the operation of the law in these instances.

Compliance and administrative costs

1.20 While it was unclear whether compliance costs had changed since 1999, the evidence indicates that the compliance costs of the small business CGT concessions are not significant for the taxpayers involved. The review suggests the concessions may be a compliance cost issue for tax practitioners who may not be able to pass on most of those costs to their clients. Aggregate annual recurrent compliance costs were estimated to be up to about $110 million in 2002-03. This estimate is likely to be at the upper end of the range of possible estimates because the estimates are heavily dependent on the value placed on practitioner time and the practitioners surveyed were not fully representative of the general population of practitioners. While these costs are significant in absolute terms, their impact needs to be seen relative to the increased benefit of the concessions to taxpayers. Compliance costs are discussed in more detail in Part C of this report.

1.21 The ATO has estimated that its aggregate recurrent administrative costs were around $2.3 million (mostly on labour and related costs) in 2003-04. This represents a reasonable estimate, subject to the caveats mentioned in Part C of this report. This estimate is not large in absolute terms, and is small in comparison to the administrative costs of other tax reform measures.

Is Division 152 expressed in a clear, simple, comprehensible and workable manner?

1.22 There are many aspects of Division 152 which meet this criterion. However, there are a number of important concepts in the provisions which require clarification. Much of this clarification can be achieved by the publication of rulings, practice statements or other forms of guidance by the ATO.

1.23 Recommendations are made for amendments or for additional ATO guidance in situations where a particular test is difficult to apply in practice or commonly misunderstood by taxpayers and their advisers.

Does Division 152 avoid unintended consequences of a substantive nature?

1.24 The small business CGT concessions are generally available to the group of taxpayers intended to benefit most from them.

1.25 A consequence of the lack of transitional provisions on introduction of the concessions is that many small businesses that satisfy the maximum net asset value test are unable to access the concessions because of the type of business structure in place

when the concessions were introduced. However, this is a policy issue, beyond the scope of the review.

Does Division 152 take account of actual taxpayer circumstances and commercial practices?

1.26 The small business CGT concessions apply in an easy and workable way to the majority of straightforward transactions entered into by eligible small business entities. However, a number of taxpayer arrangements described in submissions to the Board, because of the particular commercial decisions taken, were denied access to those concessions. This is particularly of concern in relation to transactions that pre-date the introduction of the Division.

1.27 It is difficult for taxation legislation to be designed to cater for all the potential small business taxpayer arrangements. Where it is possible to suggest amendments to the law to cater for usual and frequent transactions that arise on a straightforward dealing with business assets, appropriate recommendations are made. These recommendations are designed to improve the manner in which the small business CGT concessions apply in circumstances which are within the overall policy intent of the legislation.

Is Division 152 consistent with other tax legislation?

1.28 There is a high level of consistency at a general level. However, some inconsistencies have been identified with other aspects of the CGT legislation, other income tax law, and superannuation and related provisions.

1.29 Recommendations are made to improve the level of consistency by adopting some of the concepts that apply to small business in other areas of the tax law.

1.30 Recommendations are also made to improve the consistency with which the CGT legislation operates with Division 152 and also the provisions relating to the treatment of assets on the death of the taxpayer.

Does Division 152 provide certainty?

1.31 The operation of the provisions in uncomplicated situations is clear and provides certainty of outcomes particularly where the relevant taxpayer is 55 or over.

1.32 A lack of certainty has been identified in a number of areas, including where there is a test to be applied over time, or there is doubt about the meaning of various concepts used. In the latter case, recommendations are made for the ATO to issue guidance to assist taxpayers in this regard. Other recommendations are made to amend provisions to make their outcomes more certain.

THE BOARD'S RECOMMENDATIONS

1.33 The Board notes that the introduction of Division 152 has had a positive impact on the availability of concessions under the CGT system for eligible small business entities. This is consistent with the objectives of providing a choice of concessions based on the same underlying criteria, permitting multiple application of the concessions to one transaction so that their benefit is maximised, and allowing eligible small business entities to use significant amounts of their capital gains for funding their retirement in a largely tax-free manner or towards investing in more business assets.

1.34 The Board's recommendations cover two broad areas:

- fine-tuning a small number of the provisions relating to the application of the eligibility criteria to improve the current outcomes of the legislation; and
- minor legislative changes to address unintended consequences and administrative changes to assist understanding of the law.

1.35 The Board considers that the recommendations would result in small businesses being subject to a more homogeneous tax environment. This would increase the incentives to small business generally to invest their capital to maximise employment, investment returns, and innovation.

1.36 The Board also considers its recommendations would reduce complexity and compliance costs. This could have wider benefits, essentially by lowering, at the margin, the transactions costs of generating employment and investment returns in small businesses.

1.37 The Board has made a total of 39 recommendations, over half of which seek to address issues relating to the net asset and active asset tests. The majority of the remaining recommendations seek to clarify issues relating to the retirement exemption and small business CGT affiliates.

1.38 The recommendations have been ordered below to indicate the effect they would have, if adopted, on taxpayers. Firstly, 14 higher impact recommendations (predominantly relating to the net asset and active asset tests) that would have a higher positive impact on taxpayer interactions with the concessions. Secondly, 12 lower impact recommendations (mainly relating to the active asset test and the retirement exemption) that would have a lower, although still positive, impact on taxpayer interactions with the concessions. Thirdly, 13 recommendations seeking additional ATO guidance on the net asset and active asset tests and the retirement exemption.

1.39 Recommendations are numbered according to the chapter in which they appear.

Higher impact recommendations

Recommendations concerning the maximum net asset value test

Recommendation 6.2

The maximum net asset value test includes certain assets and liabilities of the taxpayer as well as of connected entities and small business CGT affiliates.

To ensure consistency of application of the maximum net asset value test for assets and liabilities held in connected entities and affiliates compared to assets and liabilities within the one entity, the definition in section 152-20 should be amended to clarify that a negative value of the net assets of the entity, a connected entity or a small business CGT affiliate is able to be taken into account.

Recommendation 6.3

Liabilities that are related to an asset are included in the net value of the CGT assets for the maximum net asset value test.

The meaning of net value of the CGT assets in section 152-20 should be amended so that, in addition to the present legal obligations that relate to the assets, the following provisions are included in liabilities that relate to the assets of a business:

- annual leave and long service leave;
- unearned income; and
- future tax liabilities.

Recommendation 6.8

In applying the maximum net asset value test in relation to interests in partnership assets it is unclear whether the test applies to the partner individually or to all of the CGT assets of the partnership.

To improve the certainty of the operation of the maximum net asset value test for partners and partnerships, paragraph 152-15(b) should be repealed so that the treatment of a disposal of an interest in a partnership asset is aligned with the disposal of other active assets held by the partner.

Recommendation 6.9

Where the individual uses a dwelling to generate assessable income in part and is (or would be) entitled to pro-rata interest deductions in relation to money borrowed to acquire the dwelling, the full value of the dwelling is included in the maximum net asset value test.

To give effect to the policy intent and to improve the certainty of the outcome of the maximum net asset value test, section 152-20 should be amended in relation to the inclusion of dwellings to:

- only include that percentage of the value of the dwelling that reflects the proportion of interest deductibility on the dwelling; and
- have regard to that deductibility over a specified period, rather than at the time of the CGT event.

Recommendations concerning the active asset test

Recommendation 7.1

Where a business has ceased, an asset which was 'active' immediately before the cessation of the business may attract the small business CGT concessions provided it is sold within 12 months of the cessation of the business (or within such further time as the Commissioner allows).

To avoid the unintended denial of the small business CGT concessions on the sale of business premises and other active assets, section 152-35 should be amended to allow for a similar 12 month period for the disposal of an asset after the cessation of ***use*** of the asset in the business, irrespective of whether the business itself has actually ceased.

Recommendation 7.5

To determine whether shares in a company or interests in a trust qualify as 'active assets', an 80 per cent look though test is applied to the active assets of the company or trust.

To provide a more practical test which takes into account actual taxpayer circumstances and commercial practices, subsection 152-40(3) should be amended so that financial instruments of the company or trust which are inherently connected with a business are included as active assets for the purposes of the 80 per cent look through test.

Recommendation 7.6

Monitoring of the active asset status of shares in companies or interests in trusts may be required over extended periods of time or, in some cases, continuously.

To provide a more workable formula for determining compliance with the active asset test, as well as reducing the compliance costs of testing the active asset status of shares and interests in trusts on an ongoing basis, subsection 152-40(3) should be amended to treat the 80 per cent rule as having been met:

- where breaches of the threshold are only temporary in nature; and
- in circumstances where it is reasonable to conclude that the 80 per cent threshold has been passed.

Recommendation concerning the 15 year exemption

Recommendation 10.2

The requirement for an entity to have a controlling individual to qualify for the small business 15 year exemption is tested over the entire period of ownership of the particular active asset by the entity.

To reduce compliance costs and provide a simple and more practical and workable rule, the requirement for a company or trust to have a controlling individual in paragraphs 152-105(c) and 152-110(1)(c) should be limited to 15 years, to match the required ownership period for the relevant active asset (that is, the last 15 years of ownership only).

Recommendations concerning the retirement exemption

Recommendation 12.1

Where a company or trust derives the capital gain and chooses to use the retirement exemption, the company or trust is required to make an eligible termination payment (ETP) to its CGT concession stakeholder(s).

To remove unintended consequences of the requirement to make an ETP, section 152-325 should be amended to require the company or trust to make a payment of the CGT exempt amount. Under these amendments the amount so paid could be taken to be an ETP.

Recommendation 12.7

Where the retirement exemption applies in relation to payments from a company, it is possible for various deemed dividend provisions to apply to the transaction.

To clarify the application of the deemed dividend provisions in section 109 and Division 7A, and support the policy of allowing a lifetime limit of $500,000 to fund the retirement of a CGT concession stakeholder, amendments should be introduced to ensure that none of the deemed dividend provisions have application in relation to CGT exempt components within the meaning and limits of Subdivision 152-D.

Recommendations concerning the small business roll-over

Recommendation 13.3

An eligible small business entity cannot choose to roll over only part of an active asset gain against the acquisition of replacement active assets.

To support the policy of the small business CGT concessions applying in a flexible manner and allowing taxpayers the maximum amount of choice, consistent with the other concessions available under Division 152, an amendment should be made to Subdivision 152-E to permit taxpayers to roll over all or part of a gain against replacement active assets.

Recommendation 13.4

An eligible small business entity can only claim the small business roll-over against the cost of *acquiring* replacement active assets.

An amendment should be made to section 152-415 to allow the small business roll-over where the amount of the capital gain to be disregarded does not exceed the cost of capital *improvements* which form part of the fourth element of the cost base of an active asset. This would give effect to policy to permit the rolled over amount to be reinvested generally in active business assets.

A related amendment should be made to section 104-185 to ensure that CGT event J2 happens if the deferred capital gain is applied to capital improvements to an active asset and either those improvements cease to be reflected in the state or nature of the asset or the improved asset ceases to be an active asset.

Recommendation 13.5

The operation of the current rules for making choices under the small business roll-over is not clear.

To provide more workable rules for making choices under the small business roll-over, amendments should be made to the process and timing rules for making choices in section 103-25 to clarify how and when the small business roll-over choices can be made.

These amendments should enable a taxpayer to be eligible for the small business roll-over if the conditions for the roll-over are subsequently met, irrespective of whether the original return disclosed the gain in full.

Recommendation 13.8

Where a deceased's legal personal representative (LPR) disposes of an asset which had been an active asset in the hands of the deceased, the estate cannot automatically qualify for the small business CGT concessions.

To provide more workable rules for the treatment of active assets on the death of an individual, and to promote consistency of treatment of assets under the CGT rules generally, Division 152 should be amended to allow the deceased's LPR or a beneficiary of the deceased's estate to be eligible for the small business CGT concessions where:

- the asset is disposed of within two years of the date of death; and
- the asset would have qualified for the small business CGT concessions if the deceased had disposed of the asset immediately before his or her death.

Lower impact recommendations

Recommendations concerning the maximum net asset value test

Recommendation 6.6

Partners in a partnership are not treated as small business CGT affiliates of each other merely because they act in concert with each other in relation to the affairs of the partnership.

To remove any unintended consequences of the definition of small business CGT affiliate, section 152-25 should be amended to allow a similar exclusion to that provided for partners to apply to co-directors and co-trustees to the effect that simply holding that position is insufficient to draw the conclusion that they act in concert.

Recommendation 6.7

The definition of small business CGT affiliate includes entities that act in concert and entities that act or could reasonably be expected to act in accordance with another's directions or wishes.

To improve the certainty of the definition of small business CGT affiliate, the definition in section 152-25 should be amended to ensure that companies and trusts are not small

business CGT affiliates of their directors and trustees respectively, and vice versa, merely because of the position held.

Recommendation 6.10

Certain non-business assets held by a small business CGT affiliate or entity connected with the small business CGT affiliate are excluded from the maximum net asset value test of a taxpayer by operation of subsection 152-20(4).

Subsection 152-20(4) is difficult to read and understand and should be amended to improve its readability.

Recommendations concerning the active asset test

Recommendation 7.4

Intangible assets inherently connected with the taxpayer's own business may be active assets.

Section 152-40 should be amended to give effect to the policy intent that intangible assets inherently connected with the business of a small business CGT affiliate or connected entity should also be active assets.

Recommendation 7.7

It is possible for shares or trust interests in widely held entities that conduct businesses to qualify as active assets.

To give effect to policy, section 152-40 should be amended to ensure that shares and trust interests in widely held entities are not active assets unless held by a CGT concession stakeholder in the widely held entity.

Recommendations concerning the 15 year exemption

Recommendation 10.3

Where the 15 year exemption applies to a gain made by a company or a trust, the amount of the gain paid from the company or trust to CGT concession stakeholders in the following two years is ignored for tax purposes.

To improve the consistency of Subdivision 152-B with other areas of the income tax law, section 152-125 should be amended to clarify the nature of the payment which is ignored for the purposes of the 15 year exemption and to ensure that inappropriate outcomes under other areas of the income tax law do not arise.

Recommendation 10.4

Where a company or trust is eligible for the 15 year exemption, for the payment of this amount to a CGT concession stakeholder in the company or trust to be ignored for tax purposes, it must be paid out within two years.

To take into account actual taxpayer circumstances and commercial practices, section 152-125 should be amended to allow the Commissioner to extend the two year period for payments from the company or trust in appropriate circumstances.

Recommendations concerning the retirement exemption

Recommendation 12.2

Where the retirement exemption is chosen, if the relevant individual is under 55, the retirement exemption amount must be rolled over into a complying superannuation fund.

To provide clearer and simpler requirements with internal consistency within Division 152, the requirement for the relevant individual to be under 55 should be tested in all cases when the choice is made for the retirement exemption — generally on lodgement of the relevant tax return.

Recommendation 12.5

A previously deferred capital gain because of the small business roll-over which is crystallised because of CGT events J2 or J3 can subsequently be eligible for the retirement exemption.

An amendment to Subdivision 152-D is desirable to clarify the operation of the retirement exemption in relation to capital gains from CGT events J2 and J3 and ensure that it operates in accordance with the policy intent that previously rolled-over gains may be applied to the retirement exemption.

Recommendation 12.8

The CGT provisions contain a Method Statement in section 102-5 explaining how to work out the amount of a net capital gain.

A minor amendment to correct Note 2 in Step 4 in the Method Statement in section 102-5 should be made to accurately state the operation of the small business CGT concessions.

Recommendations concerning the small business rollover

Recommendation 13.1

To be acceptable as a replacement asset for the small business roll-over, the asset must be acquired within a set timeframe and it must also be active within a set timeframe. The Commissioner has a discretion to extend the acquisition timeframe but not to extend the timeframe in which the replacement asset must be 'active'.

An amendment should be made to section 152-420 to allow the Commissioner a discretion to extend the time period in which a replacement asset must be 'active' in appropriate circumstances. This would avoid unintended consequences arising in the case of normal taxpayer circumstances and commercial practices on the acquisition of assets.

Recommendation 13.7

The ability of shares in a company or interests in a trust to qualify as acceptable replacement assets raises issues relating to whether the holder of the shares is a natural person who is a controlling individual or the spouse of the controlling individual who holds an ownership interest in the entity.

To give practical effect to these requirements for replacement assets which are shares or trust interests, subsection 152-420(5) should be amended to require that, where the replacement asset is a share in a company or an interest in a trust, just after the share or trust interest is acquired, the taxpayer must be a CGT concession stakeholder in the entity.

Recommendations relating to ATO guidance[8]

Recommendations concerning the maximum net asset value test

Recommendation 6.1

Liabilities that 'relate to' a CGT asset are included in the maximum net asset value test.

To assist taxpayers in the correct application of the maximum net asset value test in a practical and workable manner, the Commissioner should publish guidance on those liabilities which are taken to 'relate to' the CGT assets of an entity in commonly encountered situations.

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8 Such written ATO guidance may take the form of a Public Taxation Ruling or Taxation Determination, ATO Interpretative Decision, or some other published guide or Fact Sheet.

Recommendation 6.4

An entity is connected with another entity if the first entity controls the other entity or both entities are controlled by the same third entity.

To reduce any uncertainties in relation to the concept of 'control' of a discretionary trust, the Commissioner should provide guidance in relation to the circumstances in which a person will be taken to 'control' a trust.

Recommendation 6.5

To assist taxpayers in correctly calculating their maximum net asset value and to reduce uncertainties in relation to the concept of small business CGT affiliate, the Commissioner should provide guidance in relation to the practical application of the concepts of 'to act in concert' or 'reasonably expected to act in accordance with your directions or wishes' in section 152-25.

Recommendations concerning the active asset test

Recommendation 7.2

The Commissioner may allow an extension of the time period in which a formerly active asset may be sold and still qualify for the small business CGT concessions.

The Commissioner should provide detailed written guidance indicating the circumstances in which such an extension of time beyond the 12 month period specified in the law would be allowed for the disposal of an active asset.

Recommendation 7.3

The definition of an 'active asset' uses various concepts such as 'hold ready for use', 'main use' and 'temporary use'.

To reduce uncertainty in relation to the application of the active asset test, the Commissioner should provide guidance to clarify the interpretation of the various concepts in section 152-40.

Recommendation concerning the 15 year exemption

Recommendation 10.1

To be eligible for the small business 15 year exemption, the relevant individual must be retiring or permanently incapacitated.

The Commissioner should provide guidance in relation to the meaning of 'in connection with retirement' and 'permanent incapacity' in the context of the 15 year exemption in Subdivision 152-B.

Recommendation concerning the small business 50 per cent reduction

Recommendation 11.1

Where the small business 50 per cent reduction amount is distributed to interest holders in a trust, CGT event E4 happens which can give rise to further capital gains.

The Commissioner should issue guidance in relation to the operation of Division 152 and CGT event E4 to improve awareness of the tax implications of a distribution of the small business 50 per cent reduction amount to interest holders in trusts.

Recommendations concerning the retirement exemption

Recommendation 12.3

There is a high degree of interaction between the small business CGT concessions and the provisions relating to ETPs, superannuation and self-managed superannuation funds (SMSFs).

To assist taxpayers in understanding and correctly applying the rules, in particular in relation to ETPs, the retirement exemption and the ability of SMSFs to acquire business real property, the Commissioner should publish guidance on the interaction of these provisions.

Recommendation 12.4

Small business assets are often transferred between non-arm's length parties (for example generations of the same family). These transactions may attract the deemed market value consideration and cost base rules for CGT purposes.

The Commissioner should publish guidance to assist taxpayers in understanding and correctly applying the rules in relation to the deemed market value provisions and the retirement exemption, including their application to family succession planning transactions.

Recommendation 12.6

Where the retirement exemption is chosen for an amount, that CGT exempt amount is required to be reported and counted towards the relevant person's reasonable benefit limits (RBL).

The Commissioner should issue detailed education material to tax advisers and financial planners to ensure that the required RBL reporting where an ETP arises under Subdivision 152-D is done.

Recommendations concerning the small business rollover

Recommendation 13.2

The Commissioner should provide guidance in relation to when the discretions to extend the timeframe in which to acquire replacement assets, and in which the assets must be 'active', is likely to be exercised.

Recommendation 13.6[9]

The Commissioner should issue a Practice Statement or other guidance clarifying whether taxpayers should include capital gains in their returns when they are intended to be rolled-over or whether the return may be lodged without the gain.

If the latter, the Commissioner should provide guidance in relation to the circumstances in which tax shortfall penalties and/or interest charges will be remitted.

Recommendation 13.9

There are generally no CGT consequences on the death of a taxpayer.[10] The interaction of the provisions that apply on the death of a small business taxpayer with the small business concessions is not well understood.

To assist taxpayers in understanding and correctly applying the rules in relation to the operation of Divisions 128 and 152, and CGT events J2 and J3[11], the Commissioner should publish further guidance on the interaction of these provisions.

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9 Note that if Recommendation 13.5 were to be accepted, the need for such additional guidance may only be required in limited situations.

10 Division 128 of the ITAA 1997.

11 Section 104-185 and 104-190 of the ITAA 1997.

CHAPTER 2: THE REVIEW PROCESS

2.1 As part of its function to advise the Treasurer on the quality and effectiveness of tax legislation, the Treasurer asks the Board to review legislation that has been in operation for at least two years. This timeframe ensures that taxpayers and their advisers have had a reasonable opportunity to become familiar with its operation. For its second review, the Board was asked to examine the quality and effectiveness of the small business CGT concessions in Division 152 of the *Income Tax Assessment Act 1997.*

THE SCOPE OF THE REVIEW

2.2 The Board's intention in undertaking post-implementation reviews is not to reopen debates about the merits of the policy of a measure. Rather, the intention is to establish if the legislation is having its intended effect and to find out whether its implementation can be improved.[12] This can have the added benefit of improving future policy development and its implementation.

THE REVIEW CRITERIA

2.3 The Board has assessed the quality and effectiveness of Division 152 having regard to the extent to which the legislation:

- gives effect to the Government's policy intent, with compliance and administrative costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure;
- is expressed in a clear, simple, comprehensible and workable manner;
- avoids unintended consequences of a substantive nature;
- takes account of actual taxpayer circumstances and commercial practices;
- is consistent with other tax legislation; and

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12 Board of Taxation Consultation Plan for the post-implementation review of the Small Business CGT concessions.

- provides certainty. [13]

2.4 These principles are drawn from the Board's report on *Government Consultation with the Community on the Development of Taxation Legislation*.[14]

HOW THE REVIEW WAS CONDUCTED

The studies

2.5 The Board engaged two consultants to assist with the review. Webb Martin, which has extensive experience in advising and training tax practitioners, was engaged to provide a general evaluation of Division 152 including surveying and conducting focus groups for practitioners. Atax, a leading taxation education, training and research organisation which has conducted a range of quantitative studies on the impact of tax legislation for government and private sector organisations, was engaged to identify, estimate and evaluate the compliance and administrative costs of Division 152. To gather the necessary information, Atax conducted focus groups involving taxpayers, tax practitioners and professional bodies and also surveyed taxpayers and tax practitioners.

2.6 Further detail on the conduct of the general evaluation and the compliance and administrative costs evaluation is contained in Part B and Part C respectively of this report.

Public submissions

2.7 The Board developed a consultation plan setting out details of its proposed consultation process and matters that should be addressed in submissions. The consultation plan was made available on the Board's website.[15]

2.8 The Board also made available on its website extracts from the Treasurer's 21 September 1999 Press Release, and the second reading speech and Regulation Impact Statement accompanying the New Business Tax System (Capital Gains Tax) Bill 1999 and extracts from the Minister for Revenue and Assistant Treasurer's

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13 Board of Taxation Consultation Plan for the post-implementation review of the Small Business CGT concessions.

14 Board's report to the Treasurer and Minister for Revenue and Assistant Treasurer on Government Consultation with the Community on the Development of Taxation Legislation, March 2002, paragraph 61.

15 www.taxboard.gov.au.

16 October 2003 Press Release and the Regulation Impact Statement accompanying the Tax Laws Amendment (2004 Measures No. 1) Bill 2004.

2.9 The Board:

- advertised the review on its website;
- wrote to 38 selected industry and professional bodies seeking written submissions addressing the Board's review criteria; and
- met with a number of organisations to discuss their written submissions to the review.

2.10 The Board sought submissions by 28 February 2005. The Board received 20 submissions, the majority coming from professional organisations, in the period up to 30 June 2005. The organisations and individuals who provided submissions are listed at Appendix B.

2.11 The Board considered all of the issues raised in submissions. Furthermore, the submissions were provided to the Board's consultants, Webb Martin and Atax, as input to their evaluations of the small business CGT concessions. However, the Board's recommendations reflect the Board's independent judgements, after taking into account all of the information and experience available to it.

Consultation with the Treasury and the Australian Taxation Office

2.12 The Board also sought information on the development of the legislation and its implementation from the Treasury and the Australian Taxation Office.

Board processes

2.13 The Board appointed a Working Group of its members comprising Mr Curt Rendall (Chairman), Mr Keith James, Ms Jane Schwager and Mr Dick Warburton AO to oversee the review.

CHAPTER 3: BACKGROUND TO THE SMALL BUSINESS CGT CONCESSIONS

3.1 Capital gains tax (CGT) was introduced into the Australian tax system with effect from 20 September 1985. The original CGT provisions were contained in Part IIIA of the *Income Tax Assessment Act 1936* (ITAA 1936).

3.2 From its inception, the CGT provisions contained an exemption for certain gains made by small business. Originally, this exemption was provided in the form of a reduction in the amount of the taxable capital gain arising from the disposal of the goodwill of a business. Section 160ZZR ITAA 1936 provided for a 20 per cent reduction of the gain on the goodwill of a business provided the net value of the relevant business (together with associated businesses) was less than the exemption threshold for the year. Originally this exemption threshold was $1 million (unindexed).

3.3 With effect from 27 February 1992, the reduction of the gain was increased to 50 per cent and the threshold was increased to $2 million, with this figure being indexed from 1 July 1993. At the time the goodwill concession ceased to apply, the threshold had been indexed to $2,248,000.[16]

3.4 Additional concessions for small business were introduced into the CGT provisions with effect from 1 July 1997. These concessions were foreshadowed in the Coalition's policy document *Capital Gains and Fringe Benefits Tax Reform* of 18 February 1996. Design details were announced in the 1996-97 Budget on 20 August 1996 and in the Treasurer's Press Release of 3 December 1996.

3.5 The new concessions, ultimately enacted as Divisions 17A and 17B of Part IIIA of the ITAA 1936[17], contained a roll-over of capital gains on active business assets against replacement business assets and a retirement exemption respectively. The goodwill concession continued to operate as an alternate concession available to taxpayers. Taxpayers could choose to claim the 50 per cent goodwill exemption or, instead, either roll the full amount of the gain over into replacement assets or apply the gain towards their retirement exemption.

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16 See ATO Taxation Determination TD 97/13.

17 Division 17A was introduced by *Taxation Laws Amendment Act (No 1) 1997* which was enacted as Act No 122 of 1997. Division 17B was inserted by *Taxation Laws Amendment Act (No 3) 1997* which was enacted as Act No 147 of 1997.

3.6 Divisions 17A and 17B were operative until the end of the 1998 year of income. Consequent upon the rewrite of the CGT provisions as part of the Tax Law Improvement Project, Divisions 17A and 17B were replaced with Division 123 and Subdivision 118-F respectively in the *Income Tax Assessment Act 1997* (ITAA 1997). These new provisions were contained in *Taxation Laws Amendment Act (No. 4) 1999*.[18]

3.7 As a result of the rewrite, the provisions were streamlined and improved. On 13 August 1998, the Treasurer also announced an extension to the concept of an active asset (to include land and buildings not used in a business by the taxpayer but used in a business carried on by a connected entity).

3.8 The other changes made on the introduction of Division 123 and Subdivision 118-F reflected the recommendations by the Joint Committee of Public Accounts and Audit in Report 356 (Recommendation 3) tabled on 12 March 1998 and Report 364 (Recommendations 4 and 5) tabled on 21 December 1998. In particular, Recommendation 5 related to the alignment of the treatment of depreciable and other assets under Division 123.

3.9 The Treasurer announced a review of Business Taxation on 14 August 1998 to be led by Mr John Ralph.[19] The Ralph Report '*A Tax System Redesigned*' was released by the Treasurer on 21 September 1999. The Report's recommendations 17.5 and 17.6, which related to small business CGT concessions, were as follows:

> **17.5 Capital gains tax — small business**
>
> Rationalising goodwill exemption and small business CGT concessions
>
> (a) *That the existing 50 per cent Capital Gains Tax (CGT) goodwill exemption for small business be replaced with a small business assets exemption of 50 per cent of all capital gains arising on the disposal of active assets subject to capital gains treatment.*
>
> Eligibility criteria for replacement exemption
>
> (b) *That the provisions in the law used to determine eligibility for the CGT small business rollover and retirement exemptions be applied to determine eligibility for the small business assets exemption.*
>
> Additional concessions
>
> (c) *That for taxpayers who operate small businesses through partnerships or as sole traders, the 50 per cent exemption in paragraph (a) apply to the component of the capital gain*

18 Act No. 94 of 1999.

19 See Treasurer's Press Release No 81 of 14 August 1998 — Business Income Tax Consultation.

remaining after the reduction in the gain from either the proposed 50 per cent exclusion or the frozen indexation amount.

17.6 Flexible access to CGT relief

That the small business rollover and the retirement exemption continue to be available, as appropriate, in relation to gains remaining after application of the new small business assets exemption.

3.10 Following this report, the Treasurer announced on 21 September 1999 that significant changes would be made to the small business CGT concessions. Specifically:

(a) increasing the level of benefits available to small business taxpayers, including by abolishing the goodwill exemption and replacing it with a general 50 per cent active asset reduction;

(b) improving the operation of the law by merging and rationalising the existing provisions;

(c) providing greater flexibility in how small business taxpayers could access the various benefits, including by allowing multiple concessions to apply to the same transaction; and

(d) providing a new 15 year exemption.[20]

3.11 Legislation to give effect to these new rules was introduced into Parliament in the *New Business Tax System (Capital Gains Tax) Act 1999*[21]. The new law contained in Division 152 ITAA 1997 significantly improved the operation of the small business CGT concessions by:

(a) standardising the basic eligibility requirements for all of the concessions, subject to some minor modifications;

(b) removing the requirement that taxpayers must choose only one concession that can apply and allowing multiple concessions with a cascading effect;

(c) replacing the goodwill exemption with a 50 per cent active asset reduction;

(d) removing some of the complexity in relation to the operation of the retirement exemption and the small business roll-over; and

(e) introducing a new 15 year exemption.

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20 The Treasurer's Press Release No 058 of 21 September 1999.
21 Act No. 165 of 1999.

3.12 The most significant subsequent amendments to be made to Division 152 were contained in the *Tax Laws Amendment (2004 Measures No. 1) Act 2004*[22] and related to the control test for discretionary trusts. These amendments were announced by the then Minister for Revenue and Assistant Treasurer, Senator the Hon Helen Coonan on 16 October 2003[23]. These amendments ensured that taxpayers using discretionary trust structures would not be penalised by having all the net assets of all potential beneficiaries taken into consideration for the $5 million net asset threshold test.

3.13 Other less significant amendments have been made to Division 152 since its enactment. [24]

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22 Act No. 95 of 2004.

23 Press Release C097/03 of 16 October 2003.

24 See NBTS (Miscellaneous) Act (No. 2) 2000; TLAA (No. 7) 2000; NBTS (Capital Allowances — Transitional and Consequential) Act 2001; TLAA (No. 4) 2003; TLAA (No. 1) 2004.

CHAPTER 4: SUMMARY OF THE MAIN POLICY ISSUES RAISED WITH THE BOARD

4.1 This chapter provides a summary of the main policy issues raised in submissions to the Board, and in responses to the adviser and taxpayer compliance costs surveys. These issues are outside the scope of the review and the Board makes no assessment or recommendations in relation to them. Consistent with the Board's broader Charter, the main policy issues are identified here for the Treasurer's information.

POLICY ISSUES ASSOCIATED WITH THE BUSINESS STRUCTURE USED

4.2 Many of the submissions received highlighted that the outcome under the small business CGT concessions differs significantly depending on the way the small business holds the business assets. Submissions noted that some small businesses that may otherwise have qualified are unable to use the concessions because of the business structures that were already in place prior to the announcement of the way the concessions would apply from 21 September 1999.

4.3 Several submissions argued that the narrowness of the conditions for the concessions, combined with the lack of transitional provisions to allow restructuring of small businesses in existence as at 21 September 1999, has resulted in a significant tax bias in the concessions towards newly established businesses that have the benefit of choosing a structure to maximise their access to the concessions.

The controlling individual test

4.4 The requirement to have a controlling individual of an eligible small business entity in order to access many of the concessions was one of the most common policy issues raised in the submissions to the Board.

4.5 Other concerns raised in the submissions included the inability of interests of less than 50 per cent to obtain access to the concessions, unless the taxpayer is a partner in a partnership. Many view the 50 per cent requirement as unjustifiable. It is argued, for example, that where there are 3 x 1/3rd owners, all of whom carry the same level of commercial risk as 50 per cent business owners, there is no justification in denying them access to the small business CGT concessions when all other criteria for the concessions are satisfied.

4.6 Many believe that narrowing eligibility for the concessions so that they only apply to a single individual and that person's spouse, or two equal individual owners, does not properly identify a 'small business'.

The concept of CGT concession stakeholder

4.7 The policy issues raised in relation to CGT concession stakeholders centre on the ability of minority interest holders who are spouses of a controlling individual to qualify for significant tax concessions. This is in contrast to the situation for other (unrelated) minority shareholders who cannot qualify for the small business CGT concessions. If the only difference between the positions of two interest holders in an entity is their marital status, it is argued that the tax law is discriminatory in its application.

4.8 This result can be illustrated by the example of a husband and wife who own 50 per cent and 1 per cent respectively of the shares in a company conducting a business. The 49 per cent owner is an unrelated individual. On the sale of the business by the company, the wife's 1 per cent holding is sufficient to allow the company to pay her an eligible termination payment (ETP) of up to the $500,000 retirement limit to her, essentially tax-free. This is in addition to the company also being able to pay a similar amount to her husband (the 50 per cent owner) tax-free. In contrast, the 49 per cent owner would be denied access to this benefit on the basis that this person is not the spouse of the 50 per cent shareholder.

4.9 Some also view the definition of a CGT concession stakeholder as being too narrow in its scope on other grounds. Recent amendments in relation to certain aspects of the superannuation law now recognise interdependent relationships. Some believe that a similar extension is warranted in other areas of the taxation law.

Policy issues associated with the $5 million net asset value test

4.10 In relation to the $5 million net asset value test, it was submitted that:

(a) the $5 million threshold is out-dated as a measure of 'small' business and should be increased;

(b) the threshold should be indexed, as with the previous $2 million goodwill threshold; and

(c) as a fixed threshold, with no shading out, it encourages distortions to ensure that it is not exceeded.

4.11 It was also commented that the definition of 'small' business is inconsistent throughout tax legislation. There are different tests for GST, the Simplified Tax System and Fringe Benefits Tax. It was suggested by some that these should be standardised, with one set of criteria defining 'small' business across all Commonwealth taxation Acts.

4.12 The National Farmers' Federation, Australian Forest Growers and the Department of Agriculture Fisheries and Forestry all contended that the $5 million threshold is particularly disadvantageous for farming and forestry operations where the value of the land may fluctuate from time to time. Gains on sales of assets in the course of the business may be unlikely to qualify for the exemption at a particular point in time because of the value of the land or an immature plantation at that time.

4.13 It was also argued by many that it is inconsistent to include 100 per cent of the net value of a connected entity's CGT assets in the calculation, even though the taxpayer may only hold a 40 per cent interest. That is, the test is not a true reflection of the net value of the taxpayer's own assets.

4.14 It was also suggested that the complexities of the connected entity and affiliate rules could be reduced in practice by restricting the grouping provisions to immediate family (parents and children) and no-one else. In this way, the application of the $5 million test would be based on the immediate family group and only their interests in entities.

POLICY ISSUES ASSOCIATED WITH THE DEFINITION OF 'ACTIVE' ASSET

4.15 The main policy issue raised in relation to the definition of active asset related to the loss of active asset status where farmland is leased to another party. Submissions from the Department of Agriculture, Fisheries and Forestry, Australian Forest Growers and the National Farmers' Federation strongly urged that farmland used to generate rental income should not result in a loss of active asset status. It was suggested that younger farmers often lease farmland from older farmers and the loss of active asset status would be a disincentive for older farmers to agree to such arrangements.

4.16 The Taxation Institute of Australia also contended in its submission that active asset status should not be restricted to CGT assets, but should also apply to assets eligible for capital allowances under Division 40 such as intellectual property and in-house software.

POLICY ISSUES ASSOCIATED WITH THE 15 YEAR EXEMPTION

4.17 The main policy issue raised in relation to the 15 year exemption is the limited 'grandfathering' provisions available. Specifically, in calculating the 15 year time

period, section 152-115 automatically includes the period of ownership of an original asset where the current asset was acquired only in the following circumstances:

(a) as a replacement asset for an asset that was compulsorily acquired, lost or destroyed that qualified for roll-over under Subdivision 124-B; and

(b) as a new asset in replacement for another asset that came to an end as a result of an FSR (financial services reform) transition and which qualified for roll-over relief under Subdivision 124-O.

4.18 In addition, it was noted that in the case of marriage breakdown, a transferee for whom there has been an automatic roll-over of an asset under Subdivision 126-A can choose that the active asset test applies based on a period including that of the transferor. If such a choice is made, the 15 year period includes the period of ownership of the transferor.

4.19 Many submissions received commented on the lack of similar provisions where an individual has rolled an asset into a company in exchange for shares and has qualified for roll-over relief under Subdivision 122-A. Where, for example, an individual who has owned a business asset for 14 years then rolls the asset into a company, the 15 year test period for ownership of the asset by the company and in relation to the shares acquired on the roll-over recommences.

4.20 This was seen as being of particular concern where such a roll-over occurred before 21 September 1999 and, as such, a taxpayer could not have been aware that they were thereby disadvantaging themselves in relation to a future exemption.

4.21 Other submissions raised the following policy issues:

- It is possible for owners of interests for less than 15 years and who are less than 55 to access the 15 year exemption when acquiring interests in companies or trusts.[25]

- It is difficult for discretionary trusts to access the 15 year exemption since many trustees will not be able to demonstrate the existence of a controlling individual in years prior to the introduction of Division 152 with effect from 21 September 1999. This can happen because the trustee may no longer have records of distributions made in years prior to the introduction of the provisions.

- The consolidation provisions now go some way to allow taxpayers to restructure to take advantage of the 15 year exemption.

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25 See Tax Determination 2005/13.

4.22 The Institute of Chartered Accountants in Australia indicated in their submission that a number of franchisees have been disadvantaged under these rules. Many franchise arrangements operate on the basis that the franchise right is re-issued and, therefore, a new right created, at more regular intervals than 15 years. It is likely that any arrangements of this type entered into before 21 September 1999 will not be able to access the 15 year exemption even though the history of actual ownership of the franchise business is longer than 15 years.

4.23 Another issue raised was whether the age of 55 should be changed to match the current preservation age requirements in the superannuation law. Only those taxpayers born before 1 July 1960 now have a preservation age of 55. Other taxpayers will not be able to access retirement benefits until later.

POLICY ISSUES ASSOCIATED WITH THE SMALL BUSINESS 50 PER CENT REDUCTION

4.24 The main policy issue raised in relation to the 50 per cent reduction was the different ultimate tax result achieved because of the type of entity which derived the gain. Several submissions noted, however, that this result turns on the taxation treatment of companies, fixed and non-fixed trusts, partnerships and individuals in the taxation law generally. Some submissions noted this result is not peculiar to Division 152.

POLICY ISSUES ASSOCIATED WITH THE RETIREMENT EXEMPTION

4.25 The main policy issues raised in relation to the retirement exemption were the appropriateness of both the $500,000 limit and the 55 age limit.

4.26 Many consider that the $500,000 amount should be indexed. Others suggest that it should be linked to the same figure as the lump sum reasonable benefit limit (for the 2006 year — $648,946).

4.27 In relation to the age limit of 55, past which there is no requirement for the money to be rolled into a superannuation fund, the issue is raised as to whether this age limit should now match the preservation age of the individual taxpayer. This issue is also addressed at paragraph 4.23 in relation to the 15 year exemption.

POLICY ISSUES ASSOCIATED WITH THE SMALL BUSINESS ROLL-OVER

4.28 The main policy issue raised in relation to the small business roll-over was the submission that the roll-over should be available to all businesses, irrespective of whether the $5 million net asset value is exceeded.

4.29 This position was particularly urged in one submission from a business operator who argued that a business that operates from premises which are required to be sold to fund the acquisition of new premises may face a significant tax liability on the sale of the 'old' premises at a time when land values have increased.

4.30 If the relevant taxpayer breaches the $5 million net asset value threshold because of the growth in property prices, the roll-over is not available even though the full amount of any gain realised on the sale of the original premises is in fact to be applied to the cost of the new property.

PART B

EVALUATION OF THE QUALITY AND EFFECTIVENESS OF THE SMALL BUSINESS CGT CONCESSIONS IN DIVISION 152 OF THE *INCOME TAX ASSESSMENT ACT 1997*

CHAPTER 5: OVERVIEW OF THE KEY ISSUES FOR ELIGIBILITY FOR THE DIVISION 152 CONCESSIONS

5.1 Part B of the report contains a detailed analysis of the key issues for eligibility for the small business CGT concessions as well as a detailed review of issues arising in relation to each of the four small business CGT concessions.[27]

5.2 The four concessions contained in Division 152 are:

Table 5.1: The four small business CGT concessions

Subdivision 152-B	The small business 15 year exemption
Subdivision 152-C	The small business 50 per cent reduction
Subdivision 152-D	The small business retirement exemption
Subdivision 152-E	The small business roll-over

5.3 For each of the concessions, the basic eligibility requirements must be satisfied — see paragraphs 152-105(a) and 152-110(1)(a), section 152-205, paragraphs 152-305(1)(a) and 152-305(2)(a) and subsection 152-405(1).

5.4 The critical issues for eligibility are:

- the concessions only apply to capital gains and not other forms of income or gains. Specifically, gains on depreciating assets are not eligible for the concessions;[28]
- the maximum net asset test is satisfied;
- the active asset test is satisfied; and
- if the asset is a share in a company or an interest in a trust:
  - the company or trust must satisfy a controlling individual test; and
  - the taxpayer must be a CGT concession stakeholder in the company or the trust.

27 As noted in Part A of this report, the Board of Taxation commissioned Webb Martin to provide a general evaluation of Division 152 including surveying and conducting focus groups for practitioners.

28 This has been achieved in section 152-10(1) by requiring a capital gain to have resulted from a CGT event and specifically excluding CGT event K7 which relates to depreciating assets with balancing adjustment events where the asset has at some time been used for a non-taxable purpose (see section 104-235).

5.5 In Chapters 6 to 8 the following key issues are considered in detail:

- satisfying the maximum net asset value test;
- satisfying the active asset test; and
- satisfying the controlling individual and CGT concession stakeholder tests.

CHAPTER 6: THE MAXIMUM NET ASSET VALUE TEST

6.1 The Government's intention was to restrict the concessions to eligible small business entities. Consequently, to qualify for the small business CGT concessions, the taxpayer must satisfy the maximum net asset value test.[29] This value has been set at $5 million.[30] The test requires that the market value of the relevant assets be determined as well as liabilities that relate to those assets. The test is also applied in a manner which combines the value of assets and related liabilities held by connected entities, certain relatives of an individual taxpayer and certain other 'affiliates'. This is to ensure that taxpayers are not able to reduce their asset level below $5 million through the strategy of holding assets in another's name.

6.2 To satisfy the maximum net asset value test, the sum of the following assets just before the CGT event must not exceed $5 million:

- the net value of the CGT assets of the taxpayer;
- the net value of the CGT assets of any entities connected with the taxpayer;
- the net value of the CGT assets of any small business CGT affiliates of the taxpayer or entities connected with those small business CGT affiliates (not otherwise included) to the extent that they are used or held ready for use in a business carried on by the taxpayer or by an entity connected with the taxpayer.[31]

6.3 In addition, if the taxpayer is a partner in a partnership and the CGT event happens in relation to a CGT asset of a partnership — the net value of the CGT assets of the partnership cannot exceed $5 million.[32]

6.4 There is a range of practical issues associated with the current test which have been highlighted in submissions, the literature on Division 152 and the matters dealt with in Australian Taxation Office Interpretative Decisions (ATO IDs). These can be divided into the following categories:

- calculating the **net value** of the CGT assets;
- working out who is a **connected entity** of the taxpayer;

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29 Paragraph 152-10(1)(c).
30 Paragraph 152-15(a).
31 Section 152-15, subsections 152-20(3) and (4).
32 Paragraph 152-15(b).

- working out who are the taxpayer's small business CGT affiliates;
- treatment of partnership assets under the maximum net asset value test; and
- dealing with assets excluded from the calculation.

CALCULATING THE NET VALUE OF THE CGT ASSETS

6.5 Section 152-20 provides that the net value is the amount (if any) by which the sum of the market values of those assets exceeds the sum of the liabilities of the entity that are related to those assets.

6.6 A number of submissions highlighted the practical uncertainty arising in determining whether certain liabilities 'relate to' the assets as well as whether the concept of 'liabilities' in this context extends to liabilities that are recognised for accounting purposes or is limited to presently existing legal obligations.[33] Examples of where uncertainty as to the appropriate treatment of the liabilities may exist include the treatment of the following:

- income tax and other tax provisions;
- provisions for annual leave and long service leave;
- accounting liabilities (for example unearned income);
- liabilities secured over assets where the funds borrowed may or may not have been used to acquire that specific asset; and
- general liabilities of the business.

Does the liability 'relate to' the asset?

6.7 A number of submissions commented that uncertainty arises in relation to determining whether more general, non-specific liabilities of a business (for example an overdraft facility) 'relates to' the assets of the business.

6.8 Whether or not a liability 'relates to' an asset is a question of fact in each circumstance.

6.9 'Relates to' is a phrase often used in legislation and the courts have been called upon to consider its meaning from time to time.[34] Arguably it embodies sufficient

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33 See, for example, the submission from the ICAA dated 28 February 2005.

34 Tooheys Ltd v Commissioner of Stamp Duties (NSW) (1961) 105 CLR 602; Joye v Beach Petroleum NL & Anor (1996) 67 FCR 275; Australian Competition and Consumer Commission v The Maritime Union of Australia (2001) 114 FCR 472; The Recoveries Trust v FC of T [2004] AATA 1075.

flexibility to be used in the present context, without being narrow and prescriptive. Its purpose appears to be to ensure that where an asset is included in the test, a liability with some connection to that asset may be included. Conversely, if the liability relates to assets that are excluded from the test, the liability should also be excluded.

6.10 Any uncertainty in the application of the meaning of 'related to' in this context could be reduced by legislative amendment. This has been the approach taken in the CGT roll-over provisions for disposals of assets by an individual or trustee to a wholly-owned company.[35] Specifically, subsection 122-37(2) states that:

> 'A liability incurred for the purposes of a business that is not a liability in respect of a specific asset or assets of the business is taken to be a liability in respect of all the assets of the business.'

6.11 Although a similar legislative amendment may assist in clarifying the net asset value test for Division 152, it is noted that, in practice, the Commissioner has taken a practical approach to resolving this issue. In ATO ID 2004/205 the Commissioner indicated that the words 'liabilities of the entity that are related to the assets' do not require each liability to be directly related to a particular asset. The liabilities may relate to the assets of the entity more generally'.

6.12 For these reasons, the ATO ID concluded that a general bank overdraft of a business conducted in a company and an income tax liability on an assessment issued to the company were liabilities that related to the assets generally of the business, and therefore acted to reduce the net value of the assets.

6.13 A legislative amendment along the lines of section 122-37 is unlikely to remove all uncertainty in this area as it could, for example, still require that a liability be demonstrated to be 'for the purposes' of the business, rather than 'relate to' the assets. For these reasons, it is acknowledged that uncertainty may be able to be reduced by the publication of more guidance by the Commissioner to assist taxpayers and their advisers in applying the concept in commonly arising situations.

Recommendation 6.1

Liabilities that 'relate to' a CGT asset are included in the maximum net asset value test.

To assist taxpayers in the correct application of the maximum net asset value test in a practical and workable manner, the Commissioner should publish guidance on those liabilities which are taken to 'relate to' the CGT assets of an entity in commonly encountered situations.[36]

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35 Subdivision 122-A.

36 Such written ATO guidance may take the form of a Public Taxation Ruling or Taxation Determination, ATO Interpretative Decision, or some other published guide or Fact Sheet.

Negative net value

6.14 Another issue raised in relation to the formula is whether the net value can be negative. In ATO ID 2004/207, the Commissioner took the view that, as the provision refers to 'the amount, if any' by which the sum of the market values exceeds the sum of the liabilities, it is referring to an excess only and therefore cannot be a negative excess. The lowest net value, therefore, is zero.

6.15 The Commissioner also commented in ATO ID 2004/205 that: 'as subsection 152-20(1) … is directed at determining the net value of the CGT assets on an entity by entity basis and refers to the "liabilities of the entity" the liabilities of one entity cannot be taken into account in determining the net value of the CGT assets of another entity'.

6.16 The definition in section 152-20 takes the approach of the total net value of the CGT assets of an entity. On this basis, if there is an asset with a negative value (after liabilities are taken into account) in an entity which holds other assets with a positive net value, an offset is contemplated by the definition. A different result is therefore achieved if an asset with a negative overall value after liabilities are offset is held in a separate entity. An example of this is provided in Illustration 6.1.

Illustration 6.1: Negative net value

ABC Pty Ltd has a business with a net value of $5,200,000. The business operates from premises held by a connected entity. These premises were acquired for a market value of $2,500,000. At the time they were acquired the full $2,500,000 was borrowed, with the business owners providing additional security for the debt in the form of a mortgage over their private residence.

Subsequently, the value of the business premises has declined to $2,000,000 while the debt owed in relation to the property at the relevant time is $2,400,000 in the connected entity. That property owning entity continues to be supported by the business entity and the ultimate owners.

Assuming there are no other relevant assets or liabilities, if the business were to be sold, the net asset value test would not be satisfied as the net value of the business ($5,200,000) would breach the $5 million threshold. This is because the net value of the connected entity is taken up as zero for the purposes of the test.

Had the negative $400,000 value been included, an overall net value of $4,800,000 would have resulted and any gain on the sale of the business would have qualified for the small business CGT concessions.

Had the premises been owned in the same entity as the business operations the negative value would have been offset, and the small business CGT concessions would have been available.

6.17 Arguably, the same total net asset value should arise, irrespective of the holding of the assets in separate entities. It was stated in the Explanatory Memorandum (EM) to the New Business Tax System (CGT) Bill 1999 that '[t]he purpose of the maximum net asset value test is to treat the small business and all of its related entities as a single economic unit'. This should have the effect that all liabilities that relate to the assets should be included. Not to allow a negative value effectively denies an offset for a liability notwithstanding that it does in fact 'relate to' the asset.

6.18 The fundamental requirement that a liability must 'relate to' the asset in order to be included in the calculation is sufficiently limiting to ensure that only those liabilities that can be demonstrated to have the necessary connection with the asset should be included. If this calculation produces a negative value, to ignore that outcome results in an overstated value being included in the test and the possible denial of the small business CGT concessions to an otherwise eligible small business entity.

6.19 Division 152 specifically operates in a manner which acknowledges that it is common practice for small businesses to hold assets in separate entities. The Treasurer stated in Press Release No. 76 of 13 August 1998 that active asset status under the small business CGT concessions was to be extended to land and buildings held in associated entities.[37] If the policy is to extend the small business CGT concessions to assets held in these separate entities, it is an inconsistent outcome that the net asset value test should be applied in a different way compared with how it would be applied had the asset been owned in the operating entity.

Recommendation 6.2

The maximum net asset value test includes certain assets and liabilities of the taxpayer as well as of connected entities and small business CGT affiliates.

To ensure consistency of application of the maximum net asset value test for assets and liabilities held in connected entities and affiliates compared to assets and liabilities within the one entity, the definition in section 152-20 should be amended to clarify that a negative value of the net assets of the entity, a connected entity or a small business CGT affiliate is able to be taken into account.

Accounting liabilities versus legal liabilities

6.20 A number of submissions also raised concerns regarding whether, for the $5 million net asset value calculation, a 'liability' can be included if it is only a contingent liability and not a presently existing legal obligation.[38]

37 This policy is now embodied in Division 152 in paragraph 152-40(1)(c).
38 See for example, ICAA submission of 28 February 2005; TIA submission of 1 March 2005.

6.21 The Commissioner's view (contained in ATO ID 2004/206) is that, as an undefined term for Division 152 purposes, 'liabilities' takes its legal meaning. Amounts that are within the accounting meaning of the term 'liabilities' but not within the legal meaning are therefore not included. This view has the effect of excluding from the calculation provisions for annual leave, long service leave and the like.

6.22 Using this approach, whether a provision for income tax is a liability will depend on determining at what point it has ceased to be contingent and whether this is the case just before the relevant CGT event.[39] This could have the effect, for example, that if a business is sold on 1 June, any provision for income tax for the current year would not be included as a liability. If the same business were sold on 1 July, however, such a provision relating to the income tax liability for the year to 30 June would then be included in the calculation.

6.23 Other similar results can arise in relation to provisions for employees' leave entitlements. As shown in Illustration 6.2, a business which has a large provision for long service leave, calculated in accordance with accounting standards, might not satisfy the maximum net asset value test where, had the relevant employees taken their leave before the sale of the asset, the business may in fact have satisfied the test.

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39 This was acknowledged by the ATO in the minutes to the 12 November 2003 NTLG Losses and CGT Subcommittee (CGT Session) — see item 8.4. Note also that in *Fresta v FCT* 2002 ATC 2061 the AAT held that a provision for income tax is a 'present legal obligation' of the company, as the company is clearly liable for income tax at year end notwithstanding that the liability is not due and payable until assessed.

Illustration 6.2: Contingent liabilities that relate to a business

ABC is a manufacturing business. Its major assets are goodwill, plant and machinery, and stock. The market value of these assets less the presently existing legal liabilities that relate to the assets is $5,100,000.

The business employs 50 staff, 30 of which have been with the company for more than 15 years. In its accounts it has recorded a provision for long service leave and for unpaid annual leave of $400,000. This has been calculated in accordance with accounting standards.

ABC is disposing of its business premises in order to acquire more modern factory premises. It makes a gain of $500,000 on its premises and wishes to use the small business CGT concessions to roll-over that gain against the acquisition of new premises.

ABC is not eligible for the roll-over as it cannot take into account its liability for long service leave and annual leave to demonstrate a net value of the business assets of only $4,700,000.

In contrast, if the staff had taken their long service leave before the sale of the premises, the value of the assets of the business would have been reduced to pay out that leave and, as such, the business would have been entitled to the small business CGT concessions.

6.24 Arguably, to exclude from the liabilities of the business those liabilities which a purchaser would take into account when determining the value of a business does not take into account actual taxpayer circumstances and can lead to the unintended consequence that an otherwise eligible small business entity with long standing and loyal staff cannot qualify for the small business CGT concessions.

What approach is taken in other areas of taxation law?

6.25 A number of areas of the tax law use the concepts of **net assets** or **net value** or require accounting liabilities to be recognised in certain circumstances:

- in the provisions relating to consolidated groups, step 2 in working out the allocable cost amount in section 705-70 requires that accounting liabilities, in accordance with accounting standards, or statements of accounting concepts made by the Australian Accounting Standards Board be used;[40]

40 Subsection 705-70(1).

- for the purposes of CGT event K6,[41] the net value of the company or trust must be determined. In this situation, the general definition in section 995-1 of the ITAA 1997 is relied upon:
  - ‘net value of an entity means the amount by which the sum of the market values of the assets of the entity exceeds the sum of its liabilities’; and
- for the purposes of valuing assets, liabilities and equity capital in the thin capitalisation rules in Division 820 of the ITAA 1997, amendments were introduced in TLAA (No. 5) 2003 to overcome ‘anomalies’ that did not permit assets and liabilities to be defined having regard to accounting standards. Section 820-680 now requires an entity to comply with the accounting standards in determining what are its assets and liabilities and in calculating the value of its assets, liabilities and equity capital. In TR 2002/20, the Commissioner indicated that the use of accounting concepts was more appropriate than legal definitions in the context of the thin capitalisation provisions.

6.26 In the context of small business, Division 7A of the ITAA 1936 (which relates to various benefits provided by private companies to its shareholders or their associates) has regular application to small businesses conducted in companies. Division 7A uses the term ‘net assets’ when working out the distributable surplus of the particular private company.

6.27 This is defined in section 109Y to mean:

> ‘The amount (if any), at the end of the company’s year of income, by which the company’s assets (according to the company’s accounting records) exceed the sum of:
>
> (a) the present legal obligations of the company to persons other than the company; and
>
> (b) the following provisions (according to the company’s accounting records):
>
> (i) provisions for depreciation;
>
> (ii) provisions for annual leave and long service leave;
>
> (iii) provisions for amortisation of intellectual property and trademarks;
>
> (iv) other provisions prescribed under regulations made for the purposes of this subparagraph.’

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41 Section 104-230.

6.28 The Division 7A approach is to provide a limited list of provisions which may be taken up in addition to the presently existing legal obligations of the entity and it is recommended that a similar approach be taken in determining the net value of the assets for Division 152 purposes.

6.29 While, for Division 152 purposes it is not necessary to include the provisions for depreciation (as the decline in value of an asset will already be reflected in its market value in the formula), it is appropriate to include those provisions which a purchaser of a business would take into account when valuing the business. Specifically, this should include provisions relating to employee entitlements, unearned income and tax liabilities.

6.30 Adopting this approach would ease compliance costs for small businesses by providing a clearer calculation method which would take into account only those contingent liabilities which are appropriate having regard to commercial business valuation methods.

6.31 Such an approach would also take account of actual taxpayer circumstances and commercial practices while maintaining the policy intent that the liabilities must relate to the assets — in this case the business assets.

Recommendation 6.3

Liabilities that are related to an asset are included in the net value of the CGT assets for the maximum net asset value test.

The meaning of net value of the CGT assets in section 152-20 should be amended so that, in addition to the present legal obligations that relate to the assets, the following provisions are included in liabilities that relate to the assets of a business:

- annual leave and long service leave;
- unearned income; and
- future tax liabilities.

Determining market values of assets

6.32 As the net asset value formula relates to market values, it is incumbent upon the taxpayer to obtain relevant market value information. It was noted in submissions that this may be difficult in practice in relation to connected entities, where market values may be required to be obtained from related parties and, in some cases, unrelated parties. In the case of an entity that makes the gain, for example, it will be connected with any 40 per cent stakeholder in the entity and, therefore, obliged to obtain detailed market values of assets belonging to that stakeholder.

6.33 Although this may prove difficult in practice, it is, nonetheless, an obligation that remains with the taxpayer in order to establish entitlement to the concessions and is in line with the overall approach of the ITAA.

WORKING OUT WHO IS A CONNECTED ENTITY OF THE TAXPAYER

6.34 For the maximum net asset value test, the net value of the CGT assets of any entities connected with the taxpayer must be included. It is important to note that connected entity status is also relevant for the active asset test. Where an asset owned by one entity is used in the business of a connected entity, the asset may qualify as active in the hands of the first (that is non-business) entity.[42] As such, connected entity status can be an advantage in a number of circumstances.

6.35 The concept of 'connected with' is based on control. An entity is connected with another entity if either entity controls the other entity or both are controlled by the same third entity.[43] Control exists if the taxpayer and/or its small business CGT affiliates have the right to acquire the beneficial ownership of interests in the other entity, carrying between them the right to at least 40 per cent of all income and capital distributions. If the control percentage is at least 40 per cent, but less than 50 per cent, the Commissioner may determine that another entity in fact has control. Special rules apply to determine control of discretionary trusts based on control of the trustee and the actual receipt of distributions in a four year time frame.[44]

6.36 Many submissions and commentaries highlight issues associated with working out who is a 'connected entity' of the taxpayer. These rules, however, are consistent with other areas of the income tax law which base connection on 'control' and treat a 40 per cent interest as sufficient for control in the absence of evidence to the contrary. These include:

- the grouped entities rule for STS taxpayers in Division 328 of the ITAA 1997;
- control for value shifting purposes in Division 727 of the ITAA 1997;
- thin capitalisation tracing rules in Division 820 of the ITAA 1997;
- tracing rules for controlled foreign companies in Part X of the ITAA 1936.

6.37 It was also noted in submissions that the requirement for the Commissioner to determine if another entity in fact controls the relevant entity where the interest held is at least 40 per cent but less than 50 per cent places an extra compliance cost on taxpayers in that they must bring the matter to the Commissioner's attention in order

42 Paragraph 152-40(1)(c).
43 Subsection 152-30(1).
44 Section 152-30.

for this to be determined. It is noted, however, that such an approach is common throughout the similar provisions noted above and, as such, is consistent with other tax legislation. Moreover, this approach allows the Commissioner the flexibility of having regard to the circumstances of individual taxpayers which may be beneficial to taxpayers in some cases.

6.38 Some submissions also suggested that it is inconsistent to include 100 per cent of the net value of a connected entity's CGT assets in the calculation, even though the taxpayer may only hold a 40 per cent interest. That is, the test is not a true reflection of the net value of the taxpayer's own assets. This, however, is a policy matter outside the scope of this review. Policy issues raised in submissions are summarised in Chapter 4 of this report.

Control of discretionary trusts

6.39 In relation to the control of discretionary trusts, the amendments introduced by *Tax Laws Amendment (2004 Measures No. 1) Act 2004* resolved many of the issues relating to the inclusion of all potential beneficiaries of the discretionary trust as connected entities of the trust and vice versa. In particular, subsection 152-30(5) now includes a beneficiary as a controller of the trust based on actual distributions rather than potential distributions.

6.40 The amendments also resolved the issue of a discretionary trust being grouped with a beneficiary which is a tax exempt organisation or a deductible gift recipient beneficiary by ignoring these beneficiaries irrespective of the amount of the distribution actually received.

6.41 Moreover, in a year in which the trust has a tax loss and for which no distributions (of capital or income) were made, the trustee may nominate up to four beneficiaries as being controllers of the trust in that year. This nomination must be in writing and signed by the trustee and by each nominated beneficiary. As noted in ATO ID 2004/970, however, there is no time frame in which that written nomination is required to be done.

6.42 The ATO ID goes on to state:

> 'As the intention of subsections 152-30(6A) to 152-30(6C) of the ITAA 1997 is to enable the trustee in these circumstances to ensure a particular CGT asset is treated as an active asset for the purposes of qualifying for the small business CGT concessions, it would generally be expected the nomination would be made by the time the small business CGT concessions are chosen for a particular capital gain.'

6.43 In the absence of receiving distributions as outlined in the previous paragraphs, an entity will only control a discretionary trust if it is the trustee (other than the Public

Trustee[45] or other arm's length trustee[46]) or it has the power to determine the manner in which the trustee(s) exercise the power to make any payment of income or capital to or for the benefit of beneficiaries of the trust.

6.44 The issue of whether a person has the power to determine the manner in which a trustee exercises the power to make payments of income or capital to beneficiaries is a question of fact and is open to dispute. In ATO ID 2004/698, the Commissioner took the view that the appointor of the trust is in a position to determine the manner in which distributions are made and is, therefore, a controller of the trust. This interpretation was strongly disputed in a number of submissions received.[47]

6.45 As noted above, connected entity status is important not only for the maximum net asset value test but also for the active asset test. For some entities, therefore, obtaining connected entity status is advantageous. For discretionary trusts, where control is based on the receipt of distributions, the desire to be 'connected' leads to the opportunity to make a distribution of 40 per cent of the income or capital of the trust to a beneficiary to ensure that connected entity status for that beneficiary is achieved.

6.46 The ability to nominate up to four controllers in a tax loss year also provides some opportunities for entities associated with the trust to ensure connected entity status is achieved. This is particularly the case where the nomination need not in fact be done until some years after a tax loss year and at the time of the actual CGT event.

6.47 The potential tax saving as the result of attracting the small business CGT concessions makes the obtaining of connected entity status a planning issue for some taxpayers. This in turn raises the issue of when the anti-avoidance provisions of Part IVA in the ITAA 1936 may be applied in these cases.

6.48 The foregoing summary of issues highlights that:

- whether 'control' of a discretionary trust exists is a question of fact to be determined in each case;
- being 'connected' can be advantageous to taxpayers (attracting active asset status to an asset held by a connected entity) as well as disadvantageous to others (the assets of the connected entity included in the maximum net asset value test); and
- there are techniques which may be used by some taxpayers to establish that 'control' does/does not in fact exist in any given circumstance.

6.49 Any uncertainties in the application of the connected entity rules arise because of different factual situations as between taxpayers. To be more prescriptive in the

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45 Subparagraph 152-30(2)(c)(i).
46 Subsection 152-30(4).
47 See, for example, the submission from CPA Australia of 28 February 2005.

legislation in relation to control in these cases would have both advantages and disadvantages for taxpayers. As the law currently allows for specific taxpayer circumstances to be considered in practice, any further legislative changes appear unwarranted.

6.50 Further guidance from the Commissioner in relation to how these rules may apply to commonly-encountered factual situations, however, would assist in reducing some of the uncertainty in this area.

Recommendation 6.4

An entity is connected with another entity if the first entity controls the other entity or both entities are controlled by the same third entity.

To reduce any uncertainties in relation to the concept of 'control' of a discretionary trust, the Commissioner should provide guidance in relation to the circumstances in which a person will be taken to 'control' a trust.[48]

Can a self-managed superannuation fund ('SMSF') be a connected entity?

6.51 The meaning of 'connected with' in section 152-30 does not specifically deal with superannuation funds. As such, the general rules apply. As the superannuation fund is not a discretionary trust, an entity will only control the superannuation fund if it beneficially owns or has the right to acquire the beneficial ownership of interests in the other entity that carry between them the right to receive at least 40 per cent of any distribution of income or capital by the other entity.

6.52 In ATO ID 2004/147, the Commissioner took the view that these conditions could not be met in the case of a superannuation fund because:

- members do not beneficially own or have the right to acquire beneficial ownership of interests carrying the right to distributions of income or capital; and
- the superannuation fund does not distribute income or capital as such, but rather pays benefits on the occurrence of certain events.[49]

6.53 Based on this interpretation, two main issues were raised in relation to the interplay between the SMSF rules and the connected entity rules in Division 152:

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48 Such written ATO guidance may take the form of a Public Taxation Ruling or Taxation Determination, ATO Interpretative Decision, or some other published guide or Fact Sheet.

49 The Commissioner also expressed the view recorded in the minutes of the 12 November 2003 meeting of the NTLG Losses and CGT Subcommittee (CGT Session) that neither the members nor the trustees of a superannuation fund would be small business CGT affiliates of the superannuation fund — see Item 8.2 of the minutes.

- a taxpayer's interests in a superannuation fund are not included in the maximum net asset test. This is consistent with the policy intent of the provisions as expressed in subparagraphs 152-20(2)(b)(iii) and (iv).[50] This policy intent would be thwarted if the SMSF is treated as 'connected with' the members; and

- it is possible that a SMSF may own the business premises which are used in a member's or their family's business.[51] In this case, if the SMSF is incapable of being a 'connected entity', a CGT event in relation to the business premises will never qualify for small business CGT concessions within the superannuation fund. It is unclear whether this was the policy intent of the provisions.

6.54 As the superannuation fund rules acknowledge that a SMSF may be used as a vehicle to hold the business premises used by related parties of the fund, it could be argued that the small business CGT concessions should also be extended to these assets. Had this property been held in the name of another type of connected entity (for example the family discretionary trust) it may have qualified for the concessions. To allow the superannuation fund access to the concessions would enhance consistency in relation to the treatment of the business premises of small business, irrespective of in which entity the asset is held. It would also take into consideration actual taxpayer circumstances and an increasingly common commercial practice.

6.55 Notwithstanding this, however, to extend the small business CGT concessions to the business premises owned by a SMSF, the formula for the $5 million net asset value test would need to be adjusted. At the very least, the value of the premises themselves would need to be included in the taxpayer's (that is the SMSF's) calculation. This would be in contradiction with the overall policy that superannuation assets should not be included in the maximum net asset value test.

6.56 To adopt an approach of allowing the small business CGT concessions to the SMSF while amending the net asset value formula to include some but not all of the assets of the fund, would add additional complexity to the law. Such additional complexity is arguably not justified given the already concessional tax treatment available to SMSFs in relation to their capital gains.

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50 Paragraph 1.14 EM to NBTS (CGT) Bill 1999.

51 See definition of 'in-house asset' in section 71 SISA 1993 which excludes business premises held by a superannuation fund with fewer than five members, notwithstanding that they are leased to related parties of the fund. See also section 66 of SISA which permits a fund with fewer than five members to acquire the business real property from a related party of the fund.

Deceased estates

6.57 There is also uncertainty in practice as to how the connected entity rules apply in the case of deceased estates.[52] It is noted, however, that the taxation issues surrounding deceased estates are complex in their own right and are not peculiar to Division 152. Issues raised in relation to the operation of Division 152 in connection with deceased estates are mentioned in Chapter 13.

WORKING OUT WHO ARE THE TAXPAYER'S SMALL BUSINESS CGT AFFILIATES

6.58 To complete the maximum net asset value test, the taxpayer must also include certain assets held by their small business CGT affiliate. Section 152-25 defines a small business CGT affiliate as follows:

- where the taxpayer is an individual — their spouse or child under 18 years; and
- for all entities — another person who acts, or could reasonably be expected to act, in accordance with the taxpayer's directions or wishes, or in concert with the taxpayer.

6.59 A number of submissions and commentaries highlighted issues with this definition. The most common issues raised are as follows:

- whether it is possible to have more than one spouse;
- determining whether a person acts or could reasonably be expected to act in accordance with another's directions or wishes; and
- determining whether a person acts in concert with another.

Is it possible to have more than one spouse?

6.60 'Spouse' is a non-defined term for the purposes of Division 152, although the definition of spouse in section 995-1 includes a de facto spouse.

6.61 It is noted in ATO ID 2004/538 that 'spouse' will also include a person who is legally married to another person even though they may be permanently separated. As such, it may be possible for a person to have more than one spouse for the purposes of

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52 In ATO ID 2005/43 the Commissioner indicated that two unadministered deceased estates were not connected with each other even though they had the same executor and beneficiaries. This is because the concept of 'control' entails entitlement to interests that carry the right to receive distributions of income or capital. A beneficiary of an unadministered deceased estate has no such interest, nor does the executor.

the definition of a small business CGT affiliate in section 152-25 (for example a permanently separated spouse as well as a de facto spouse).

6.62 The issue of there being more than one spouse is not peculiar to Division 152, nor is it peculiar to the income tax law generally. As such, it raises broader policy issues which are not within the scope of this review. It is noted that a difficult compliance issue can arise if an estranged spouse refuses to provide market value details of assets that may, prima facie, be required to be included in the maximum net asset test. Given, however, that assets held by the small business CGT affiliate which are not used in a business carried on by the taxpayer or an entity connected with the taxpayer are excluded,[53] this potential issue should rarely arise in practice.

Determining whether a person acts or could reasonably be expected to act in accordance with another's directions or wishes

6.63 In practice, it is difficult to determine if another person acts, or could reasonably be expected to act, in accordance with another's wishes.

6.64 A similar test is to be found in the definition of STS affiliate in Division 328. Specifically, subsection 328-380(8) defines an entity as an STS affiliate if:

> '… the entity acts, or could reasonably be expected to act, in accordance with your directions or wishes, or in concert with you, in relation to the affairs of the entity's business.'

6.65 An important difference between subsection 328-380(8) and the definition in paragraph 152-25(1)(b) is that, for STS purposes, the actions considered are only those 'in relation to the affairs of the entity's business'. No such qualification exists in the Division 152 definition which makes the breadth of that definition and its application uncertain.

6.66 While there is no detailed ATO Public Ruling in relation to the concept of small business CGT affiliate, the meaning of STS affiliate has been discussed in Taxation Ruling (TR) 2002/6 and provides some guidance. The contexts of the two definitions, however, are significantly different. The STS context is much narrower, involving the determination of whether an entity is grouped with another in relation to their business supplies for the $1 million turnover test for eligibility to be in the Simplified Tax System. The implications for a small business CGT affiliate under Division 152 are far broader and deserving of guidance from the Commissioner in their own right.

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53 Subsections 152-20(3) and (4).

Acting in concert with another

6.67 Whether entities act in concert is also a difficult matter to determine and more often than not demonstrated in order to obtain affiliate status, to ensure that an asset held by one and used by another is in fact 'active'. This concept was also discussed in the STS ruling TR 2002/6, but, again, in the narrow context of relating only to business affairs of the relevant entities. The definition in Division 152 is not so limited and, as such, deserving of further guidance from the Commissioner in relation to the application of this test in practice.

Recommendation 6.5

To assist taxpayers in correctly calculating their maximum net asset value and to reduce uncertainties in relation to the concept of small business CGT affiliate, the Commissioner should provide guidance in relation to the practical application of the concepts of 'to act in concert' or 'reasonably expected to act in accordance with your directions or wishes' in section 152-25.[54]

Partners, directors and trustees and the 'in concert' rule

6.68 There is an exception under the 'act in concert' rule for partners in a partnership. Specifically, another partner is not taken to be acting in concert with the taxpayer because they act in concert in relation to the affairs of the partnership.[55]

6.69 There is no similar exclusion for co-directors of a company or co-trustees of a trust who may be viewed as acting in concert with each other. On this view, it is possible for each director and trustee to be affiliated because they act in concert with each other in these roles. If this is the case, it would be possible for an otherwise unrelated third party to be a small business CGT affiliate of a taxpayer because they act 'in concert' with each other. It is unlikely that such an outcome was within the policy intent of the provisions.

Companies and trusts as affiliates of directors/trustees

6.70 It is also unclear whether a company or trust can be said to be acting in concert with its directors or trustees, and therefore whether the two are small business CGT affiliates of each other.

6.71 It is not the ATO's practice, however, to interpret the law in this way. The minutes of the 12 November 2003 meeting of the National Taxation Liaison Group (NTLG) Losses and CGT Subcommittee (CGT Session) records that, in the ATO's view:

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54 Such written ATO guidance may take the form of a Public Taxation Ruling or Taxation Determination, ATO Interpretative Decision, or some other published guide or Fact Sheet.

55 Subsection 152-25(2).

> '… it is considered in general that companies and trusts are not affiliates of the various officer/entities/persons that are related to the company or trust in various capacities, such as the trustees or beneficiaries of a trust and the directors or shareholders of a company or trustee company.'[56]

6.72 This conclusion was drawn on the basis that the relationship in these situations is dictated more by obligations imposed by law, formal agreements, fiduciary obligations and the like.

6.73 A clarifying amendment to the law in these areas would remove the uncertainty of the current provisions and overcome an unintended consequence which could lead to the assets of unrelated third parties being included in the maximum net asset value test for a taxpayer. Such an amendment could remove the presumption of acting in concert. If the parties were shown to act in concert for other reasons, small business CGT affiliate status would arise.

Recommendation 6.6

Partners in a partnership are not treated as small business CGT affiliates of each other merely because they act in concert with each other in relation to the affairs of the partnership.

To remove any unintended consequences of the definition of small business CGT affiliate, section 152-25 should be amended to allow a similar exclusion to that provided for partners to apply to co-directors and co-trustees to the effect that simply holding that position is insufficient to draw the conclusion that they act in concert.

Recommendation 6.7

The definition of small business CGT affiliate includes entities that act in concert and entities that act or could reasonably be expected to act in accordance with another's directions or wishes.

To improve the certainty of the definition of small business CGT affiliate, the definition in section 152-25 should be amended to ensure that companies and trusts are not small business CGT affiliates of their directors and trustees respectively, and vice versa, merely because of the position held.

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56 See Item 8.1, minutes of the 12 November 2003 meeting of the NTLG Losses and CGT Subcommittee (CGT session).

TREATMENT OF PARTNERSHIP ASSETS UNDER THE MAXIMUM NET ASSET VALUE TEST

6.74 Issues have also been raised in relation to the clarity of the test in paragraph 152-15(b) in relation to partnership assets. Paragraph 152-15(b) states that, if the taxpayer is a partner in a partnership and the CGT event happens in relation to a CGT asset of the partnership, the net value of the CGT assets of the partnership must not exceed $5 million.

6.75 Uncertainty is created by the reference in this paragraph to 'the CGT assets of the partnership'. This uncertainty is because section 106-5 makes it clear that any capital gain or capital loss from a CGT event happening in relation to a partnership or one of its CGT assets is made by the partners individually.

6.76 Division 152 has regard to whether a partnership is disposing of an asset, even though for the purposes of calculating the CGT liability each of the partners must treat the disposal as a separate CGT event for each of them giving rise to different consequences as between them.

6.77 The Commissioner has tried to clarify the meaning of paragraph 152-15(b) in the ATO Booklet: Advanced Guide to Capital Gains Tax Concessions for Small Business as follows:

> 'This additional test does not apply if a partner in a partnership disposes of an interest in a partnership asset (and the other partners retain their interest in the partnership asset). This is because a partner's interest in a partnership asset is a CGT asset of the partner and not of the partnership.[57]'

6.78 The ATO's interpretation has the result that if, at different times, individual partners sell their individual fractional interests in a CGT asset used by the partnership, the additional test for the net value of all of the CGT assets of the partnership itself does not apply to work out whether the individual partner passes the maximum net asset value. Each partner may or may not qualify for the concessions based on their own individual application of the maximum net asset value test to their personal circumstances.[58]

6.79 In contrast, if all the partners were to sell all interests together (that is the partnership is disposing of the asset in full), the additional test does apply. In this case if the net value of the partnership's CGT assets exceeds $5 million, none of the

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57 Page 9, ATO Booklet: Advanced Guide to Capital Gains Tax Concessions for Small Business.

58 This will include the individual partner's connected entities and small business CGT affiliates. It is noted, however, that the net value of the partnership's assets can still be included for an individual partner on the basis that it is 'connected with' the partner (for example because the partner has a 40 per cent partnership interest).

individual partners will be eligible for the small business CGT concessions, irrespective of their personal net worth.

6.80 This difference in result is inconsistent with the overall CGT approach to the treatment of interests in partnership assets, which considers the individual partner's position only.

6.81 Moreover, this interpretation is itself not free from doubt. It could be argued that, as paragraph 152-15(b) simply requires that the event happen 'in relation to' a CGT asset of the partnership, and the treatment of partnership assets for CGT purposes focuses on the individual partner, it is not necessary for all the interests in the asset to be sold by all partners to attract the test.

6.82 It is unclear whether the purpose of the test for partnership assets is to determine if the partnership itself is conducting a 'small' business when there is a change of ownership of an interest in the partnership. If this is the case, the test should apply even where a partner is selling a fractional interest in the business asset in isolation to the other partners. In this way, if the partner were selling an interest in a 'big' business, the small business CGT concessions would not apply even if the partner was otherwise below the maximum net asset value of $5 million.

6.83 For these reasons, there appear to be inconsistencies in the treatment of interests in partnership assets both within the CGT system as a whole as well as within Division 152. These inconsistencies could be removed by aligning the treatment of partnership assets with those of all other connected entities for Division 152 purposes. On this basis, the total net value of the assets of the partnership would only be included in a partner's individual calculation if the partnership is an entity connected with the partner. As discussed above, this connection is based on control. Control in this context is based on the right to receive at least 40 per cent of all capital and income distributions. It follows that, generally, a partner will control a partnership if the partner has the rights to 40 per cent of the partnership capital and income.

6.84 This approach could be achieved by removing the test for partnerships in paragraph 152-15(b) altogether. If paragraph 152-15(b) were to be repealed, the general rules for the maximum net asset value calculation would apply in the same way to the disposal of interests in partnership assets as they do to the disposal of other active assets held by a partner.

6.85 It is noted that, while a partnership is an 'entity' for these purposes[59] and, therefore, can be 'connected with' the partner, the partnership cannot be a small business CGT affiliate of the partner. This is because such an affiliate must be a 'person'. Person is defined in section 995-1 to include a company. Further, section 22 of the *Acts Interpretation Act 1901* provides that, unless a contrary intention appears, a

59 'Entity' is defined in subsection 960-100(1) to include, inter alia, a partnership.

reference to 'person' includes a body politic or corporate as well as an individual. As a partnership is not a 'person', the partner could not be grouped with the partnership for the maximum net asset value test on the basis of the small business CGT affiliate rules. The partner can only be grouped on the basis of the connected entity rules.

Recommendation 6.8

In applying the maximum net asset value test in relation to interests in partnership assets it is unclear whether the test applies to the partner individually or to all of the CGT assets of the partnership.

To improve the certainty of the operation of the maximum net asset value test for partners and partnerships, paragraph 152-15(b) should be repealed so that the treatment of a disposal of an interest in a partnership asset is aligned with the disposal of other active assets held by the partner.

DEALING WITH ASSETS EXCLUDED FROM THE CALCULATION

6.86 In determining the net asset value for the $5 million threshold, a number of assets are specifically excluded from the calculation. These are:

- interests held in connected entities and small business CGT affiliates (to avoid double counting);
- the following assets provided they are held by an individual:
  - assets being used solely for the personal use and enjoyment of the particular individual or their small business CGT affiliate;
  - a dwelling of the individual if the individual uses it to produce assessable income, provided no interest is (or would be) deductible in relation to borrowings to acquire the dwelling;
  - rights to, or to any part of, any allowance, annuity, or capital amount payable out of a superannuation fund or an approved deposit fund;
  - a right to, or to any part of, an asset of a superannuation fund or an approved deposit fund; and
  - a policy of life insurance on the life of the individual; and
- assets held by a small business CGT affiliate (or an entity connected with a small business CGT affiliate) which are not used in connection with a business carried on by the taxpayer or an entity connected with the taxpayer. Assets used in the

business of a connected entity are also excluded if that entity is only connected with the taxpayer because of the interests of the small business CGT affiliate.

6.87 The following issues surrounding the treatment of the following assets have been raised in submissions:

- personal use and enjoyment assets;
- dwellings that have mixed private and business use; and
- non-business assets of small business CGT affiliates.

Personal use and enjoyment assets

6.88 Assets being used solely for the personal use and enjoyment of the entity or their small business CGT affiliate are excluded from the maximum net asset value test in accordance with the overall policy intent of the provisions.[60]

6.89 Where the personal use and enjoyment asset is owned by a connected entity and not an individual, the net value of the asset is taken into account for the maximum net asset value test. A personal use asset is only disregarded if it is held in the name of **an individual**.

6.90 It is a common practice of the owners of many small businesses to hold private assets in the name of a related trust rather than in personal names. These assets may have been held exclusively for personal use. They will, however, be included in the $5 million calculation because they are held in the connected entity's name.

6.91 As the inclusion of these assets in the test is a policy issue, it is outside the scope of this review. As noted in some submissions, however, it does highlight that the lack of a transitional provision at the time of the introduction of Division 152 resulted in personal use assets held in the name of a trustee not being able to benefit from the exclusion.

Treatment of dwellings that have mixed private and business use

6.92 A dwelling is excluded from the maximum net asset value test, even if used to produce some amount of assessable income, provided no deduction is (or would be) available in relation to interest incurred on money borrowed to acquire the dwelling.

6.93 Conversely, if, hypothetically, interest had been incurred on money borrowed to acquire the dwelling and the taxpayer could have deducted any proportion of this,

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60 Paragraph 1.14 EM to NBTS (CGT) Bill 1999.

100 per cent of the value of the dwelling will be included in the calculation irrespective of the percentage deduction for interest that would have been available.

6.94 This test requires the taxpayer to perform a hypothetical calculation and entails no de minimis rule. This means that if a taxpayer were, hypothetically, entitled to as little as a 1 per cent interest deduction, this would result in 100 per cent of the value of the home being included in the test. This seems to be an inappropriate result where, had the taxpayer used premises separate from their home, no part of the value of the home would have been included.

6.95 Conversely, in cases where the property is used even minimally for business use (and provided the eligibility criteria are met), the taxpayer would actually be eligible for the small business CGT concessions on 100 per cent of the gain on the dwelling (see discussion below in Chapter 7).

6.96 These outcomes are inconsistent with the overall policy intent of the provisions and lead to unintended consequences of a substantive nature. Amendments to section 152-20 are desirable to improve the certainty of the provisions.

Recommendation 6.9

Where the individual uses a dwelling to generate assessable income in part and is (or would be) entitled to pro-rata interest deductions in relation to money borrowed to acquire the dwelling, the full value of the dwelling is included in the maximum net asset value test.

To give effect to the policy intent and to improve the certainty of the outcome of the maximum net asset value test, section 152-20 should be amended in relation to the inclusion of dwellings to:

- only include that percentage of the value of the dwelling that reflects the proportion of interest deductibility on the dwelling; and
- have regard to that deductibility over a specified period, rather than at the time of the CGT event.

Non-business assets of small business CGT affiliates

6.97 Subsection 152-20(4) also excludes from the net asset value calculation, assets held by a small business CGT affiliate or an entity connected with a small business CGT affiliate if they are not used or held ready for use in carrying on a business by the taxpayer or an entity connected with the taxpayer. Even if they are business assets of an entity connected with the taxpayer, they are still excluded if the connection is only because of the small business CGT affiliate.

6.98 It is generally accepted that this subsection is highly confusing, using as it does, a triple negative. An anomaly has also been pointed out in relation to the operation of this subsection in the case of a business being conducted from premises held by another party who is a small business CGT affiliate only because they act in concert with each other. In this case, a sale of the business would require that the value of the property be included in the $5 million calculation. Conversely, a sale of the premises would not require the business assets to be included.[61]

Recommendation 6.10

Certain non-business assets held by a small business CGT affiliate or entity connected with the small business CGT affiliate are excluded from the maximum net asset value test of a taxpayer by operation of subsection 152-20(4).

Subsection 152-20(4) is difficult to read and understand and should be amended to improve its readability.

SUMMARY OF FINDINGS IN RELATION TO THE MAXIMUM NET ASSET TEST

6.99 Based on the foregoing analysis and in evaluating the operation of the maximum net asset value test against the review criteria, the following conclusions can be drawn.

6.100 Overall, section 152-15 gives effect to the policy intent that eligible small business entities qualify for the concessions if their net asset value (excluding certain assets) does not exceed $5 million.

6.101 Although, predominantly, section 152-15 operates in a clear, simple, comprehensible and workable manner, parts are unclear and their application uncertain. These parts should be rewritten to more accurately reflect the outcomes sought and remove uncertainty. Amendments are particularly required in relation to determining the liabilities which can be taken into account as part of the 'net value' of the relevant assets; the definition of small business CGT affiliate; the treatment of partnership assets; and also in the case of subsection 152-10(4) the treatment of non-business assets held by connected entities and small business CGT affiliates.

6.102 The methodology of the calculation will generally provide an accurate reflection of the net value of the taxpayer for the maximum net asset test. It does however give rise to an unintended consequence of a substantive nature in that the full value of a taxpayer's home would be included in the calculation when it is only partially used for business.

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61 Hourigan, V ATP Weekly Tax Bulletin 4/2/05.

6.103 Some amendments in relation to the liabilities to be included in the net asset value calculation would enable actual taxpayer circumstances and commercial practices to be taken into account.

6.104 The operation of the maximum net asset value test is generally consistent with other tax legislation.

6.105 Where there is a lack of certainty in relation to the correct interpretation of some of the concepts included in Subdivision 152-A, this can be addressed in part by the Commissioner publishing guidance on these issues.

CHAPTER 7: THE ACTIVE ASSET TEST

7.1 The active asset test is fundamental to the small business CGT concessions in Division 152. The test has two elements to it — a time element specifying when and for how long the asset must be 'active' and a character element dealing with the use of the asset identifying this with business use. There are also specific rules identifying certain types of assets which cannot qualify as active assets. It is possible for a share in a company or an interest in a trust to be 'active', subject to specific conditions being satisfied.

7.2 While the active asset test is fundamental to the eligibility for the concessions, active asset status is also critical for access to the small business roll-over in Subdivision 152-E. An asset is only acceptable as a replacement asset on the roll-over if it is an active asset. Should that status subsequently change, the roll-over allowed under Subdivision 152-E ceases and CGT event J2 or J3 event happens. The effect of this is to crystallise the deferred capital gain in the year when the replacement asset ceases to be 'active'.

7.3 In this chapter the following aspects of the active asset test are evaluated against the review criteria:

- The timing rule — when and for how long must the asset be active?
- The meaning of 'active asset' for assets other than shares in companies and interests in trusts.
- Determining when shares in companies and interests in trusts are treated as active assets.

THE TIMING RULE — WHEN AND FOR HOW LONG MUST THE ASSET BE 'ACTIVE'?

7.4 There are two parts to the timing rule for active assets:

(a) the asset must be active just before the earlier of:

- the CGT event; and
- if the relevant business ceased to be carried on in the last 12 months or any longer period that the Commissioner allows — the cessation of the business; and

(b) during at least half of the period beginning at the later of:

- when the taxpayer acquired the asset; and
- if the taxpayer has owned the asset for more than 15 years — 15 years before the time that applies under (a);

and ending at the time that applies under paragraph (a).

Determining active asset status over time

7.5 The practical ability to determine an asset's active status for half the period of ownership (which could be up to a 15 year period) poses compliance problems for taxpayers. This is particularly the case in relation to the 'look through' rule, to determine the active status of shares and trust interests, which is discussed below.

7.6 The integrity of the provisions, however, requires a timing rule in order to avoid short term changes of the status of an asset merely to access the small business CGT concessions. The current requirement for the asset to be demonstrated to be active for 50 per cent of the time held is not considered to be onerous in the context of the concessions available.

7.7 Alternate approaches (for example active status continuously since acquisition; or active status for, say, the last four years prior to the CGT event) would equally disadvantage some business taxpayers. As such the current rule is considered to appropriately balance the various considerations. In addition, a rule of this nature is necessary to give effect to the policy intent that the concessions are available only for genuine business assets.

The 12 month 'look back' rule

7.8 The 12 month 'look back' rule in subparagraph 152-35(a)(ii) is only available in the limited circumstance that a business has actually ceased to be carried on by the relevant taxpayer.

7.9 It is argued by some that limiting the rule to circumstances only where the business has ceased is unwarranted. In many situations, a business that has not in fact ceased will hold an asset for sale which was previously used in that business. In these circumstances the asset cannot be treated as active as it is not active 'just before' the CGT event. This causes particular problems for situations such as:

- taxpayers that hold business premises and upgrade to new premises prior to selling the old premises;[62] and
- entities that cease part of their business operations and sell the premises held in a separate entity which were used in that part only.[63]

Illustration 7.1: Cessation of use of asset in business

ABC Pty Ltd conducts a manufacturing business. It has decided to upgrade to more modern premises. These premises are acquired before the old premises are sold. This is because machinery, fittings and stock from the old premises must be moved to and installed in the new premises.

Once the transfer of depreciating assets and stock has occurred, the former business premises are vacated and minor renovations are undertaken to ensure that they are in a suitable and attractive condition for sale. The premises are offered for sale with vacant possession.

At the time the contract for sale has been entered into the company conducts no business activities from the former premises. It does not use the premises in its business nor does it hold the premises ready for use in its business. All of its operations are conducted from the new location.

The former business premises cannot qualify as an 'active asset' just before their disposal. As such, the business is unable to access the small business CGT concessions in relation to any gain made on premises which have only ever been used for business purposes.

7.10 An outcome such as that described in Illustration 7.1 is an unintended consequence of a substantive nature in that it denies active asset status to assets which have been used for no other purpose than in the particular business. This outcome is not in accordance with the intention to allow the small business CGT concessions to genuine business assets. Moreover, the existence of a 12 month 'look back' rule already acknowledges the commercial reality that it can take some time for an asset to be disposed of. This time frame equally applies to businesses which, during their life, also dispose of assets that become surplus to their requirements. Such time frames needed for the sale of assets are not peculiar to cessation of business.

7.11 The current outcome is also inconsistent with the acknowledgement in the small business roll-over in Subdivision 152-E that a replacement business asset can have been acquired up to one year before the disposal of the particular business asset.[64]

62 ATO ID 2003/747 (withdrawn).
63 See, for example ATO ID 2003/503.
64 See section 152-405.

7.12 This unintended consequence would be avoided if the requirement to cease business in the last 12 months was replaced with a more general requirement to cease use of the asset in the business in the last 12 months.

7.13 Although it could be argued that there is a practical difficulty in determining when the asset has ceased to be 'used' in the business, the requirement to determine 'use' already exists in the legislation[65] — active asset status itself, turns on a determination of 'use' or 'held ready for use' in the business in any event.

Recommendation 7.1

Where a business has ceased, an asset which was 'active' immediately before the cessation of the business may attract the small business CGT concessions provided it is sold within 12 months of the cessation of the business (or within such further time as the Commissioner allows).

To avoid the unintended denial of the small business CGT concessions on the sale of business premises and other active assets, section 152-35 should be amended to allow for a similar 12 month period for the disposal of an asset after the cessation of ***use*** of the asset in the business, irrespective of whether the business itself has actually ceased.

The Commissioner's discretion to extend the 12 month period

7.14 Subparagraph 152-35(a)(ii) allows the Commissioner to permit a longer period than 12 months in which to dispose of an asset after the business has actually ceased. Although some guidance on when the Commissioner would exercise this discretion has been given in such ATO IDs as 2001/406, 2003/26 and 2003/713, more general guidance in relation to when the Commissioner will allow such further time should be made available.

Recommendation 7.2

The Commissioner may allow an extension of the time period in which a formerly active asset may be sold and still qualify for the small business CGT concessions.

The Commissioner should provide detailed written guidance indicating the circumstances in which such an extension of time beyond the 12 month period specified in the law would be allowed for the disposal of an active asset.[66]

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65 See, for example, subsection 40-25(20) of the capital allowance provisions which requires that the deduction for the decline in value of an asset is reduced by the part attributable to the 'use of the asset', or the asset having been installed 'ready for use' for a purpose other than a taxable purpose.

66 Such written ATO guidance may take the form of a Public Taxation Ruling or Taxation Determination, ATO Interpretative Decision, or some other published guide or Fact Sheet.

THE MEANING OF 'ACTIVE ASSET' FOR ASSETS OTHER THAN SHARES IN COMPANIES AND INTERESTS IN TRUSTS

7.15 The policy intent of Division 152 is that the small business CGT concessions relate to gains on business rather than passive assets.[67] The definition in section 152-40 seeks to achieve this by defining an active asset at a time the taxpayer owns it as an asset which is:

- used or held ready for use in the course of carrying on a business;
- an intangible asset that is inherently connected with a business that the taxpayer carries on; or
- used or held ready for use in the course of carrying on a business by the taxpayer's small business CGT affiliate or connected entity.

7.16 Specifically excluded from the category of active assets (irrespective of whether they are owned by a business entity) are:

- shares in all companies and interests in all trusts, except where they meet the requirements for active asset status in their own right under subsection 152-40(3);
- financial instruments (such as loans, debentures, bonds, promissory notes, futures contracts, forward contracts, currency swap contracts and a right or option in respect of a share security, loan or contract);
- an asset whose main use in the course of carrying on the business is to derive interest, an annuity, rent, royalties or foreign exchange gains unless:
  - the asset is an intangible asset and has been substantially developed, altered or improved by the taxpayer so that its market value has been substantially enhanced; or
  - its main use for deriving rent was only temporary.

7.17 The issues raised in relation to this definition include:

- various interpretation issues requiring clarification; and
- the treatment of financial instruments.

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67 Attachment E to Treasurer's Press Release No. 58, 21 September 1999.

Various interpretation issues

7.18 There is some uncertainty as to the application of the law in relation to the following concepts used in the active asset test:

- The meaning of to hold an asset 'ready for use' in the course of carrying on a business is unclear.[68]
- It is difficult to be certain of the status of an asset used to generate some rental income because of 'main use' and 'temporary' use concepts.[69]
- The drafting of subsection 152-40(1) does not make it clear whether:
  - intangible assets used or held ready for use in the course of carrying on a business can qualify as 'active' irrespective of whether they are inherently connected with the business; and
  - intangible assets inherently connected with a business carried on by a small business CGT affiliate or connected entity will be active assets.

  In ATO ID 2004/7 the Commissioner takes the view that the purpose and effect of paragraph 152-40(1)(b) (which specifically refers to intangible assets) is to extend (not impliedly limit) the concept of an active asset and this applies also in relation to assets used or held ready for use in the businesses of connected entities and small business CGT affiliates.

7.19 Uncertainty in relation to the application of the law in these circumstances could be reduced by the issuing of guidance by the Commissioner and, in the case of intangible assets inherently connected with businesses of affiliates and connected entities, a minor technical amendment to the law.

Recommendation 7.3

The definition of an 'active asset' uses various concepts such as 'hold ready for use', 'main use' and 'temporary use'.

To reduce uncertainty in relation to the application of the active asset test, the Commissioner should provide guidance to clarify the interpretation of the various concepts in section 152-40.[70]

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68 For example, the Commissioner's view in ATO ID 2002/354 that land on which minor earthworks have been carried out in preparation for the construction of a shed, but sold prior to the construction of the shed, has been disputed.

69 ATO ID 2003/253.

70 Such written ATO guidance may take the form of a Public Taxation Ruling or Taxation Determination, ATO Interpretative Decision, or some other published guide or Fact Sheet.

Recommendation 7.4

Intangible assets inherently connected with the taxpayer's own business may be active assets.

Section 152-40 should be amended to give effect to the policy intent that intangible assets inherently connected with the business of a small business CGT affiliate or connected entity should also be active assets.

Treatment of financial instruments

7.20 Financial instruments cannot be active assets (paragraph 152-40(4)(d)). This provision raises practical issues for determining the correct treatment of assets such as:

- debtors;
- bank accounts; and
- cash.

7.21 The financial instruments rule has two effects. First, it ensures that such instruments cannot count for access to the small business CGT concessions in their own right. The second effect concerns the operation of the 80 per cent look through rule for shares and trust interests (discussed below). The effect of this rule is that shares and trust interests will only qualify as active assets if the company or trust can satisfy the 80 per cent active asset test in subsection 152-40(3). Financial instruments held by the company or trust cannot be taken into account in order to satisfy the 80 per cent look through rule.

7.22 The Commissioner has taken the view that trade debtors can be active assets on the basis that they are not financial instruments but are business facilitation mechanisms that are inherently connected with the conduct of the business.[71] In contrast, he is of the view that cash and bank accounts cannot be active assets even if they are inherently connected with the business operations.[72]

DETERMINING WHEN SHARES IN COMPANIES AND INTERESTS IN TRUSTS ARE TREATED AS 'ACTIVE' ASSETS

7.23 The policy intent of the legislation is to allow taxpayers to dispose of interests in companies and trusts and be eligible for small business CGT concessions in relation to

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71 ATO ID 2002/1003.

72 ATO IDs 2003/167 and 168.

any gain made, provided a 'look through' test is satisfied.[73] For active asset status to be achieved, satisfaction of this look through test is required just before the CGT event in relation to the share or trust interest (or just before the business conducted by the company or trust ceased if less than 12 months prior to the relevant CGT event[74]) and at least 50 per cent of the time the share or trust interest was owned.

7.24 It is also important to note that where shares or interests in a trust have been acquired as replacement assets for a small business roll-over, they must be active assets to qualify as replacement assets[75]. Should that status cease at any time, CGT event J3 happens and the rolled-over gain is crystallised.[76] As this is a 'sudden death' provision (see Chapter 13), the ability to continuously pass the active asset test for share or trust interests is mandatory in these cases.

What is the test for 'active asset' status for shares and trust interests?

7.25 The test in subsection 152-40(3) is satisfied if:

- the company or trust is an Australian resident for CGT purposes for the income year in which the test time occurs; and
- the total of:
  - the market values of the active assets of the company or trust; and
  - any capital proceeds that the company or trust received, during the 2 years before that time, from CGT events happening to its active assets and that the company or trust holds in the form of cash or debt pending the acquisition of new active assets;

  is 80 per cent or more of the market value of all of the assets of the company or trust.

Issues raised in relation to the active asset status of shares in companies and interests in trusts

7.26 The operation of the 80 per cent look through test was raised in a number of submissions which highlighted that the current structure of the test imposes onerous compliance costs and practical difficulties on taxpayers.[77] These difficulties are such

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73 Attachment E to Treasurer's Press Release No. 58, 21 September 1999.

74 In ATO ID 2003/844, the Commissioner confirmed the interpretation that the relevant business that must have ceased when considering the disposal of the shares in a company (for example on liquidation), is the business of the company itself.

75 Subsection 152-420(4).

76 Paragraph 104-190(1)(c).

77 See submission from the ICAA of 28 February 2005; and Nissen Kestel Harford of 28 February 2005.

that it would be very difficult for a taxpayer to confirm compliance with the test for the required amount of time (50 per cent of the ownership period, capped at 15 years).

7.27 Moreover, in the case of determining if CGT event J3 has happened, one breach of the 80 per cent test is 'sudden death' causing crystallisation of a gain deferred by the small business roll-over in Subdivision 152-E. As a result, taxpayers would almost universally be advised that roll-over of a gain into a replacement share or unit would give rise to such a high level of compliance costs and risks as to be unworkable in practice.

Illustration 7.2: Temporary breach of the 80 per cent test for shares in a company

XYZ Pty Ltd conducts a building business. Its standard commercial practice is to require an initial payment of 40 per cent of the contract price on commencement of the building work. The next 3 instalments of 20 per cent are receivable at completion of specified stages in the work.

XYZ Pty Ltd is awarded the contract for a project with an initial up front 40 per cent payment of $240,000. This amount is deposited into its bank account and will be used to cover the material purchase costs and subcontractor payments required to be made in Stage 1 of the contract.

The deposit of $240,000 is not an active asset of the business. This is the case, notwithstanding that it clearly relates to working capital of the business and the company is fully committed to expending this money on operating expenses of the project for which it has contracted.

Illustration 7.3: Effect of temporary breach of the 80 per cent test on small business roll-over

One of the shareholders in XYZ Pty Ltd is Mr Jones. Mr Jones had previously owned a business which he sold. Part of the gain made on the sale of the previous business ($400,000) has been rolled-over under Subdivision 152-E. The replacement assets chosen by Mr Jones are the shares that he owns in XYZ Pty Ltd. Mr Jones owns 50 per cent of the shares in the company.

In order for the roll-over to be maintained, the shares in XYZ Pty Ltd must remain active continuously. If they cease to be active at any time, CGT event J3 happens and the deferred gain ($400,000 in this example) will be crystallised.

When XYZ Pty Ltd was awarded the contract set out in Illustration 7.2, the moment the $240,000 initial payment was deposited in the company's bank account, the company was unable to pass the 80 per cent active asset test.

Even though this breach is only temporary, and notwithstanding that the payment arose in the ordinary course of the company's business and will be expended on normal operating costs (and not the acquisition of investment assets), Mr Jones is required to show the $400,000 capital gain as having been crystallised.

Practical issues associated with the 80 per cent test

7.28 Practical issues raised in relation to the calculation of the 80 per cent test include:

- The test requires the market values of all active assets to be determined on a continuous basis. This requires taxpayers to consider the day to day value of such assets as goodwill and other intangibles which might not be recognised on their balance sheets.

- By excluding cash and bank accounts generally from the concept of active assets, business entities that are highly cashed up from time to time (for example on sale of an asset; preparatory to payment of dividends; payment of tax assessments etc.) may breach the test.

- By including cash or debt only if it is received during the two years before the relevant test time (bearing in mind this is a continuous test in some cases), provided that such cash or debt is from the happening of CGT events in relation to active assets and provided further that it is held pending the acquisition of new active assets, is discriminatory in its application since service entities with high working capital requirements simply cannot meet this requirement.

- When a business is winding down, it may have cash reserves which are not held in order to acquire new active assets. In this case, the shares will not be 'active' if sold and, if the business has not in fact ceased in the last 12 months, there is no ability to

retain active asset status, notwithstanding that the status may clearly have been met throughout the ownership period of the shares.

- The application of the test in some cases is uncertain. For example, where a taxpayer disposes of shares in a company, which holds cash or debt from the sale of an active asset in the previous two years, the taxpayer will be required to ascertain whether the company intends to acquire new active assets with that cash or debt. Is this possible where the intentions of the new shareholders in relation to the company's use of such cash or debt are not known at the time the shares are disposed of?

- When coupled with the 'sudden death' nature of CGT event J3 on the loss of active asset status, one temporary breach of the 80 per cent threshold causes crystallisation of the gain deferred under the small business roll-over. The simple act of a related entity temporarily borrowing funds from a company or trust could cause this to occur, since the loan will not be an 'active' asset of the entity.

- Where a company is liquidated, the shares in the company may still qualify as active assets, provided the active asset time and character tests can be satisfied. This means, effectively, that liquidation must be complete within 12 months of the cessation of business in the entity (or within such further time as the Commissioner allows). A taxpayer must also show that the shares were active just before the business ceased. This raises the difficulty of showing that any cash reserves at that time were for acquiring other active assets — which will not be the case if the decision has been taken to sell/cease the business and place the company into voluntary liquidation.

7.29 A look through rule for shares and trust interests is required for the integrity of the active asset provisions. An 80 per cent threshold test is also not inappropriate for determining the acceptable extent of business assets held in the entity. Amendments to the definition are required, however, to relieve the onerous compliance costs currently entailed in the rules and to make the test more commercially realistic and practical in its application.

7.30 The test can be improved, without undermining its overall integrity, by allowing:

- financial instruments which are inherently connected with a business to be included as active assets for the purposes of the 80 per cent look through rule;

- temporary fluctuations in the valuation of assets which cause the entity to breach the 80 per cent threshold to be ignored;[78] and

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78 Other tests in the CGT provisions permit failures to comply with a threshold to be ignored if the failure was of a temporary nature only or because of circumstances outside an entity's control — see, for example, subsection 115-290 in relation to listed investment companies.

- the test to be treated as having been passed where it is reasonable to conclude that this is the case.

7.31 Amendments of this nature would remove the inappropriate outcomes described above in genuine business situations.

Recommendation 7.5

To determine whether shares in a company or interests in a trust qualify as 'active assets', an 80 per cent look though test is applied to the active assets of the company or trust.

To provide a more practical test which takes into account actual taxpayer circumstances and commercial practices, subsection 152-40(3) should be amended so that financial instruments of the company or trust which are inherently connected with a business are included as active assets for the purposes of the 80 per cent look through test.

Recommendation 7.6

Monitoring of the active asset status of shares in companies or interests in trusts may be required over extended periods of time or, in some cases, continuously.

To provide a more workable formula for determining compliance with the active asset test, as well as reducing the compliance costs of testing the active asset status of shares and interests in trusts on an ongoing basis, subsection 152-40(3) should be amended to treat the 80 per cent test as having been met:

- where breaches of the threshold are only temporary in nature; and
- in circumstances where it is reasonable to conclude that the 80 per cent threshold has been passed.

Investment shares treated as active assets

7.32 Some uncertainty also exists in practice because the 'active' status of shares is not determined by who owns them. That is, it is not necessary for shares to be held by an individual for them to be 'active'. It is only necessary for the 80 per cent 'look through' rule to be satisfied. It is necessary for an individual to be the owner only where there is a CGT event in relation to those shares. Small business CGT concessions are available on that gain only if the taxpayer is a controlling individual or the spouse of the controlling individual.[79]

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79 This is a basic condition for the concessions contained in subsection 152-10(2).

7.33 The practical effect of this is that shares in a public company which could meet the 80 per cent test are in fact active assets. If they are owned in a private investment entity, they would count towards the 80 per cent active asset test for interests in that private investment entity.[80] This is an unintended consequence of the provisions and an amendment to the law would better reflect the policy intent.

Recommendation 7.7

It is possible for shares or trust interests in widely held entities that conduct businesses to qualify as active assets.

To give effect to policy, section 152-40 should be amended to ensure that shares and trust interests in widely held entities are not active assets unless held by a CGT concession stakeholder in the widely held entity.

Summary of findings in relation to the active asset test

7.34 Based on the foregoing analysis and in evaluating the operation of the active asset test against the review criteria, the following conclusions can be drawn.

7.35 The broad impact of the active asset test is generally in line with the policy intent to limit the small business CGT concessions to business assets only.

7.36 Many elements of the active asset rules are clear, simple, comprehensible and workable. Some issues can be clarified further by the publication of detailed guidance by the Commissioner. The 80 per cent look through rule for interests in companies and trusts, however, is very difficult to apply in its current form when it is applied over time, because of high compliance costs. This outcome can be overcome with amendments to the operation of the test which will retain its integrity but reduce compliance costs and practical difficulties.

7.37 The drafting of the rules in relation to shares and trust interests may lead to unintended consequences in that small business CGT concessions may apply to interests in entities that hold investments in widely held companies and trusts that pass the 80 per cent underlying asset test.

7.38 The ability of the 12 month look back rule to only apply in the case of a business having ceased does not take into account practical taxpayer circumstances and the commercial realities of disposing of business assets that are no longer required in a continuing business.

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80 See also ATO ID 2001/411 (withdrawn).

7.39 In relation to the 80 per cent look through test, actual taxpayer circumstances and business practices require that financial instruments such as cash and bank accounts which are inherently connected with the business should be treated as active in order to avoid unintended consequences of a substantive nature.

7.40 Generally the active asset test provides consistency with other tax legislation.

7.41 Generally the active asset rules are certain although a number of difficult interpretation issues arise in relation to some of the concepts used.

CHAPTER 8: CONTROLLING INDIVIDUAL TEST AND CGT CONCESSION STAKEHOLDER TEST

8.1 It was noted in Chapter 5 that, where the active asset is a share in a company or an interest in a trust, one of the key requirements for eligibility for the small business CGT concessions is that the company or trust must satisfy a controlling individual test and the taxpayer must be a CGT concession stakeholder in the company or trust.

8.2 The existence of a controlling individual is also necessary for certain types of the small business CGT concessions to be used by a company or a trust — in particular the retirement exemption[81] and the 15 year exemption require a controlling individual test to be satisfied[82].

8.3 In almost all of the submissions received, it was highlighted that the outcome under the small business CGT concessions differs significantly depending on the way the small business holds the business assets. In particular, if the business structure used does not have a controlling individual, some or all of the small business CGT concessions are not available.

8.4 That the CGT rules apply in different ways to individuals, partners, trusts and companies is not an issue peculiar to Division 152 and, as such, is outside the scope of this review. It is also noted that the requirement for there to be a controlling individual has been a key feature of the small business CGT concessions since their original enactment in Divisions 17A and 17B.

WHO IS A CONTROLLING INDIVIDUAL AND A CGT CONCESSION STAKEHOLDER?

8.5 The meaning of 'controlling individual' and 'CGT concession stakeholder' is set out in Table 8.1.

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81 Subsection 152-305(2).
82 Subsection 152-110(1).

Table 8.1: Definitions of 'controlling individual' and 'CGT concession stakeholder'

Controlling individual (section 152-55)	CGT concession stakeholder (section 152-60)
A natural person who owns at least 50 per cent of the legal and beneficial interests in an entity or is entitled to at least 50 per cent of distributions of both income and capital from a discretionary trust.	A natural person who is: • a controlling individual in his or her own right; or • the spouse of the controlling individual, who also holds an interest in the entity.

8.6 These definitions mean that an entity can have no more than two CGT concession stakeholders at any one time as shown in Illustration 8.1.

Illustration 8.1: CGT concession stakeholders

Facts	Controlling individual	CGT concession stakeholders
A unit trust is owned 50 per cent by Mrs A and 50 per cent by Mr B	Mrs A and Mr B	Mrs A and Mr B
A family company is owned 50 per cent by Mrs A, 1 per cent by Mr A and 49 per cent by a family discretionary trust	Mrs A	Mrs A and Mr A
A unit trust is wholly owned by a family discretionary trust	None	None
A unit trust is owned as to 25 per cent each by Mr A, Mrs A, Mr B and Mrs B	None	None
The only distribution made by a family discretionary trust in the year is distributed equally to Mrs A and Mr A	Mr A and Mrs A	Mr A and Mrs A
The only distribution made by a family discretionary trust in the year is distributed 50 per cent to Mrs A, 30 per cent to Mr A, and 20 per cent to a child	Mrs A	Mrs A and Mr A

8.7 The concept of CGT concession stakeholder allows interests held by a spouse of a controlling individual to qualify for the concessions, even though the spouse holds only a minority interest. It is possible, therefore, for a spouse holding only a 1 per cent interest in an entity in which his or her spouse holds a 50 per cent interest to gain access to the concessions.

8.8 The use of these concepts of controlling individual and CGT concession stakeholder indicates that it was intended that:

- it is necessary for a 50 per cent ownership interest to be held for certain forms of the concessions to be available, where business assets are held indirectly through a trust or company; and
- the interests of spouses are to be specifically recognised as eligible for the concessions, even if they constitute minority interests.

When is it necessary for a CGT concession stakeholder to hold interests in an entity in order to access the small business CGT concessions?

8.9 Where an entity — be it individual, trust or company — derives a capital gain from a CGT event relating to an active asset (which is not a share in a company or an interest in a trust), provided the basic eligibility criteria are met, the entity can claim (as a minimum) the small business 50 per cent reduction and the small business roll-over. Neither of these concessions requires the existence of a controlling individual or CGT concession stakeholder in such circumstances.

8.10 A controlling individual and a CGT concession stakeholder must exist, however, to access the small business CGT concessions in the following circumstances:

- where the gain is made in relation to shares in companies or interests in trusts — the holder of the share or trust interest must be a CGT concession stakeholder[83];
- where the gain is made by a company or trust and the requirements for the 15 year exemption are otherwise met, the company or trust must have a controlling individual for the entire period of ownership of the relevant active asset[84]. In addition, payments of the amount of the gain from the company or trust must be made to a CGT concession stakeholder in order to be tax-free in the hands of the recipient[85];
- where the gain is made by a company or a trust, for that entity to use the retirement exemption, there must be a controlling individual[86] and the amount must be paid in relation to a CGT concession stakeholder[87]; and
- where the taxpayer chooses a share in a company or an interest in a trust as a replacement asset for the small business roll-over, the taxpayer, or an entity connected with the taxpayer, must be a controlling individual of the company or trust[88].

8.11 The main issues raised in the submissions, articles and commentaries in relation to the controlling individual and CGT concession stakeholder requirements relate to the policy underpinning the use of these concepts and, in particular:

- the inability of many small business operators who were in existence at 21 September 1999 to access the small business CGT concessions because their

83 Subsection 152-10(2).
84 Subsection 152-110(1).
85 Subsection 152-125(2).
86 Subsection 152-305(2).
87 Subsection 152-325(1).
88 Subsection 152-420(5).

pre-existing structure had no controlling individual. With the cost of changing their structure likely to be prohibitive, the pre-existing structure generally excludes them from accessing the concessions even though the other basic eligibility criteria may be met; and

- the practical issues associated with monitoring compliance of controlling individual status for 15 years or more.

8.12 As noted in Chapter 4, however, as these issues relate to the policy underpinning the core eligibility criteria for the small business CGT concessions, they are outside the scope of this review.

SUMMARY OF FINDINGS IN RELATION TO THE CONTROLLING INDIVIDUAL TEST

8.13 The requirement that an individual have at least a 50 per cent direct interest in a company or trust in order to access the small business CGT concessions gives effect to the policy intent.

8.14 The definitions of a controlling individual and CGT concession stakeholder are expressed in a clear, simple, comprehensible and workable manner.

8.15 The controlling individual test and the CGT concession stakeholder concept do not give rise to unintended consequences of a substantive nature as their effect is to limit the application of the concessions to specific types of business structures.

8.16 The controlling individual test is generally consistent with other tax legislation.

8.17 The controlling individual test and the CGT concession stakeholder definitions provide certainty in their application.

CHAPTER 9: ORDER OF APPLICATION OF THE SMALL BUSINESS CGT CONCESSIONS

9.1 The four specific CGT concessions contained in Division 152 are:

Table 9.1: The four small business CGT concessions

Subdivision 152-B	The small business 15 year exemption
Subdivision 152-C	The small business 50 per cent reduction
Subdivision 152-D	The small business retirement exemption
Subdivision 152-E	The small business roll-over

9.2 A taxpayer may be able to benefit from more than one small business CGT concession, provided that the relevant eligibility requirements have been met.

9.3 The concessions also apply in addition to the CGT discount where it is available.

9.4 If the taxpayer qualifies for the 15 year exemption, the capital gain is disregarded entirely and is not taken into account in offsetting capital losses.[89]

9.5 The method of applying the CGT rules to a gain which is not eligible for the 15 year exemption is contained in section 102-5 and is as follows:

- Reduce the capital gains made during the year by any capital losses made in the same year. This reduction occurs in the order chosen by the taxpayer.
- Next, offset any prior year capital losses against any remaining capital gain (in the order the taxpayer chooses).
- For individuals, trusts and complying superannuation funds who qualify for the 50 per cent or 33.33 per cent discount on gains, apply the available discount to the relevant gains.
- Next, if any of the gains qualify for the small business 50 per cent reduction, apply this reduction. Note, however, that section 152-220 allows taxpayers to choose not to claim the 50 per cent reduction on a gain on an active business asset.[90]

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89 Section 152-215 states that the 15 year exemption in Subdivision 152-B has priority over the other small business CGT concessions.

90 This choice allows taxpayers to maximise the amount which is applied towards the retirement exemption.

- Next, apply either of the following concessions:
  - the retirement exemption; or
  - the roll-over into replacement assets.

  If the taxpayer qualifies for both the retirement exemption and the roll-over, the taxpayer can choose in which order to apply these concessions.

- The total of the remaining gains (if any) is the net capital gain for the year which is included in assessable income.

9.6 In Chapters 10 to 13 the operation of each of the four types of small business CGT concessions is evaluated against the review criteria.

CHAPTER 10: THE 15 YEAR EXEMPTION

WHAT DOES THE 15 YEAR EXEMPTION DO?

10.1 The small business 15 year exemption in Subdivision 152-B provides the most benefit of all the small business CGT concessions in Division 152. It takes priority over all the other concessions[91] and provides a complete exemption in relation to the particular gain, without any dollar limit. In addition, provided the relevant conditions are met, the Subdivision provides a mechanism for the gain to be paid out of a company or trust with no tax consequences for the recipient.[92]

APPLICATION OF THE 15 YEAR EXEMPTION TO INDIVIDUALS

10.2 For a taxpayer who is an individual to be eligible for the concession, the following conditions must be satisfied:

- the basic conditions in Subdivision 152-A must be satisfied for the gain;
- the taxpayer must have continuously owned the CGT asset for the 15 year period ending just before the CGT event (subject to very limited roll-over concessions[93]);
- if the CGT asset is a share in a company or an interest in a trust — at all times during the whole period for which the taxpayer owned the share or trust interest, the company or trust must have had a controlling individual (which need not be the same controlling individual during the whole period);[94] and
- either the taxpayer is:
  - fifty-five or over at the time of the CGT event and the event happens in connection with the taxpayer's retirement; or
  - permanently incapacitated at the time of the CGT event.

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91 Section 152-215.
92 Subsection 152-125(2).
93 Continuing time periods are recognised for the 15 year test where the asset is compulsorily acquired, lost or destroyed, is transferred as a result of marriage breakdown, or is transferred as a result of financial services reform (section 152-115).
94 This requirement is modified for discretionary trusts in tax loss years (section 152-120).

10.3 Note that, in the case of a share in a company or an interest in a trust, it is a requirement of section 152-105 that the company have a controlling individual but not that the taxpayer be that controlling individual. The basic conditions for the concessions in section 152-10, however, require that the taxpayer be a CGT concession stakeholder in the company or trust (that is, the controlling individual or the spouse of that individual).[95]

10.4 Where an individual qualifies for the exemption, the capital gain is simply disregarded. This means that the amount of the gain does not offset any capital losses that the individual may have incurred.[96] Nor is it treated as a retirement benefit that counts towards the person's reasonable benefit limits.

APPLICATION OF THE 15 YEAR EXEMPTION TO COMPANIES AND TRUSTS

Eligibility rules

10.5 For a company or trust to be eligible for the exemption, the following conditions must be satisfied:

- the basic conditions in Subdivision 152-A must be satisfied for the gain;
- the company or trust has continuously owned the CGT asset for the 15 year period ending just before the CGT event (subject to the limited roll-over concessions);
- at all times during the whole period for which the entity owned the asset, the entity had a controlling individual (even if it was not the same controlling individual during the whole period);[97] and
- an individual who was a controlling individual of the company or trust just before the CGT event either:
  - was 55 or over at the time of the CGT event and the event happened in connection with that individual's retirement; or
  - was permanently incapacitated at that time.

10.6 For a company or trust, subsection 152-110(2) treats any ordinary or statutory income derived from the CGT event as neither assessable income nor exempt income

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95 Paragraph 152-10(2)(b).

96 See the rules for 'Working our your net capital gain' in section 102-5.

97 The requirement for a controlling individual does not apply for a non-fixed trust in relation to an income year for which the trust did not make a distribution of income or capital, if it had a tax loss for that year (section 152-120).

(except for income arising as a result of a balancing adjustment event occurring to a depreciating asset). This has the effect that the amount does not reduce any capital or other losses available to the entity.

10.7 This provision also has the effect that if the criteria for the 15 year exemption are satisfied, even if the event produces an amount of ordinary or statutory income outside the CGT provisions (other than in relation to balancing adjustments for depreciating assets covered by Divisions 40 and 328) no amount will be included in assessable income (or exempt income) of the entity.

Paying the gain out of the company or trust

10.8 Subdivision 152-C allows the 15 year exemption amount to be passed on tax-free within two years after the CGT event to an individual who was a CGT concession stakeholder of the company or trust just before the event. Specifically, subsection 152-125(2) provides that:

> 'Any payment the company or trust makes (whether directly or indirectly through one or more interposed entities) within two years after the CGT event to an individual who was a CGT concession stakeholder of the company or trust just before the event is not taken into account in determining the taxable income of the company or trust, the individual or any of the interposed entities.'

10.9 This exemption, however, is restricted to the stakeholder's control percentage multiplied by the exempt amount. For companies and fixed trusts the stakeholder's control percentage is determined based on the percentage of interests held in the entity. For non-fixed trusts with one CGT concession stakeholder it is 100 per cent and where there are two CGT concession stakeholders — 50 per cent each.[98]

10.10 Gains on pre-CGT assets are also able to be paid out in this way. That is, if the gain would have been eligible for the 15 year exemption, but for the fact that it related to an asset acquired pre-20 September 1985, the exemption for payments of the gain from the entity to the CGT concession stakeholders applies.[99] This has the effect that the treatment of a gain made on an asset which was acquired before 20 September 1985 is no less concessional than the treatment of a gain which is otherwise within the CGT system.

Issues in relation to the 15 year exemption

10.11 Issues which have been raised in relation to the 15 year exemption can be divided into three categories:

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98 Subsection 152-125(3).
99 Paragraph 152-125(1)(c).

- issues which are relevant to individuals as well as companies and trusts;
- issues which are relevant to individual taxpayers only; and
- issues which are relevant to company and trust taxpayers only.

Issues relevant to individuals as well as companies and trusts

10.12 The following issues were raised in relation to the current format of the concessions:

- the operation of the retirement and/or permanent incapacity requirements; and
- the requirement that a controlling individual be present for the entire period of ownership of the relevant asset.

Retirement and/or permanent incapacity requirements

10.13 It was noted in a number of submissions that particular difficulty arises in determining when the CGT event happens 'in connection with retirement'.[100] The term 'permanent incapacity' is also an undefined term for Subdivision 152-B purposes.

10.14 The Commissioner has provided some guidance in relation to the meaning of 'retirement' in this context, particularly in the ATO Booklet: Advanced Guide to Capital Gains Tax Concessions for Small Business. This booklet and the ATO IDs issued in relation to this requirement[101] indicate that the Commissioner administers this requirement in a practical manner having regard to the particular circumstances of each taxpayer.

10.15 Further ATO guidance dealing with these matters in detail would also be of assistance.

Recommendation 10.1

To be eligible for the small business 15 year exemption, the relevant individual must be retiring or permanently incapacitated.

The Commissioner should provide guidance in relation to the meaning of 'in connection with retirement' and 'permanent incapacity' in the context of the 15 year exemption in Subdivision 152-B.[102]

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100 See submission from Dr Mark Burton, Law School, University of Canberra of 28 February 2005.

101 Although now withdrawn, see, for example, the approach adopted in ATO IDs 2001/606; 2003/328; and 2003/864.

102 Such written ATO guidance may take the form of a Public Taxation Ruling or Taxation Determination, ATO Interpretative Decision, or some other published guide or Fact Sheet.

Controlling individual requirement

10.16 One of the requirements that must be satisfied for the exemption (in the case of company and trust taxpayers,[103] and individual taxpayers disposing of shares or trust interests[104]) is that there must be a controlling individual of the entity during the whole period for which the entity owned the asset. In contrast, the same sections — sections 152-105 and 152-110 — only require that the relevant active asset being disposed of was actually owned for 15 years.

10.17 This inconsistency of testing period can lead to difficulties for taxpayers in establishing that the criteria for the exemption are met, for the following reasons:

- The period that an asset was actually owned by the entity may be considerably in excess of 15 years (and may extend back to pre-20 September 1985). In some cases information in relation to the ownership of the entity over such lengthy periods (including prior to 1985) may simply be unavailable to the current taxpayer.

- Where the controlling individual throughout the period of ownership is not the same person,[105] it may not be possible to obtain the necessary records from previous owners. For example, if the interests in the trust or shares in the company were acquired 20 years ago, the previous owners may now be untraceable or even deceased.

- Even if some records are available, they may not be detailed enough to establish the legal and beneficial ownership of the interests. A controlling individual in an entity must hold both the legal and equitable interests in shares or trust interests that carry at least 50 per cent of the requisite rights. It may be almost impossible for a current shareholder or unitholder in a trust to determine whether a prior individual registered as the owner held those shares or units in the capacity as trustee for another.[106]

- The requirement for legal and equitable interests also raises issues for those companies with two shareholders where one has always held the shares as trustee for the other. In the period prior to Corporations Laws Simplification in 1995, a single shareholder company was not permitted. One hundred per cent beneficial ownership of shares was achieved by having a second shareholder hold shares as trustee for the other shareholder. If the 15 year controlling individual test is applied to this arrangement, only the shares held both legally and beneficially can be counted in determining the existence of a controlling individual.

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103 Paragraph 152-110(1)(c).

104 Paragraph 152-105(c).

105 Paragraphs 152-105(c) and 152-110(1)(c) acknowledge that the controlling individual can change throughout the ownership period.

106 Even if the shares are held as trustee for another individual, it should be noted that neither the legal nor the beneficial owner would qualify as a controlling individual as a controlling individual must hold both legal and equitable interests (section 152-55).

10.18 The difficulties associated with obtaining the records noted above mean that a taxpayer who may be entitled to the 15 year exemption may be unable to establish that entitlement because records have been abandoned before the introduction of Division 152 and in compliance with the normal record keeping rules.

10.19 To reduce some of these difficulties and to provide more workable provisions with reduced compliance costs, an amendment to paragraphs 152-105(c) and 152-110(1)(c) is desirable to match the requirement for a company or trust to have a controlling individual to the same 15 year period as the required ownership of the relevant active asset (that is, the last 15 years of ownership only).

Recommendation 10.2

The requirement for an entity to have a controlling individual to qualify for the small business 15 year exemption is tested over the entire period of ownership of the particular active asset by the entity.

To reduce compliance costs and provide a simple and more practical and workable rule, the requirement for a company or trust to have a controlling individual in paragraphs 152-105(c) and 152-110(1)(c) should be limited to 15 years, to match the required ownership period for the relevant active asset (that is, the last 15 years of ownership only).

Issues relevant to individuals only

10.20 To be eligible for the 15 year exemption (as with all of the small business CGT concessions) the asset must satisfy the active asset test. This test must be satisfied just before the CGT event (or, if the business has ceased in the last 12 months, just before the business ceased) and for at least 50 per cent of the time the asset was owned. Where the asset is a share in a company or an interest in a trust, this will involve satisfying the '80 per cent look through' rule in subsection 152-40(3). This rule has been explained in detail in Chapter 7. For the reasons set out in detail in that chapter, it may be practically impossible for a taxpayer to demonstrate passing this test during the requisite 15 years, except in the simplest of cases.

10.21 For many this means that the ability to claim the 15 year exemption is not a realistic option in practice when selling shares or trust interests in business entities. The compliance costs of establishing entitlement to the exemption may be prohibitive for many small businesses.

10.22 For the reasons set out in Chapter 7 an amendment to the 80 per cent test is recommended in order to substantially reduce compliance costs for taxpayers in relation to gains on the sale of shares in companies or interests in trusts that carry on business and otherwise meet the requirements for the small business CGT concessions.

(See Recommendations 7.5 and 7.6 in relation to amendments to the test for determining whether shares in companies or interests in trusts are active assets.)

Issues relevant to company and trust taxpayers only

10.23 There is some uncertainty in relation to the correct treatment across all areas of the income tax law of payments of the 15 year exempt amount from a company or trust to a CGT concession stakeholder.

10.24 Subsection 152-125(2) provides that:

> 'Any payment the company or trust makes (whether directly or indirectly through one or more interposed entities) within two years after the CGT event to an individual who was a CGT concession stakeholder of the company or trust just before the event is not taken into account in determining the taxable income of the company or trust, the individual or any of the interposed entities.'

10.25 Subsection 152-125(2), however, does not specifically deal with the consequences of the payment in other areas of the tax law and does not clearly identify the nature of the payment being made.

10.26 The term 'any payment' could arguably cover payments of any nature. Within the two year period, the company or trust may make payments to its CGT concession stakeholders in the form of:

- salary;
- fringe benefits;
- repayments of loans;
- dividends; or
- Eligible Termination Payments.

10.27 It is arguably an unintended consequence that these types of payments should have no tax consequences for the CGT concession stakeholder until an amount equal to the exempt amount of the capital gain has been fully paid out.

10.28 Particular concern arises in relation to the payment of amounts which may, in fact, constitute 'dividends' — for example, payments out of a capital profits reserve to the shareholders. Notwithstanding that the effect of subsection 152-125(2) is to treat these payments as not being 'taken into account in determining the taxable income' of the shareholders, the distribution still remains a frankable distribution within the

meaning of section 202-40 and may be required to be franked in accordance with the company's benchmark franking percentage of the relevant franking period.[107]

10.29 If the benchmark franking percentage is greater than zero, there is confusion in relation to the correct outcome under the franking provisions. This is because subsection 152-125(2) states that the payment 'is not taken into account in determining the taxable income of the company or trust, the individual or any of the interposed entities'. The provision does not explicitly make the payment either exempt income or non-assessable and non-exempt income. Where a distribution is exempt income or non-assessable non-exempt income, the franking credit is not included in assessable income and no tax offset is allowed for it.[108]

10.30 This ambiguity could be removed by an amendment to subsection 152-125(2) specifying that the relevant payments are payments of the exempt amount of the gain and not payments of another nature and that these exempt amounts are not treated as dividends or any other form of income.[109]

Recommendation 10.3

Where the 15 year exemption applies to a gain made by a company or a trust, the amount of the gain paid from the company or trust to CGT concession stakeholders in the following two years is ignored for tax purposes.

To improve the consistency of Subdivision 152-B with other areas of the income tax law, section 152-125 should be amended to clarify the nature of the payment which is ignored for the purposes of the 15 year exemption and to ensure that inappropriate outcomes under other areas of the income tax law do not arise.

Two year time frame for payment

10.31 The exemption for payments from the company or trust is limited to payments made within two years after the CGT event. An ability on the part of the Commissioner to extend this time frame is warranted given that many sale of business agreements provide for the proceeds to be received in instalments over a longer than two year period. The existence of a discretion to extend the time frame would provide more workable provisions which would appropriately reflect ordinary commercial practice.

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107 Section 203-25.

108 Section 207-110.

109 It is noted that this confusion is remedied in the case of CGT event E4. Where a non-assessable payment from a trustee is in respect of a unit or an interest in a trust, which would ordinarily reduce the cost base of the unit or give rise to a capital gain under CGT event E4, the 'exempt amount' referred to in section 152-125 is specifically excluded — see paragraph 104-71(1)(g).

Recommendation 10.4

Where a company or trust is eligible for the 15 year exemption, for the payment of this amount to a CGT concession stakeholder in the company or trust to be ignored for tax purposes, it must be paid out within two years.

To take into account actual taxpayer circumstances and commercial practices, section 152-125 should be amended to allow the Commissioner to extend the two year period for payments from the company or trust in appropriate circumstances.

SUMMARY OF FINDINGS IN RELATION TO THE 15 YEAR EXEMPTION

10.32 Generally the provisions of Subdivision 152-B give effect to the policy intention of allowing a 15 year ownership exemption where the relevant taxpayer is 55 or over and retiring or is otherwise permanently incapacitated.

10.33 In relation to the exemption for gains made by individuals, the rules are expressed in a clear, simple, comprehensible and workable manner. Some clarification of the treatment of payments from a company or trust is required, however, for the provisions to be workable in practice for those entities and to be consistent with the treatment of payments generally across the income tax legislation.

10.34 The provisions fail to take account of actual taxpayer circumstances and commercial practices in relation to the determination of ownership by a controlling individual for the entire period an asset was owned by an entity, since there is an inherent practical difficulty in determining this for considerable years prior to the introduction of Division 152.

10.35 The difficulties with establishing compliance with the active asset test for shares and trust interests over a lengthy period have been previously noted. When considered in the context of the 15 year exemption, the active asset test for shares in companies and interests in trusts results in a costly and unworkable test with uncertain outcomes. This may lead to the consequence that the 15 year exemption is not realistically available on the disposal of interests in entities, except in the simplest of cases.

10.36 Although generally consistent with other tax legislation, the provisions demonstrate a lack of consistency in relation to the treatment of payments from a company or trust.

10.37 Except for the issues noted above, the application of the legislation is certain and does not give rise to unintended consequences of a substantive nature.

CHAPTER 11: THE SMALL BUSINESS 50 PER CENT REDUCTION

WHO IS ELIGIBLE FOR THE REDUCTION?

11.1 All taxpayers who meet the basic conditions in Subdivision 152-A are eligible for the 50 per cent reduction.[110] This means, in practice, that the reduction is available to individuals, companies and trusts. The application of the Subdivision to superannuation funds is unclear.[111]

11.2 In the case of trustees assessed under section 99A of the ITAA 1936, section 115-225 reverses the benefit of the small business 50 per cent reduction (as well as the general 50 per cent discount under Division 115).[112]

11.3 As the 15 year exemption has priority, any taxpayer eligible for the 15 year exemption is not eligible for the 50 per cent reduction.[113]

11.4 A taxpayer otherwise eligible for the reduction may choose not to apply it to a particular gain.[114]

HOW DOES THE REDUCTION WORK?

11.5 The Method Statement in section 102-5 provides the manner in which a net capital gain is worked out. The small business 50 per cent reduction applies after any gain has been offset against any available capital losses and any reduction in the gain under the general discount rules in Division 115.

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110 Section 152-205.

111 As the superannuation fund is unlikely to be conducting a business in its own right, it would only be eligible for the reduction if it is 'connected with' the business entity which uses the asset. As discussed in Chapter 6, the Commissioner takes the view that it cannot meet this requirement. Alternatively, the superannuation fund could argue that it is a small business CGT affiliate of the business entity, because it acts 'in concert' with that entity.

112 Trustees are assessed under section 99A of the ITAA 1936 in relation to income to which no beneficiary is presently entitled where the Commissioner does not exercise his discretion to assess the trustee under section 99. See ATO ID 2003/749 for an example of this.

113 Section 152-215.

114 Section 152-220.

11.6 After application of the 50 per cent reduction, the remaining gain may be applied to either or both of the small business roll-over and the retirement exemption.[115]

11.7 A previously deferred capital gain under the roll-over provisions in Subdivision 152-E which is crystallised on the happening of CGT event J2 or J3 is not eligible for a further 50 per cent reduction under the small business CGT concessions in Subdivision 152-C.[116]

Issues raised in relation to the 50 per cent reduction

Different outcomes based on type of entity used

11.8 The main issue raised in submissions in relation to the application of the 50 per cent reduction is the policy issue that different ultimate tax outcomes are achieved by taxpayers depending on the business entity used by the taxpayer. This is summarised in Table 11.1.

Table 11.1: Effect of 50 per cent reduction based on entity used

Individual	Full 50 per cent reduction available.
Discretionary trust	Generally, the full 50 per cent reduction can be paid out without further tax to discretionary beneficiaries.[117]
Unit trust	The 50 per cent reduction amount gives rise to CGT event E4 when paid to unitholders and may give rise to further capital gains in the hands of the recipient of the payment.[118] Capital gains arising as the result of E4 events, however, may be eligible for the small business CGT concessions in their own right, provided the units are held by CGT concession stakeholders and the other relevant conditions are met.
Company	The 50 per cent reduction may be paid out as a taxable dividend while the company is a going concern. Such a dividend is often unfranked as the company has paid no tax on this part of the gain. The payment of the amount by a liquidator of the company does not give rise to a deemed dividend.[119] Rather, on liquidation of the company, the amount constitutes capital proceeds for the cancellation of the shares and may give rise to further capital gains as the result of CGT event C2[120] or G1[121]. Those further gains may be eligible for the small business CGT concessions provided the shareholder is a CGT concession stakeholder and the relevant conditions are satisfied.

115 Section 152-210.
116 Subsection 152-10(4).
117 Although it may be applied to reduce capital losses of a beneficiary — see section 115-215. See also TD 2003/28 in relation to discretionary trust distributions not giving rise to CGT E4 events.
118 Other than unitholders who are the trustees of another fixed trust — see section 104-72.
119 Section 47.
120 Section 104-25.
121 Section 104-135.

11.9 The legislation giving rise to these different outcomes relates to the different tax treatment of entities generally under the income tax law. As such, its operation is not peculiar to Division 152.

Operation of CGT event E4

11.10 The interaction between CGT event E4 and Division 152 appears to give rise to some uncertainty in practice. Many advisers appear mistakenly to believe that the 50 per cent reduction does not give rise to CGT event E4.[122] Some anecdotal evidence suggests that a distribution of the small business 50 per cent reduction is often mistakenly treated as a tax-free distribution along the lines of the general discount (under Division 115). This mistaken application of the law can result in a gain from CGT event E4 not being recognised for tax purposes.

11.11 Further education is required in this area to improve the understanding of how the small business 50 per cent reduction in Subdivision 152-C interacts with CGT event E4.

Recommendation 11.1

Where the small business 50 per cent reduction amount is distributed to interest holders in a trust, CGT event E4 happens which can give rise to further capital gains.

The Commissioner should issue guidance in relation to the operation of Division 152 and CGT event E4 to improve awareness of the tax implications of a distribution of the small business 50 per cent reduction amount to interest holders in trusts.[123]

SUMMARY OF FINDINGS IN RELATION TO THE SMALL BUSINESS 50 PER CENT REDUCTION

11.12 The provisions of Subdivision 152-C and the Method Statement in section 102-5 give effect to the policy intent that active asset gains should be reduced by 50 per cent for eligible small business entities. The ability to choose not to claim the reduction adds a significant level of flexibility for taxpayers who wish to maximise their access to retirement benefits in a non-taxable form.

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122 CGT event E4 arises where the trustee of a trust makes a payment to a taxpayer in respect of a unit or an interest in the trust and some or all of this payment is not included in the taxpayer's assessable income under any other provision (section 104-70). Generally, the effect of the event happening is that the cost base of the unit or trust interest is reduced by the amount of the non-assessable payment. Where the payment is more than the cost base of the unit or the interest in the trust, a capital gain equal to the amount in excess of the cost base generally results.

123 Such written ATO guidance may take the form of a Public Taxation Ruling or Taxation Determination, ATO Interpretative Decision, or some other published guide or Fact Sheet.

11.13 The provisions are expressed in a clear, simple, comprehensible and workable manner, they do not give rise to unintended consequences of a substantive nature, and they take account of actual taxpayer circumstances and commercial practices.

11.14 The outcome in relation to the 50 per cent reduction is consistent with other legislation regarding how other non-assessable amounts are treated and this outcome is certain.

11.15 The most frequently raised issue in relation to the 50 per cent reduction (and, indeed, the other small business CGT concessions) is that the ability to benefit most from the concession is affected by the type of structure that holds the asset. This is not a consequence which is peculiar to the operation of Division 152 but relates to the general taxation treatment of different entities under income tax law.

CHAPTER 12: THE RETIREMENT EXEMPTION

WHAT DOES THE RETIREMENT EXEMPTION DO?

12.1 The retirement exemption in Subdivision 152-D allows a taxpayer to disregard a capital gain if the capital proceeds from the CGT event are used in connection with funding the retirement of the relevant person. There is a lifetime limit per person of $500,000 in relation to all choices made under this exemption.[124]

12.2 The retirement exemption applies after any general discount in relation to the gain has been applied and the 50 per cent reduction is allowed.[125] In many cases, this has the practical effect that the full amount of the gain derived on the sale of a business asset is tax-free for an eligible small business entity.

12.3 In addition, if a taxpayer chooses not to apply the 50 per cent reduction, a larger proportion of the gain can be applied towards the retirement exemption.[126] This may mean in some cases that the full amount of the gain is tax-free even for a company or trust. In this case the company or trust avoids the need to consider the tax treatment of any other form of payment of the gain made out of the entity — since the total gain is paid out in the form of eligible termination payments (ETPs) to the CGT concession stakeholders.

12.4 There is a requirement that, if the recipient of the payment is under 55, the retirement exemption amount must be rolled over into a complying superannuation fund.[127] The law does have built in flexibility, however, in that where there are two concession stakeholders, the gain need not be paid out strictly in proportion to ownership.[128] A greater proportion, for example, could be paid in relation to one CGT concession stakeholder principally to fund that person's retirement.

12.5 Any amount not applied to the retirement exemption can be eligible for the small business roll-over in Subdivision 152-E.[129] This also allows considerable flexibility for eligible small business entities to choose the amount that is to be used for retirement and the amount of the gain which is to be reinvested into other business assets.

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124 Section 152-320.
125 Sections 152-205 and 152-210.
126 This choice is made under section 152-220.
127 Paragraph 152-305(1)(b) and subsection 152-325(7).
128 Subsection 152-315(5).
129 Section 152-210.

Application of the retirement exemption to individuals

When can an individual choose the exemption?

12.6 An individual can choose the retirement exemption provided the following conditions are met:

- the basic eligibility conditions in Subdivision 152-A are satisfied; and
- if the individual is under 55 just before they received an amount of capital proceeds from the CGT event — an amount equal to the CGT exempt amount of the payment (which is deemed to be an ETP by subsection 152-310(2)) must be rolled over into a complying superannuation fund (within the meaning of the ETP provisions in Subdivision AA of Division 2 of Part III of the ITAA 1936).

12.7 If the individual is 55 or over just before they receive an amount of the capital proceeds from the event, there is no requirement for it to be rolled over into a complying superannuation fund.

How is the choice made?

12.8 The choice is made in accordance with the normal CGT rules in Part 3 for making choices. Essentially, section 103-25 provides that a choice must be made by the day the taxpayer lodges the income tax return for the year of the CGT event, or within a further time allowed by the Commissioner.

12.9 Normally the way the return is prepared is sufficient evidence of making the choice.[130] In the case of the retirement exemption, however, the choice must be made in writing and in a way that ensures that the lifetime CGT retirement limit for the individual ($500,000) is not exceeded.[131] The amount so chosen is the CGT exempt amount.

What are the consequences of the choice for an individual?

12.10 The consequences of the choice for an individual are:

- The part of the capital gain that qualifies for the exemption is disregarded.
- The capital proceeds from the event (up to the CGT exempt amount) are deemed to be an ETP.
- That deemed ETP is taken to have been paid to the individual at the later of:

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130 Subsection 103-25(1).
131 Subsection 152-315(2).

  - when the choice for the exemption was made; and
  - when the amount of the proceeds was actually received.

- The amount of this deemed ETP qualifies as a 'CGT exempt component' under the ETP provisions.[132]

12.11 The effect of the formula in section 27AA of the ITAA 1936 is that the CGT exempt component is not a taxable component of the ETP.

12.12 Although not taxable, the deemed ETP must nonetheless be reported to the Commissioner under section 140M and taken into account for RBL purposes. Specifically, subsection 140M(6) provides that notice of the deemed ETP must be given to the Commissioner before the end of the 14th day of the month after the payment month or within such further time as the Commissioner allows. The payment month for these purposes will relate to the month in which the deemed payment occurred — that is the later of when the choice was made (on lodgement of the individual's return) or when actual payment of the capital proceeds was received.

APPLICATION OF THE RETIREMENT EXEMPTION TO COMPANIES AND TRUSTS

When can companies and trusts choose the retirement exemption?

12.13 Companies and trusts (other than public entities) can also choose the retirement exemption and thereby disregard part of a capital gain provided:

- the basic conditions in Subdivision 152-A are satisfied;
- the entity satisfies the controlling individual test — which requires the entity to have a controlling individual just before the CGT event happens;[133]
- each time the company or trust receives an amount of capital proceeds from a CGT event for which it makes the choice the company or trust must make an ETP in relation to each of its CGT concession stakeholders;
- if there are two such stakeholders, the amount of each ETP is to be worked out by reference to each individual's percentage of the CGT exempt amount. Note that these percentages must add up to 100 per cent and it is possible for one to be 0 per cent;

132 Section 27A(1) definition of CGT exempt component.
133 Section 152-50.

- this ETP must be made by the later of:
  - seven days after the company or trust makes the choice for the exemption — which will be done at the time of lodging the relevant company or trust income tax return or within such further time as the Commissioner allows;[134] and
  - seven days after the company or trust receives an amount of capital proceeds from the CGT event;
- the total amount of the ETPs made must be equal to the lesser of:
  - the actual amount of capital proceeds received; and
  - the relevant CGT exempt amount;
- if the stakeholder entitled to the ETP is under 55 just before receiving the ETP, it must be rolled over into a complying superannuation fund; and
- an RBL notification is required to be completed. The ATO also provides a separate (non-compulsory) form — ETP — CGT exempt component roll-over statement — which can be used to give the information required under the Income Tax Regulations to a superannuation fund in relation to the roll-over of a CGT exempt component.

How is the choice made?

12.14 As for individuals, the choice is made by the time the return is lodged by the company or trust (or within such further time as the Commissioner allows).[135] The company or trust must specify in writing the CGT exempt amount for each individual for whom the choice is made. This amount cannot be such as to cause the individual to exceed their CGT lifetime retirement exemption limit.

12.15 In addition, if there are two CGT concession stakeholders in the company or trust, the company or trust must specify the percentage of each asset's CGT exempt amount that is attributable to each CGT concession stakeholder. As noted above, where there are two CGT concession stakeholders, the percentages for each one must add up to 100 per cent in total, but it is possible for one CGT concession stakeholder to receive 0 per cent of the CGT exempt amount.

What are the consequences for the company or trust of the choice made?

12.16 There are three consequences for the company or trust of the choice being made:

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134 Section 103-25.
135 Section 103-25.

- the CGT exempt amount of the gain is disregarded for the company or trust;
- the ETP that the company or trust makes to comply with these provisions is a CGT exempt component for the purposes of the ETP provisions and no tax is required to be withheld when it is paid;[136] and
- the payment of the ETP does not give rise to an allowable tax deduction for the company or trust.[137]

12.17 The treatment of the ETP for the recipient is the same as if the gain had been derived as an individual.

ISSUES RAISED IN RELATION TO THE RETIREMENT EXEMPTION

Policy issues raised in relation to the retirement exemption

12.18 The main policy issues raised in relation to the retirement exemption were the appropriateness of the $500,000 limit and the 55 age limit and the difficulties associated with accessing the concessions because of the requirement that a company or trust have a controlling individual. These issues are summarised in Chapter 4 of this report.

Other issues raised in relation to the retirement exemption

12.19 The practical issues raised in relation to the retirement exemption include:

- the requirement for a company or trust to make an ETP to all CGT concession stakeholders;
- the time frame for rolling the proceeds into the superannuation fund;
- whether an in specie transfer of an asset to the superannuation fund can meet the requirements for the roll-over;
- operation of the deemed market value rule for the capital proceeds;
- access to the retirement exemption for CGT events J2 and J3;
- documentation requirements; and
- whether the deemed dividend provisions in section 109 and Division 7A can apply to the ETP paid under Subdivision 152-D.

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136 Pay as you go (PAYG) withholding Tax tables: Eligible Termination Payments (NAT 3349.02.2004).
137 Paragraph 152-310(5)(b).

The requirement for a company or trust to make an ETP to all CGT concession stakeholders

12.20 To qualify for the retirement exemption, subsection 152-325(1) requires the company or trust to **make an ETP** each time part of the capital proceeds is received. An ETP is defined in subsection 27A(1) of the ITAA 1936 to mean, inter alia, 'any payment made in respect of the taxpayer **in consequence of the termination of any employment** of the taxpayer'. Although paragraph (jaa) of that definition specifically includes the deemed ETP arising under subsection 152-310(2) as an ETP, this only relates to situations where the gain is made by the individual and does not apply to ETPs required to actually be paid by the company or the trust under section 152-325. It follows that the company must actually terminate the employment of each CGT concession stakeholder in order to make an ETP to each person.[138]

12.21 This requirement is difficult to meet in practice and imposes considerable constraints and compliance costs on eligible small business entities who make capital gains in the course of a **continuing** business where the CGT concession stakeholders are either not employees or not, in reality, terminating employment. The following concerns have been raised in relation to the appropriateness of the requirement to 'make an ETP' in the context of the retirement exemption.

- There is no requirement in Division 152 that a CGT concession stakeholder must actually be an employee of the company or trust.[139] CGT concession stakeholder status turns on whether the person is a controlling individual or the spouse of that person. In either case, it is the right to distributions of income and capital from the entity, **not employment**, which is the determining factor. A beneficiary of a discretionary trust, therefore, could be a CGT concession stakeholder irrespective of whether they actually work in the business or have 'employment' status. If the CGT concession stakeholder is not an employee, therefore, it is not possible for the entity to actually pay an ETP to that person.

- Subsection 152-315(5) acknowledges that the amount of one of the ETPs can in fact be zero. It is confusing to imply that a termination of employment must occur for a zero payment with the requisite forms being required to be completed.

- Logically, there should be no requirement for a termination of employment, especially in cases where the CGT concession stakeholder is, in fact, under 55 and the moneys are being rolled over into a superannuation fund. Subdivision 152-D does not in fact require the CGT concession stakeholder to be retiring at the time the retirement exemption is claimed. The point of the exemption, especially for an

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138 See ATO ID 2003/748 (withdrawn) and subsequent comments in the ATO's Booklet: Advanced Guide to Capital Gains Tax Concessions for Small Business.

139 Historically there has been a requirement for employment status for the controlling individual. This was contained in section 160ZZPZP of Division 17B of the ITAA 1936 and section 118-410 of Subdivision 118-F of the ITAA 1997. This requirement was removed on the enactment of Division 152.

individual under 55, is to put the amount of the gain away to fund a **future** retirement.

- The requirement to 'make an ETP' does not take into account actual taxpayer circumstances. It is impractical to require that the realisation of a gain on the sale of a business asset in the course of an ongoing business enterprise (for example, because business premises are too small and being sold and replaced with new premises), should require the termination of employment status simply to make a contribution of the capital gain to a superannuation fund.[140] In no other circumstances does the taxation law have as a condition of an acceptable contribution to a superannuation fund, the termination of the employment of the relevant person.

- Where the gain is made by an individual rather than a company or trust, there is no requirement that the individual be retiring or ceasing a particular type of activity in order for the payment to be deemed to be an ETP. As such, the application of the retirement exemption is inconsistent as between individuals and companies and trusts.[141]

- The requirement in subsection 152-325(1) that the company or trust must make an ETP **each time** an amount of the capital proceeds is paid also highlights the issue of how many times a person's employment can be terminated. Although it is noted that, in ATO ID 2002/494, the Commissioner took the view that the subsequent payments could be treated as in relation to the earlier termination, this approach still leads to uncertainty as to the operation of the law if the person has been 're-hired' because the business continues.

12.22 For all of these reasons it can be seen that the current requirement to make an ETP is uncommercial in its application. Nor is it necessary to support the policy intent of the legislation — to enable amounts to be put aside in a complying superannuation fund for **future** retirement. As such, an amendment to section 152-325 is desirable to the effect that the payment of the amount is deemed to be an ETP rather than required to be actually paid in this form.

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140 In ATO ID 2002/493 (withdrawn), for example, the Commissioner accepted that a CGT concession stakeholder who was a director and an employee could cease to be an employee (and not be re-engaged as an employee in the same capacity) but continue to be a director of the company and this would meet the termination of employment condition. In addition, in the minutes of the meeting of 9 June 2004 of the NTLG Losses and CGT Subcommittee, it was indicated that the ATO was also reviewing the issue of whether a shareholder who was a director, secretary and common law employee of a company could simply resign as secretary and meet the requirements for section 152-325.

141 See ATO ID 2003/658 (withdrawn).

Recommendation 12.1

Where a company or trust derives the capital gain and chooses to use the retirement exemption, the company or trust is required to make an eligible termination payment (ETP) to its CGT concession stakeholder(s).

To remove unintended consequences of the requirement to make an ETP, section 152-325 should be amended to require the company or trust to make a payment of the CGT exempt amount. Under these amendments the amount so paid could be taken to be an ETP.

The time frame for rolling the proceeds into the superannuation fund

12.23 There appears to be some confusion in practice in relation to the time frame for rolling the ETP into the superannuation fund and when the relevant individual must be under 55 years of age. This is set out in Table 12.1.

Table 12.1: When must the person be under 55?

Where the gain is made by:	If the person is under 55 at the following time:	The gain must be rolled into a complying fund:
An individual	Just before they received an amount of the capital proceeds for the CGT event.	Immediately after the later of: • making the choice on the lodgement of the return; and • receiving the amount.
A company or a trust	Just before they received the ETP from the company or the trust. This ETP is required to be paid by the later of: • 7 days after making the choice on the lodgement of the return; and • 7 days after the company or trust receives an amount of capital proceeds from the CGT event.	Immediately — Generally it is required to be paid directly from the payer to the complying superannuation fund. In limited circumstances the Commissioner has accepted that a transfer to the individual and then promptly from the individual to the superannuation fund is acceptable (see TD 96/36).

At what point in time must the person be under 55 for the roll-over to be compulsory?

12.24 For an individual making the gain, if the person was under 55 just before receipt of the capital proceeds, the amount must be rolled into a superannuation fund. The roll-over may happen when lodging the income tax return for the year. Even if the person has reached 55 by that time, the amount must still be paid to the superannuation fund.

12.25 In contrast, where the company or trust makes the gain, the relevant age of the CGT concession stakeholder is the time the ETP is paid — which may be at the time of lodging the company or trust return. This causes some confusion in practice and will become increasingly relevant in the future as the preservation age for superannuation benefits increases to 60.

Recommendation 12.2

Where the retirement exemption is chosen, if the relevant individual is under 55, the retirement exemption amount must be rolled over into a complying superannuation fund.

To provide clearer and simpler requirements with internal consistency within Division 152, the requirement for the relevant individual to be under 55 should be tested in all cases when the choice is made for the retirement exemption — generally on lodgement of the relevant tax return.

Can an in specie transfer of an asset to the superannuation fund meet the requirements for the roll-over?

12.26 In ATO ID 2004/969 (withdrawn) the Commissioner considered whether the roll-over required under paragraph 152-305(1)(b) can be made by transferring real property to a complying superannuation fund (assuming the property satisfies the relevant provisions of the SISA for example, it constitutes business real property).

12.27 Subsection 27A(8) provides that for the purposes of the ETP provisions, 'a transfer of property… shall be deemed to be a payment to, or for the benefit of, the person of an amount equal to the value of the property immediately before the transfer'. That is, an ETP can be paid in the form of a transfer of property. It follows that, provided the value of the asset is at least equal to the amount of the CGT exempt component, it is possible for the Subdivision 152-D requirements to be satisfied with an in specie transfer of an asset to the complying superannuation fund.

12.28 This allows eligible small business entities the flexibility of transferring business real property to the superannuation fund directly and the value of this property to reflect, at least in part, the amount of the CGT exempt component.

12.29 The interaction between Division 152 and the superannuation provisions is a complex area of the law. In order to assist taxpayers and their advisers in applying the law in a clear and correct way with certain outcomes, the Commissioner should issue detailed guidance in relation to the interaction of the ETP, retirement exemption and superannuation fund rules, particularly in relation to acquiring property from related parties.

Recommendation 12.3

There is a high degree of interaction between the small business CGT concessions and the provisions relating to ETPs, superannuation and self-managed superannuation funds (SMSFs).

To assist taxpayers in understanding and correctly applying the rules, in particular in relation to ETPs, the retirement exemption and the ability of SMSFs to acquire business

real property, the Commissioner should publish guidance on the interaction of these provisions.[142]

Operation of the deemed market value rule for the capital proceeds

12.30 The market value substitution rule in section 116-30 provides, inter alia, that:

- if no capital proceeds are received from a CGT event, the taxpayer is taken to have received the market value of the CGT asset that is the subject of the event; and
- where the capital proceeds actually received are more or less than the market value of the asset and the taxpayer and the entity that acquired the asset did not deal with each other at arm's length in connection with the event, the capital proceeds from the CGT event are taken to be the market value of the CGT asset.

12.31 When working out the amount of the capital proceeds which can form the CGT exempt component to be disregarded under the retirement exemption, subsections 152-310(3) and 152-325(4) both require that the market value substitution rule be disregarded. The effect of this should be that only actual proceeds can be treated as an ETP under these provisions. If this is the case, the retirement exemption is not available where an asset is gifted between non-arm's length parties — for example, on transferring of the business assets from an older to a younger generation of a family.

12.32 In practice, however, this result may be avoided by a sale for actual consideration and a subsequent forgiveness of a debt between the related parties.

12.33 Some confusion appears to exist in practice in relation to the effect of the deemed market value rule on the entitlement to use the retirement exemption. This is of particular concern in relation to succession planning in family businesses. This confusion could be reduced if the Commissioner were to issue detailed guidance indicating how the law applies in these circumstances.

Recommendation 12.4

Small business assets are often transferred between non-arm's length parties (for example generations of the same family). These transactions may attract the deemed market value consideration and cost base rules for CGT purposes.

The Commissioner should publish guidance to assist taxpayers in understanding and correctly applying the rules in relation to the deemed market value provisions and the

142 Such written ATO guidance may take the form of a Public Taxation Ruling or Taxation Determination, ATO Interpretative Decision, or some other published guide or Fact Sheet.

retirement exemption, including their application to family succession planning transactions.[143]

Access to the retirement exemption for CGT events J2 and J3

12.34 It is possible for a deferred capital gain under the roll-over provisions of Subdivision 152-E, which has subsequently crystallised as the result of CGT event J2 or J3 happening, to qualify for the retirement exemption.[144] This is a particularly useful element of the concessions, in that it allows eligible small business entities to invest gains in replacement assets during the life of the business and, subsequently roll these original gains into retirement funding to obtain the benefit of the retirement exemption.

12.35 The provisions of Subdivision 152-D, however, do not specifically refer to CGT events J2 and J3 and require technical amendment. Currently, the provisions refer to the CGT exempt amount as part of the capital proceeds from the CGT event that has happened. Technically, there are no capital proceeds for either CGT event J2 or J3, the capital gain is simply the amount previously disregarded under Subdivision 152-E.

12.36 While the Commissioner has dealt with this issue in ATO ID 2004/240 and indicated that the 'capital proceeds' are to be taken to be the proceeds from the original CGT event which gave rise to the deferred gain and this interpretation is in accordance with the policy intent of the provisions, clarifying amendments are desirable.

Recommendation 12.5

A previously deferred capital gain because of the small business roll-over which is crystallised because of CGT events J2 or J3 can subsequently be eligible for the retirement exemption.

An amendment to Subdivision 152-D is desirable to clarify the operation of the retirement exemption in relation to capital gains from CGT events J2 and J3 and ensure that it operates in accordance with the policy intent that previously rolled-over gains may be applied to the retirement exemption.

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143 Such written ATO guidance may take the form of a Public Taxation Ruling or Taxation Determination, ATO Interpretative Decision, or some other published guide or Fact Sheet.

144 Such a capital gain will arise where the taxpayer has previously chosen the small business roll-over and the replacement asset acquired for those purposes has ceased to be an active asset. When this happens, the amount of the previously deferred gain is treated as a capital gain under either CGT event J2 (generally) or CGT event J3 (where the replacement asset was a share in a company or an interest in a trust, and that asset no longer meets the test for being active; or the relevant person has ceased to be a controlling individual of that entity).

Documentation requirements

12.37 Anecdotal evidence suggests that RBL reporting is often overlooked in practice. This is particularly likely to be the case where the sale proceeds are received after the taxpayer's 55th birthday and are retained rather than rolled over into a superannuation fund.

12.38 If this is the case, breaches of an individual's RBL may go undetected and superannuation funds will not be aware that benefits subsequently paid out constitute excessive benefits.

12.39 For these reasons, further guidance may be necessary to ensure that advisers, including financial planners, are aware of the required RBL reporting where an ETP arises under Subdivision 152-D.

Recommendation 12.6

Where the retirement exemption is chosen for an amount, that CGT exempt amount is required to be reported and counted towards the relevant person's reasonable benefit limits (RBL).

The Commissioner should issue detailed education material to tax advisers and financial planners to ensure that the required RBL reporting where an ETP arises under Subdivision 152-D is done.[145]

Can the deemed dividend provisions in section 109 and Division 7A apply to the retirement exemption amount?

12.40 The issue has been raised that it is open for the Commissioner to form the view that an amount paid by a company as an ETP to a CGT concession stakeholder (whatever their level of interest in the company), which would be exempt under Subdivision 152-D, could nonetheless be deemed to be a dividend, either under s 109 (excessive remuneration) or Division 7A (payments to shareholders and associates of shareholders).

12.41 In ATO ID 2003/743 the Commissioner indicated that section 109 could apply to the ETP under Subdivision 152-D and, if it did in a particular case, where the Commissioner after taking all the circumstances of the case into account formed the view that the amount was excessive, the amount would be deemed to be a dividend. This would result in it being excluded from the definition of ETP in subsection 27A(1). The ATO ID states that 'it would be incorrect for the Commissioner to base his decision as to what is reasonable solely with reference to the CGT retirement exemption limit of $500,000.' That is, mere compliance with the limits in Subdivision 152-D does not

145 Such written ATO guidance may take the form of a Public Taxation Ruling or Taxation Determination, ATO Interpretative Decision, or some other published guide or Fact Sheet.

automatically imply that the payment from the company is reasonable and should not be deemed to be a dividend.

12.42 The issue referred to in ATO ID 2003/743 concerned a payment of $500,000 to the single shareholder/employee of a private company who having reached retirement age after five years of working in the company had decided to retire. The company disposed of its assets in order to provide the shareholder/employee with a benefit under the small business retirement exemption. After considering all the circumstances, the Commissioner did not consider the payment of $500,000 to be unreasonable.

12.43 It could be argued that as the introduction of Division 152 post-dates both Section 109 and Division 7A, and was designed to provide CGT concessions (such as the retirement exemption) to CGT concession stakeholders in eligible small business entities, the concessions in Division 152 should not be subject to review under the provisions in Section 109 or Division 7A. Having this concession subject to section 109 review does, in a significant number of instances, add to uncertainty and complexity and results in additional compliance costs as prudent taxpayers may see the need to undertake an assessment (potentially involving an independent analysis) of the reasonableness of any payments made under the retirement exemption.

12.44 The following arguments also support the view that section 109 should not apply to the small business retirement exemption.

- Section 109 operates on a payment by payment basis. In contrast the retirement exemption limit allowed under Subdivision 152-D is a lifetime limit. Capital gains are made by businesses on an irregular basis. Subdivision 152-D allows business owners to consider investing some of the gains for their future retirement. As such, in many cases it could be viewed as remuneration for future work, and not past work.

- The retirement exemption payment made by the company must be made in relation to a CGT concession stakeholder. A CGT concession stakeholder is an owner of the business — a controlling individual and their spouse — and not necessarily a worker in the business. Arguably, then, the retirement exemption amount is not paid to the recipient in their capacity as an employee, since that is not a condition of the payment being made.

- If section 109 can only apply to remuneration, it follows that if the CGT concession stakeholder is not an employee, the provision cannot apply. In contrast, if the CGT concession stakeholder does some part time, irregular work for the business, the provision could apply. This leads to the inconsistent outcome that it could not apply where an owner does no work at all, but could apply where another owner performs a very small amount of work.

12.45 Section 109C in Division 7A provides that payments from a private company to its shareholders, or associates of shareholders, are taken to be an unfranked dividend, unless inter alia:

- the payment is made to the shareholder or associate in their capacity as employee of the company, or an associate of an employee of the company;[146] or
- the payment is made to discharge a pecuniary obligation of the company.[147]

12.46 It follows that the actual payment of an ETP by a company in compliance with the requirements of the retirement exemption could not be deemed to be a dividend by section 109C. However, if the payment were deemed to be an ETP (as proposed in Recommendation 12.1) Division 7A arguably could apply.

12.47 That section 109 or Division 7A could be used effectively to limit the amount of an exemption explicitly provided for as a concession in Subdivision 152-D introduces ongoing uncertainty into the provisions, and presents an inconsistency between the operation of Division 152 and the relevant deemed dividend provisions.

12.48 In contrast, this issue does not arise in the context of the 15 year exemption under which considerably greater sums than $500,000 could be paid to a shareholder in a private company. That is because subsection 152-125(2) explicitly provides that payments from the company representing the exempt amount are not taken into account in determining the taxable income of the individual. Given that this is consistent with the policy intent that the small business CGT concessions assist taxpayers in funding their retirement, it is appropriate that a similar outcome should apply to a gain which benefits from the retirement exemption.

12.49 These inconsistencies could be eliminated with a specific provision removing a CGT exempt component within the limits set by Subdivision 152-D from the operation of any of the deemed dividend provisions. Such an amendment would give effect to the policy of permitting a lifetime limit of $500,000 to be available to CGT concession stakeholders provided it goes towards retirement funding for the particular person.

12.50 There are, however, arguments to support another view, ie the safeguarding application of section 109 (and similar provisions) should not be automatically excluded simply because the amount paid is sourced from an amount that is exempt from CGT by reason of the retirement exemption. This view would consider that the fact that a payment has such a source may be all the more reason that the safeguarding nature of section 109 should not be lost.

12.51 This view considers the purpose of section 109, in general terms, is to prevent a private company from unreasonably reducing its taxable income by making excessive

146 Subsection 109ZB(3).
147 Section 109J.

payments to members and related persons in the guise of remuneration for services or retiring allowances. The safeguards provided by section 109 might be indirectly defeated if a relevant amount paid can never be treated as unreasonable irrespective of factors such as the terms of employment, the length of service, the level of remuneration during the period of service, other benefits to which the retiree may be entitled and commercial practice.

Recommendation 12.7

Where the retirement exemption applies in relation to payments from a company, it is possible for various deemed dividend provisions to apply to the transaction.

To clarify the application of the deemed dividend provisions in section 109 and Division 7A, and support the policy of allowing a lifetime limit of $500,000 to fund the retirement of a CGT concession stakeholder, amendments should be introduced to ensure that none of the deemed dividend provisions have application in relation to CGT exempt components within the meaning and limits of Subdivision 152-D.

Other minor amendments required

12.52 It is noted that Note 2 in Step 4 in the Method Statement in section 102-5 does not accurately state the current law and needs to be amended to reflect the correct operation of the small business CGT concessions.

Recommendation 12.8

The CGT provisions contain a Method Statement in section 102-5 explaining how to work out the amount of a net capital gain.

A minor amendment to correct Note 2 in Step 4 in the Method Statement in section 102-5 should be made to accurately state the operation of the small business CGT concessions.

SUMMARY OF FINDINGS IN RELATION TO THE RETIREMENT EXEMPTION

12.53 Subdivision 152-D gives effect to the policy intent that a retirement exemption of up to $500,000 per individual be available to eligible small business entities.

12.54 The key rules are generally expressed in a clear, simple, comprehensible and workable manner. Some confusion exists, however, when dealing with the deemed market value rule. Clarification is also warranted in relation to the operation of the exemption in relation to previously rolled over gains under the small business roll-over which have subsequently been crystallised on CGT events J2 and J3.

12.55 Apart from the requirement of a company or trust to make an ETP, application of the retirement exemption generally avoids unintended consequences of a substantive nature.

12.56 The requirement of a company or trust to make an ETP fails to take account of actual taxpayer circumstances and commercial practices. It is difficult and cumbersome to comply with and does not take into account the commercial reality of an ongoing business which makes gains through its life that are chosen to be used to fund the future retirement of a controlling individual and/or their spouse.

12.57 While the provisions have an interaction with the ETP and superannuation provisions, they fail to deliver consistency with other tax legislation in some cases, particularly in relation to the possibility of the deemed dividend provisions also applying.

12.58 For those who can qualify for the concession (and except for the ETP requirements), the outcome is certain and generous.

CHAPTER 13: THE SMALL BUSINESS ROLL-OVER

WHAT DOES THE SMALL BUSINESS ROLL-OVER DO?

13.1 The small business roll-over in Subdivision 152-E allows a taxpayer to choose to defer paying tax on a capital gain on an active asset. The nature of the deferral is that the amount of the deferred gain must be used to acquire replacement active assets within a set time frame. The deferral only continues while those replacement assets maintain their status as active assets in their own right. If that status changes, the deferred gain is crystallised as a separate CGT event — J2 or J3.

13.2 Although the word 'replacement' is used in the provisions, the asset acquired as a replacement is not required to be similar to, or fulfil the same function as the original asset.[148] It simply needs to qualify as an active asset in its own right.

Eligibility for the roll-over

13.3 The specific requirements to be satisfied to obtain the roll-over are set out in section 152-410 and are as follows:

- the basic conditions in Subdivision 152-A are satisfied for the gain;
- one or more CGT assets are chosen as replacement assets during the period starting one year before and ending two years after the last CGT event in the relevant year for which the small business roll-over has been chosen;
- the replacement asset satisfies the following conditions:
  - the replacement asset is acquired during the period starting one year before and ending two years after the happening of the last CGT event in the income year for which the roll-over is obtained.[149] The Commissioner has the ability to extend these time limits;

148 See ATO ID 2003/147.

149 This time period is extended where the non-receipt rule in section 116-45 has previously applied to reduce the consideration payable and, subsequently, an additional amount is received — see subsection 152-420(2).

- a replacement asset must be an active asset when it is acquired or an active asset by the end of two years after the last CGT event during the year for which the roll-over is chosen; and
- if the replacement asset is a share in a company or an interest in a trust, the taxpayer or an entity connected with the taxpayer must be a controlling individual of the company or trust just after the taxpayer acquired the share or interests which is the replacement asset for the roll-over.

13.4 The form of the roll-over is that the capital gain that would have remained apart from the roll-over is disregarded to the extent to which it does not exceed the total of the first and second elements[150] of the cost base of the replacement assets.[151]

13.5 Note that the effect of the roll-over is not to reduce the cost base of the replacement asset. Such a reduction would lead to an inappropriate result on the subsequent sale of that asset by potentially attracting the general discount and the active asset reduction again. Instead, the deferral is akin to a 'tag' which attaches to the replacement asset. Should the conditions for the roll-over cease, the 'tagged' amount is treated as a separate capital gain which is not eligible for the discount, the 50 per cent reduction or the 15 year exemption. In these cases, the CGT provisions continue to apply as normal to the asset which was 'tagged'.

Effect of change of status of the replacement asset

13.6 Where the replacement asset ceases to be an active business asset, the deferred capital gain is crystallised as a gain on a separate CGT event in the year of the change of status of the asset. Where such a gain is made on a CGT event J2 or J3, the taxpayer has three choices in dealing with this gain:

- treat the amount as a taxable capital gain for the year of the change of status and include it in the calculation of the total net capital gain for the year under section 102-5 as normal;
- roll-over the deferred amount again against the acquisition of new replacement assets acquired within one year before and two years after the change in status of the replacement asset under Subdivision 152-E; or
- apply the previously deferred amount towards the retirement exemption in Subdivision 152-D.

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150 The first element of the cost base is the money paid or required to be paid in respect of acquiring the asset and/or the market value of any property given or required to be given in respect of acquiring the asset (subsection 110-25(2)). The second element of the cost base is the incidental costs incurred to acquire the asset or that relate to the CGT event that happens in relation to the asset (subsection 110-25(3)).

151 Section 152-415.

What causes a change in status?

For replacement assets other than shares in companies or interests in trusts

13.7 Where the replacement asset is not a share in a company or an interest in a trust, the following circumstances give rise to a capital gain under CGT event J2 equal to the amount of the deferred gain rolled over against this asset's acquisition:

- the asset stops being the taxpayer's active asset;
- the asset becomes trading stock;
- the asset is the subject of a testamentary gift under the Cultural Bequests Program; or
- the taxpayer starts to use the asset solely to produce their exempt income or non-assessable non-exempt income.

For replacement assets that are shares in companies or interests in trusts

13.8 Where the replacement asset chosen is a share in a company or an interest in a trust, the amount of the deferred gain will be crystallised as a taxable capital gain under CGT event J2 in a year in which any of the following happens:

- any of the following events happen to the share or the trust interest:

  A1 — Disposal of the asset
  C2 — Cancellation, surrender or similar ending of the asset
  E1 — A trust is created over the asset
  E2 — The CGT asset is transferred to a trust
  G3 — Liquidator or administrator declares shares worthless
  I1 — The taxpayer ceases to be a resident;

- the share or trust interest becomes trading stock; or
- the taxpayer starts to use the share or trust interest solely to produce their exempt income or non-assessable non-exempt income.

13.9 In addition, the gain can also be crystallised under CGT event J3 if any of the following happens:

- if the replacement asset conditions were satisfied because the taxpayer was a controlling individual of the company or trust — if the taxpayer ceases to be a controlling individual;

- if the replacement asset conditions were satisfied because an entity connected with the taxpayer was a controlling individual of the company or trust:[152]
  - that entity stops being a controlling individual of the company or trust; or
  - that entity stops being connected with the taxpayer; or
- the share or trust interest ceases to be an active asset.[153]

Effect of death on roll-over

13.10 Section 152-425 provides limited rules for dealing with the circumstances of the death of a taxpayer who has applied the roll-over to a replacement asset. Essentially it provides that, provided the status of the active asset continued for the deceased, anything done or not done by the deceased in relation to the asset is treated as if it had been done or not done by the deceased's legal personal representative ('LPR').

13.11 Ultimately, should the asset pass to a beneficiary of the estate, provided the status of the asset did not change in the hands of the deceased or, in the case of replacement assets that are shares in companies or interests in a trust, in the hands of either the deceased or the deceased's LPR, then anything done by the deceased or the LPR in relation to the asset is treated as having been done by the beneficiary.

Issues raised in relation to the small business roll-over

13.12 Issues raised in relation to the small business roll-over include:

- the time frame in which the replacement asset must be 'active' and the Commissioner's discretion to extend the period in which to acquire the replacement asset;
- the amount of the roll-over;
- extending the roll-over to improvements to active assets;
- the timing of making choices for the roll-over;

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152 Note, however, if the taxpayer was also a controlling individual of the company and remains as such, CGT event J3 will not happen just because the connected entity ceases to be a controlling individual of the company or trust (subsection 104-190(4)).

153 The tests for whether a share or trust interest is an active asset have been discussed in detail in Chapter 7 and turn on the satisfaction of an 80 per cent active asset 'look through' rule. Note that subsection 104-190(5) provides that a failure of this test does not happen simply because of changes in the market values of assets that were owned by the company or trust when the share or trust interest was chosen as a replacement asset.

- the risk of penalties and interest where a replacement asset is not acquired;
- choosing shares or trust interests as replacement assets; and
- how the provisions work on the death of the taxpayer.

Time frame in which replacement assets must be active

13.13 The replacement asset must be acquired no later than two years after the last CGT event in the relevant year for which the roll-over was claimed.[154] In addition, the replacement asset must also be active when it is acquired or by the end of the same two year period.[155] This allows a taxpayer a time frame between acquiring an asset and it becoming an active asset. For example, a business could acquire new business premises, subject to a short term lease to an unrelated party. Provided that lease ends and the business commences to use the property directly in its own business activities before the expiry of the two year period (or holds it ready for such use in that time frame), the conditions for the roll-over will be met.

13.14 It has been noted in submissions, however, that the Commissioner has the power to allow an extension of the two year period for acquisition of the replacement asset, but no similar discretion applies to the requirement for the time frame in which the asset must in fact be active.[156] In effect, if the Commissioner did extend the period for the acquisition beyond the initial two year period, the replacement asset could only meet the conditions if it was active immediately on acquisition. This is inconsistent with the leeway provided for assets acquired within the two year period and does not take into account practical taxpayer circumstances.

13.15 In many circumstances it will be impossible for an asset to be 'active' immediately it is acquired. Acquired for these purposes essentially turns on the time the relevant CGT event happens.[157] On a purchase of premises, for example, CGT event A1, by virtue of the timing rules in section 109-5, will result in the asset being treated as acquired by the purchaser when the contract is entered into. Prior to settlement, it would be difficult to argue that the asset is 'used' or 'held ready for use' in the course of carrying on the business.[158]

13.16 This issue could be resolved with an amendment to allow the Commissioner, in appropriate circumstances, to extend the time frame in which the asset can become

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154 Subsection 152-420(1).
155 Subsection 152-420(4).
156 See submission from the ICAA of 28 February 2005.
157 See definition of acquired in section 995-1 and the general acquisition rules for CGT in section 109-5.
158 The Commissioner also acknowledged in the minutes to the 28 November 2001 NTLG CGT Subcommittee meeting that in some cases it may be difficult to satisfy the active asset requirement within the two years, even though the asset is acquired within that time frame (see item 4.3).

active. Further guidance published to explain the circumstances in which the discretions in Subdivision 152-E would be exercised should also be provided.

Recommendation 13.1

To be acceptable as a replacement asset for the small business roll-over, the asset must be acquired within a set time frame and it must also be active within a set time frame. The Commissioner has a discretion to extend the acquisition time frame but not to extend the time frame in which the replacement asset must be 'active'.

An amendment should be made to section 152-420 to allow the Commissioner a discretion to extend the time period in which a replacement asset must be 'active' in appropriate circumstances. This would avoid unintended consequences arising in the case of normal taxpayer circumstances and commercial practices on the acquisition of assets.

Recommendation 13.2

The Commissioner should provide guidance in relation to when the discretions to extend the time frame in which to acquire replacement assets, and in which the assets must be 'active', is likely to be exercised.[159]

The amount of the roll-over

13.17 Currently Subdivision 152-E does not operate to permit a roll-over of only part of the gain, where the cost of the replacement asset is equal to or greater than the amount of the capital gain as shown in Illustration 13.1

159 Such written ATO guidance may take the form of a Public Taxation Ruling or Taxation Determination, ATO Interpretative Decision, or some other published guide or Fact Sheet.

Illustration 13.1: Roll-over of part of the gain

The John Smith Family Trust has disposed of an active business asset and made a capital gain of $200,000. This gain is reduced by 50 per cent under the general discount rules in Division 115 to $100,000. It has been further reduced by 50 per cent under Subdivision 152-C for the small business 50 per cent reduction, leaving a remaining amount of $50,000.

The trustee has acquired a new business asset for a cost of $75,000. The trustee wishes to roll over $35,000 against the acquisition of the new asset and show the remaining $15,000 as a taxable capital gain for the year.

Currently, Subdivision 152-E does not allow a taxpayer to choose to roll over less than the $50,000 amount.

13.18 The inability to choose to roll-over only part of the gain under the small business roll-over is in contrast to the flexibility available under the retirement exemption in Subdivision 152-D. Under that Subdivision, a taxpayer is permitted to choose to disregard 'all or part of a capital gain' which is applied towards retirement funding.[160]

13.19 To introduce similar flexibility to allow a roll-over of a lesser amount than the full amount of the gain remaining, after the general discount and the small business 50 per cent reduction, would allow taxpayers more choice in how they apply their capital gains and be consistent with the other provisions of Division 152. Moreover, as any amounts not rolled-over or applied to the retirement exemption will be included in taxable income in the year the gain was made, this flexibility does not result in any loss of revenue.

Recommendation 13.3

An eligible small business entity cannot choose to roll over only part of an active asset gain against the acquisition of replacement active assets.

To support the policy of the small business CGT concessions applying in a flexible manner and allowing taxpayers the maximum amount of choice, consistent with the other concessions available under Division 152, an amendment should be made to Subdivision 152-E to permit taxpayers to roll-over all or part of a gain against replacement active assets.

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160 See subsection 152-305(1) in relation to gains made by individuals; and subsections 152-305(2) in relation to gains made by companies or trusts.

Extending the roll-over to improvements to active assets

13.20 The amount of the roll-over cannot exceed the first and second elements of the cost base of the replacement assets. This requirement, together with the explicit requirement that the taxpayer must acquire a replacement asset (in subsection 152-420(1)) means that a roll-over is not permitted where the capital gain is to be used to improve assets already owned.

13.21 The first element of the cost base is the total of:

- the money paid or required to be paid in respect of acquiring the asset; and
- the market value of any property given or required to be given, in respect of acquiring the asset.[161]

13.22 The second element of the cost base is the incidental costs incurred:

- to acquire the CGT asset; or
- that relate to a CGT event that happens in relation to the asset.

13.23 Incidental costs are specifically defined in section 110-35 to be:

- remuneration for the services of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal adviser;[162]
- costs of transfer;
- stamp duty or other similar duty;
- costs of advertising to find a seller or buyer; and
- costs of obtaining a valuation or apportionment for the purposes of the CGT provisions.

13.24 The main issue arising in relation to the use of the first two elements of the cost base and requiring that the replacement asset be 'acquired' is that it denies a roll-over against the cost of improvements to :

- upgrade active assets already owned; or
- new assets purchased that require improvements to be undertaken shortly after purchase to place the asset in a useable condition for the business.

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161 Subsection 110-25(2).

162 Note that tax advice costs are included in incidental costs provided the tax advice is provided by a recognised tax adviser.

13.25 It would also deny the roll-over where the gain is used to fund the building of new premises on post-CGT land already held. The new premises are not separate assets 'acquired'. Rather the cost of the building would be a capital improvement which would form part of the fourth element of the cost base of the land and, as such, be excluded.[163]

Illustration 13.2: Capital improvements to active assets

The White Family Discretionary Trust carries on a child care business from premises it has owned at two separate locations since 1990. Three years ago the Trust acquired the property next door to one of its child care centres. It made the acquisition in the hope that it would be able to extend its current premises. It also wanted to ensure that no inappropriate development was undertaken next door to its centre.

In 2005, the trustee has decided to amalgamate the two properties and build extended child care facilities. In order to finance this, the trust decides to sell the premises it owns at its other location. This sale realises a capital gain of $600,000. After applying the general discount and the active asset reduction, the remaining amount of the capital gain is $150,000. The costs of the building work on the extended child care premises is $250,000 and the trustee would like to roll over the capital gain made against the improvements to be undertaken to its other active business asset.

Such a roll-over is not permitted by the current provisions of Subdivision 152-E.

13.26 As shown in Illustration 13.2, a business that sells assets in order to fund significant upgrades to other business assets already held is denied access to the roll-over. If the roll-over were extended to include the fourth element of the cost base, a business reinvesting in existing assets would be able to access the concession. This would be in line with the general policy intent of the provisions to permit eligible small business entities to reinvest capital gains on active business assets into other business assets and would take into account actual taxpayer circumstances and commercial choices open to them.

13.27 The roll-over provisions may have excluded fourth element expenditure on the basis that this element is not eligible to be included in the cost base of the asset if it ceases to be reflected in the state or nature of the asset at the time of a later CGT event. CGT event J2 could be amended to deal with this situation by triggering the capital gain under CGT event J2 if an amount rolled over was used for a capital improvement and that expenditure subsequently ceased to be reflected in the state or nature of the relevant asset or the improved asset itself ceased to be an active asset.

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163 It was reported in the minutes of the NTLG Losses and CGT Subcommittee meeting of 9 June 2004 that the building materials purchased should not be viewed as the replacement assets, as they would not be active in their own right. The building that is constructed with those materials is the relevant thing to consider (see Item 12.3 of the minutes).

Recommendation 13.4

An eligible small business entity can only claim the small business roll-over against the cost of *acquiring* replacement active assets.

An amendment should be made to section 152-415 to allow the small business roll-over where the amount of the capital gain to be disregarded does not exceed the cost of capital *improvements* which form part of the fourth element of the cost base of an active asset. This would give effect to policy to permit the rolled over amount to be reinvested generally in active business assets.

A related amendment be made to section 104-185 to ensure that CGT event J2 happens if the deferred capital gain is applied to capital improvements to an active asset and either those improvements cease to be reflected in the state or nature of the asset or the improved asset ceases to be an active asset.

The timing of making choices for the small business roll-over

13.28 Subdivision 152-E simply provides that a taxpayer 'can' choose to obtain a roll-over provided the relevant conditions are satisfied. This choice must be made by the day of lodgement of the income tax return for the year of the relevant CGT event or within such further time as the Commissioner allows.[164] Subsection 103-25(2)states that:

> 'The way you (and any other entity making the choice) prepare your income tax return is sufficient evidence of the making of the choice.'

13.29 In addition, as is noted by paragraph 103-25(3)(c), the small business roll-over also allows a period extending from one year before to two years after the relevant CGT event in which to choose the replacement assets (paragraph 152-410(b)).

13.30 It was pointed out by the Administrative Appeals Tribunal (AAT) in Re *Sherlinc Enterprises Pty Ltd and Federal Commissioner of Taxation*[165] that section 103-25 prescribes the time and method for making permitted choices but it does not operate to validate a choice in circumstances where the pre-conditions for making the choice have not been met.

13.31 Although the Tribunal in that case was comparing the wording of Division 17A of the ITAA 1936 and Division 123 of the ITAA 1997, its conclusions in relation to the validity of choices are relevant for Subdivision 152-E. In the *Sherlinc* case it was held that a valid choice cannot be made if acceptable replacement assets are not in fact acquired within the set time frame (up to two years after the last CGT event in the year the gain was made).

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164 Subsection 103-25(1).
165 [2004] AATA 113.

13.32 As a result, two issues arise in relation to the mechanics for making choices for the small business roll-over:

- given the decision in the *Sherlinc* case, can a taxpayer make a valid choice for the roll-over if the replacement assets have not in fact been acquired as at the date of lodgement of the income tax return for the year of the capital gain; and
- if so, where no replacement asset has been acquired at the time of lodgement of the return and therefore no valid choice has been made, the ability to make such a later choice will lie only with a favourable exercise of the Commissioner's discretion to allow further time to make the choice under paragraph 103-25(1)(b).[166]

Is it possible to make a valid choice before the replacement assets have in fact been acquired?

13.33 The Commissioner's approach to the making of choices is set out in ATO IDs 2003/102 and 103. This approach turns on the view that the choice must be made at the time of the lodgement of the return, irrespective of whether the replacement assets have in fact been acquired at that time. As such, it is at odds with the approach taken by the AAT in the *Sherlinc* case. This has resulted in uncertainty as to the manner in which the law currently operates. This uncertainty places taxpayers at risk of not complying with the law and, as a result, being subsequently found to be ineligible for the small business roll-over.

13.34 It is understood that the ATO is currently working on resolving this issue and may issue a Practice Statement to provide guidance as to whether capital gains intended to be rolled over should be disclosed on returns lodged, pending satisfaction of the requirements for the roll-over.[167]

Could a taxpayer not choose the roll-over on lodgement of the return, but subsequently claim the roll-over when replacement assets are acquired?

13.35 Following the reasoning in the *Sherlinc* decision, a taxpayer who has not actually acquired the replacement assets at the time of lodging the relevant income tax return cannot make a valid choice for the roll-over at that time. Subsequently, if the replacement assets are acquired, the ability to claim the roll-over would only arise if the Commissioner allowed further time for making the choice.

13.36 In considering whether the Commissioner would allow such further time in which to make a choice, the Commissioner appears to have taken the approach of trying to determine if the taxpayer genuinely intended to acquire replacement assets at

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166 This will be so irrespective of whether there is evidence of a purported choice having been made one way or another on the return.

167 See comments in Item 12.1 of the Minutes to the 9 June 2004 NTLG Losses & CGT Subcommittee meeting.

the time the return was lodged or whether the taxpayer had made a choice not to claim the roll-over (and is subsequently changing their mind).

13.37 This issue has been considered in two ATO IDs — 2003/102 and 103. Originally, in ATO ID 2003/102 it was stated that:

> 'A taxpayer who has considered the application of the CGT concessions and chosen a particular concession, **or alternatively decided not to choose any concession** has made a choice which cannot later be changed. However, a taxpayer who did not consider the CGT concessions and accordingly included a capital gain in their income tax return has not made a choice and can, if the Commissioner allows further time, later make a choice for a CGT concession and amend their return to reduce or disregard the capital gain.' [Emphasis added]

13.38 ATO ID 2003/102 was amended and re-issued in May 2005 as part of the review being conducted by the ATO of when a choice can be made for the small business roll-over. In the amended version of ATO ID 2003/102, the emphasised words noted above have been removed. Notwithstanding this deletion, the ATO has taken the view that it would be reasonable for the Commissioner to allow an extension of time to make a choice for the small business roll-over where the choice was not made originally because of an oversight by the taxpayer's former tax agent in the preparation of the income tax return.

13.39 The above ATO IDs indicate that the Commissioner's approach is to allow such an extension only if there is evidence that no choice was made on lodgement of the return and based on a consideration of the following factors:

- evidence of an acceptable explanation for the period of extension requested (and whether it would be fair and equitable in the circumstances to provide such an extension);
- prejudice to the Commissioner which may result from the additional time being allowed (but the mere absence of prejudice is not enough to justify the granting of an extension);
- unsettling of people, other than the Commissioner, or of established practices;
- fairness to people in like positions and the wider public interest;
- whether any mischief is involved; and
- consequences of the decision.

13.40 If the approach taken in the *Sherlinc* decision is correct, where the replacement asset has not in fact been acquired before lodgement of the relevant return, the ability to later make a valid choice will always be subject to a favourable exercise of the Commissioner's discretion. That is, the taxpayer will have no automatic right to claim

the small business roll-over in all such cases. The exercise of the Commissioner's discretion therefore will turn on the above factors. The prospect of all taxpayers who have not acquired the replacement asset at the time the relevant income tax return is lodged, subsequently requesting the Commissioner to exercise his discretion to extend the time for the choice, will result in increased compliance and administration costs.

13.41 In contrast to the approach in the *Sherlinc* case, the Commissioner's approach in the ATO IDs appears to be that, if a choice to claim or not to claim is indicated at the time of lodgement of the return, that choice is valid and cannot be changed. The Commissioner would only be called upon to exercise his discretion, therefore, if no choice was in fact made at the time of lodgement of the original return. This leaves open the uncertainty as to whether taxpayers can establish on an individual by individual case basis whether they have in fact made a choice not to use the roll-over, or whether they have failed to make a choice at all.

13.42 Clearly the small business roll-over, in allowing a further two years in which to acquire an asset, contemplated that the income tax return for the relevant year may be lodged prior to the replacement asset actually being acquired. Is it necessary for the taxpayer to explicitly make the choice at this time if replacement assets are subsequently acquired? Is the intention of the taxpayer at this time more important than the actual act of acquiring the replacement assets within the two year time period? Arguably the most important condition for the small business roll-over is the actual acquisition of replacement assets. If a taxpayer has in fact met this requirement within the appropriate time frame, there is no compelling reason to deny access to the roll-over based on the manner in which the return for the year of the gain may or may not have been completed (or, indeed, intended to be completed).

13.43 It is desirable that the uncertainty surrounding the making of choices for the roll-over be resolved with a legislative amendment. A more workable approach to the making of choices in this area could be as follows:

- allow the choice to be made on the lodgement of the return where the replacement asset has in fact been acquired by that time; and
- where no replacement asset has been acquired at the time of the lodgement of the return, permit the roll-over to be available for the year of the gain where the conditions of the roll-over are subsequently met. This would allow taxpayers to choose to either not show the gain (as is the current practice) or disclose the gain and later amend the assessment where the conditions for the roll-over are subsequently met.

Recommendation 13.5

The operation of the current rules for making choices under the small business roll-over is not clear.

In order to provide more workable rules for making choices under the small business roll-over, amendments should be made to the process and timing rules for making choices in section 103-25 to clarify how and when the small business roll-over choices can be made.

These amendments should enable a taxpayer to be eligible for the small business roll-over if the conditions for the roll-over are subsequently met, irrespective of whether the original return disclosed the gain in full.

Risk of penalties and interest where replacement asset not acquired

13.44 The decision in the *Sherlinc* case also has implications for the imposition of penalties and interest when a taxpayer has chosen the small business roll-over when lodging the return but has failed to acquire the replacement asset within the statutory period allowed.

13.45 As noted above, in the minutes for the NTLG Losses and CGT Subcommittee Meeting of 9 June 2004, it was indicated that the ATO was preparing a Law Administration Practice Statement dealing with whether it is expected that taxpayers would need to include gains in the original returns when they are intended to be rolled over. In the absence of legislative clarification, such a Practice Statement should be issued to provide guidance for taxpayers and their agents.

13.46 If the gain is not required to be included, the Commissioner should provide guidance on the circumstances in which any shortfall penalties and/or interest will be remitted.

Recommendation 13.6[168]

The Commissioner should issue a Practice Statement or other guidance clarifying whether taxpayers should include capital gains in their returns when they are intended to be rolled-over or whether the return may be lodged without the gain.

If the latter, the Commissioner should provide guidance in relation to the circumstances in which tax shortfall penalties and/or interest charges will be remitted.

Choosing shares or trust interests as replacement assets

13.47 To qualify for the roll-over in circumstances where replacement assets are shares or trust interests, the taxpayer **or an entity connected with the taxpayer** must be a

168 Note that if Recommendation 13.5 were to be accepted, the need for such additional guidance may only be required in limited situations.

controlling individual of the company or trust just after the share or trust interest is acquired.[169]

13.48 As currently defined, it is not possible for an 'entity connected with the taxpayer' to be a 'controlling individual' of a company or trust. This is because a controlling individual is an individual (that is, natural person) who holds the legal and equitable interests in at least 50 per cent of the relevant shares or trust interests. As the concept of connected entity is based on 'control',[170] it is not possible for an individual to be a 'connected entity' of another individual. The concept of CGT concession stakeholder is the appropriate concept to apply in these cases, as this refers to controlling individuals and their spouses, where the spouse holds an ownership interest in the entity.

13.49 For these reasons, the roll-over requirement in subsection 152-420(5) should be amended to require that, just after the share or trust interest is acquired, the taxpayer must be a CGT concession stakeholder in the entity. This requirement would then be met if the taxpayer holds 50 per cent of the interests in their own right, or the taxpayer is the spouse of another person who is a controlling individual in the entity at that time and holds an ownership interest in the entity.

Recommendation 13.7

The ability of shares in a company or interests in a trust to qualify as acceptable replacement assets raises issues relating to whether the holder of the shares is a natural person who is a controlling individual or the spouse of the controlling individual who holds an ownership interest in the entity.

To give practical effect to these requirements for replacement assets which are shares or trust interests, subsection 152-420(5) should be amended to require that, where the replacement asset is a share in a company or an interest in a trust, just after the share or trust interest is acquired, the taxpayer must be a CGT concession stakeholder in the entity.

How the provisions work on the death of the taxpayer

13.50 A range of small business CGT tax issues are triggered as the result of the death of a taxpayer. The provisions of Subdivision 152-E highlight that the current outcomes do not give effect to the overall policy intent that death should not result in capital gains being crystallised[171] and that gains on active business assets should qualify for the small business CGT concessions if the basic eligibility criteria are met.

169 Subsection 152-420(5).
170 See section 152-30.
171 Division 128 of the ITAA 1997.

General rule for active assets on death

13.51 In relation to active assets generally, on the death of the taxpayer, the asset devolves to the deceased person's LPR. While this does not give rise to a capital gain or loss in the deceased's final return (section 128-10), the status of active asset does not automatically flow through to the estate. The normal rules for the treatment of CGT assets on death will apply and the estate will be taken to have acquired the asset as at the date of death,[172] and will inherit the deceased's cost base.[173] A market value cost base will apply if the asset was pre-CGT in the hands of the deceased.[174]

Where the estate does not carry on business

13.52 Should the LPR ultimately sell the asset, if the estate does not carry on the business (even for one day), the asset will have no active asset status, even though it may have qualified as an active asset for the entire period it was owned by the deceased.

13.53 This means that an untimely death of a business person which causes the cessation of a business and the sale of the business assets by the deceased's estate may result in a taxable capital gain in the hands of the estate. This is the case notwithstanding that, had the asset been sold immediately before death, the deceased would have qualified for the small business CGT concessions.

Where the estate or beneficiary uses the inherited asset in a business

13.54 In contrast, if the estate actually does continue to carry on the business, or the beneficiary to whom the asset passes uses the asset in a business (irrespective of whether this was the deceased's business), the asset will have active asset status in that entity's hands.

13.55 If it is subsequently sold, the period of time during which the asset must be shown to be active for at least 50 per cent of the time, will commence from when actual ownership was acquired by the LPR or the beneficiary, as the case may be.[175] As such, the deceased's use will be irrelevant.[176] For example, a beneficiary of the estate could acquire the asset, use it for the full period of ownership (say 1 month) in a business and then sell the asset and attract the small business CGT concessions, provided the other conditions are met.

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172 Subsection 128-15(2).
173 Subsection 128-15(4).
174 Item 4 in the Table in subsection 128-15(4).
175 See ATO ID 2004/531.
176 See ATO ID 2003/165 (withdrawn).

Rule where there is a deferred capital gain under Subdivision 152-E

13.56 Where the deceased has previously rolled-over an amount under Subdivision 152-E, section 152-425 has the effect that, provided the replacement asset remained 'active' in the hands of the deceased, anything done or not done by the deceased in relation to the replacement asset is treated as if it had been done or not done by the deceased's LPR.

13.57 Ultimately, should the asset pass to a beneficiary of the estate, provided the status of the asset did not change in the hands of the deceased or, in the case of replacement assets that are shares in companies or interests in a trust, in the hands of either the deceased or the deceased's LPR, then anything done by the deceased or the LPR in relation to the replacement asset is treated as having been done by the beneficiary.

13.58 The practical impact of this is that, if the estate and/or the beneficiary does not in fact continuously maintain the active asset status of the replacement asset in their own hands from the date of death onwards, there may be CGT consequences for the estate or the beneficiary when they sell the asset. As such, the concession provided by section 152-425 is of little practical value if the estate or the beneficiary faces difficulties in, or has no power to, continue to run the business. The result will be that the death will give rise to a capital gain in the hands of the estate or the beneficiary on a subsequent sale.

The result on death evaluated against the review criteria

13.59 The outcomes in the three situations described above are not consistent with the overall policy intent of Division 152 that eligible small business entities should be given access to the small business CGT concessions. They result in unintended consequences of a substantive nature and do not take into account the situation of a family forced to sell business assets due to the untimely death of a family member.

13.60 Moreover, the treatment of active assets on death is not consistent with the treatment of inherited main residences and pre-CGT dwellings under the CGT provisions. In these cases the trustee of the deceased's estate has two years in which to sell the asset and take advantage of the exemption that would have been available to the deceased (provided that other relevant conditions are satisfied). This time frame recognises the difficulties associated with the administration of estates and the length of time it may take to dispose of assets and/or resolve disputes between beneficiaries.

13.61 To allow a similar two year time frame in which the LPR or beneficiary may sell the deceased's active assets would promote consistency within the CGT rules which apply to deceased estates.

13.62 Some submissions also indicated possible confusion around the interaction of CGT events J2 and J3 with the concessions.

Recommendation 13.8

Where a deceased's legal personal representative (LPR) disposes of an asset which had been an active asset in the hands of the deceased, the estate cannot automatically qualify for the small business CGT concessions.

To provide more workable rules for the treatment of active assets on the death of an individual, and to promote consistency of treatment of assets under the CGT rules generally, Division 152 should be amended to allow the deceased's LPR or a beneficiary of the deceased's estate to be eligible for the small business CGT concessions where:

- the asset is disposed of within two years of the date of death; and
- the asset would have qualified for the small business CGT concessions if the deceased had disposed of the asset immediately before his or her death.

Recommendation 13.9[177]

There are generally no CGT consequences on the death of a taxpayer.[178] The interaction of the provisions that apply on the death of a small business taxpayer with the small business CGT concessions is not well understood.

To assist taxpayers in understanding and correctly applying the rules in relation to the operation of Divisions 128 and 152, and CGT events J2 and J3[179], the Commissioner should publish further guidance on the interaction of these provisions.

SUMMARY OF FINDINGS IN RELATION TO THE SMALL BUSINESS ROLL-OVER

13.63 Subdivision 152-E does give effect to the policy intent that eligible small business entities that reinvest capital gains on business assets into new business assets should be permitted a deferral in relation to the tax liability on the original gain. It is within this policy intent that an eligible small business entity should be eligible for the roll-over where the gain is used to upgrade other capital assets already held and amendments should be made to permit this.

13.64 Although the legislation is generally expressed in a clear, simple, comprehensible and workable manner, it is desirable that the current technical difficulties associated

177 Note that, if amendments in line with Recommendation 13.8 were to be enacted, those amendments could also apply to the happening of CGT events J2 and J3 triggered by the death of the taxpayer.

178 Division 128 of the ITAA 1997.

179 Section 104-185 and 104-190 of the ITAA 1997.

with the mechanism for making the choice for the roll-over be resolved with an amendment to the legislation.

13.65 The legislation fails to avoid unintended consequences of a substantive nature in so far as a change in status of the asset is likely to occur upon the death of the taxpayer. This is of particular concern in relation to roll-over assets which do not continue to be used in a business of the LPR or beneficiary as relevant.

13.66 The legislation generally takes account of actual taxpayer circumstances and commercial practice.

13.67 The treatment of active assets on the death of the taxpayer is not consistent with other tax legislation, particularly where there is a deferred capital gain.

13.68 In other areas, the outcome of the deferral is certain. However, the provisions which deal with the making of a choice to use the roll-over give rise to uncertainty and would benefit from amendment.

Part C

Evaluation of the compliance and administrative costs of the small business CGT concessions in Division 152 of the *Income Tax Assessment Act 1997*

CHAPTER 14: OVERVIEW OF THE EVALUATION OF THE COMPLIANCE AND ADMINISTRATIVE COSTS ASSOCIATED WITH THE DIVISION 152 CONCESSIONS

14.1 Part C of this report provides details of the analysis conducted by Atax to identify, estimate and evaluate the operating costs of the small business CGT concessions.[180] Operating costs comprise compliance costs incurred by taxpayers and administrative costs incurred by the Australian Taxation Office (ATO). Compliance costs, which may be transitional (one-off) or recurrent (on-going), may be actual expenses or time costs and could be incurred by either affected taxpayers or by their tax practitioners. Tax practitioners may pass some, all or none of their costs on to clients.

14.2 The costs are analysed from a number of perspectives. A (quantitative) estimate of the typical compliance costs incurred by individual claimants of the concessions is provided. An estimate is also provided of the compliance costs incurred by a typical tax practice in dealing with the small business CGT concessions. These figures are then used to calculate the aggregate costs incurred, on a society-wide basis. Finally, a (more qualitative) evaluation of incremental costs, identifying the extent to which they may have changed as a result of the 1999 reforms to the concessions, is also undertaken.

14.3 This Part is structured as follows. Chapter 15 considers the research methodology that was employed in the project, and Chapters 16 and 17 detail the substantive outcomes from the focus groups and surveys that were conducted in order to explore the individual, aggregate and incremental compliance costs of the concessions. Chapter 18 is concerned with administrative costs. Conclusions are provided in Chapter 19.

14.4 The research methodology utilised interviews, focus groups, and large and small scale postal and electronic surveys. Business taxpayers, tax practitioners and ATO officers who have had exposure to the small business CGT concessions were all involved in this extensive process. This Part reflects an analysis of the information collected in the research project, together with analysis of the various submissions to the Board of Taxation and other literature and documents.

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180 As noted in Part A of this report, the Board of Taxation commissioned Atax (the Australian Taxation Studies Program), part of the Law Faculty of The University of New South Wales, to conduct an evaluation of the compliance and administrative costs of Division 152.

COMPLIANCE COSTS

14.5 At the individual level, and based on data relating to the 2002-03 year, claimants typically incurred transitional compliance costs of nearly $700 in learning about the small business CGT concessions, and incurred recurrent compliance costs of about $1,250 in actually claiming the concessions. Just over half of the transitional costs and over 80 per cent of the recurrent costs were represented by fees paid to practitioners. The balance was a combination of a monetary value of the time spent by the business taxpayers on issues relating to the concessions and external costs such as valuation fees etc. These amounts are not large in absolute terms. While they may not be insignificant to the business taxpayers concerned, their impact needs to be seen relative to the increased benefit of the concessions to those taxpayers.

14.6 At the level of the tax practice, the evidence suggests that practitioners typically incur transitional compliance costs of about $12,500 and annual recurrent compliance costs of about $5,000 per practice (the figures vary according to the size of the practice) relating to the concessions. Practitioners are not able to pass on the bulk of these costs to clients — approximately 58 per cent of transitional costs and 56 per cent of recurrent costs are absorbed by the practice.

14.7 Extrapolating these figures to the broader economy, and taking into account that practitioners claim that roughly 60 per cent of transitional and recurrent costs cannot be passed on to their clients, the aggregate transitional compliance costs are estimated currently to be about $223 million. Aggregate annual recurrent compliance costs are estimated to be about half that amount, at roughly $110 million. Both estimates are likely to be at the upper end of the possible range of estimates for the following two reasons (detailed in Chapter 17). Firstly, such estimates are very sensitive to the value placed on practitioner time. Secondly, the practitioners surveyed may have over-represented the general population of practitioners so far as work on small business CGT concessions is concerned. While material in absolute terms, the estimates fit comfortably with existing knowledge of compliance costs of legislative provisions.

14.8 For reasons explained in Chapter 15, it was not possible to estimate the amount by which compliance costs may have changed (upwards or downwards) as a result of the introduction of the revised small business CGT concessions in 1999. A qualitative analysis, however, clearly indicates that these incremental compliance costs are likely to have increased since 1999. This is a view strongly held by practitioners and confirmed (on a much smaller scale) by ATO officers. This outcome is not surprising given there are more concessions with more rules and conditions.

ADMINISTRATIVE COSTS

14.9 The ATO has estimated that its aggregate recurrent administrative costs were around $2.3 million (mostly on labour and related costs) in 2003-04. This estimate is not

large in absolute terms, and these figures are relatively small in comparison to the administrative costs of other tax reform measures. The evidence derived from the project also indicates that the initial administrative costs after the introduction of the small business CGT concessions in 1999 (primarily involving ATO staff learning about the concessions) may have been higher although the amounts involved cannot now be quantified. Subsequently these initial costs are likely to have settled down and are neither high nor relatively significant.

SUMMARY — TOTAL OPERATING COSTS

14.10 In summary, therefore, the transitional and recurrent operating costs of the small business CGT concessions are as follows:

Table 14.1: Operating costs of the small business CGT concessions

	Transitional costs ($)	Recurrent costs ($)
Average		
Business taxpayer	681	1,261
Tax practitioner	12,443	4,873
Aggregate		
Compliance costs	223 million	110 million
Administrative costs	Not available	2 million
Operating costs	Not available	112 million

14.11 The qualitative evidence suggests that the 'rationalisation' and 'streamlining' of the small business CGT concessions in 1999 may not have, as indicated in the Explanatory Memorandum and Regulation Impact Statement, 'reduce[d] compliance costs'. While the qualitative evidence suggests that compliance costs are likely to have increased since the 1999 changes, the lack of a reliable benchmark for the pre-1999 compliance costs means that there is no quantitative data to confirm this. There is probably more evidence to support the 1999 contention that 'the measures…are not expected to give rise to any significant increase in administration costs', again subject to the caveat that no pre-1999 benchmark exists against which to judge this assertion.

14.12 Even though the compliance costs may not have reduced since 1999, the evidence indicates that the small business CGT concessions are not a significant issue for business taxpayers. Business taxpayers' compliance costs are absolutely and relatively insignificant. The concessions are a compliance cost issue for tax practitioners, who face significantly higher relative and absolute costs and who cannot pass on most of those costs to their clients. However, this needs to be considered in the context that the benefits of the concessions for their clients have increased.

CHAPTER 15: RESEARCH DESIGN

15.1 The aim of Part C of this report is to estimate and evaluate the operating cost[181] implications of the concessions introduced in Division 152 of the ITAA 1997. Part of the focus of the project is upon the aggregate operating costs of the small business CGT concessions.[182] This Part also analyses, on a qualitative basis, whether the introduction of Division 152 in 1999 has led to any change in the compliance costs incurred by small business taxpayers and administrative costs incurred by the ATO (that is an evaluation of the incremental costs).

15.2 The following sections detail the design and methodologies through which both the compliance costs and administrative costs of the small business CGT concessions were explored.

COMPLIANCE COSTS

15.3 Compliance costs are generally defined as those costs incurred by taxpayers or by third parties in meeting the requirements laid upon them in complying with a given tax structure or set of provisions. Typically they comprise a monetary value of the time that taxpayers spend in dealing with their tax affairs (or particular aspects of their tax affairs), together with the monetary costs (whether expended on the provision of professional assistance from tax practitioners and others, or on incidental expenses connected to the obligations imposed upon them as a result of the requirements of the tax system) incurred by the taxpayer.

15.4 The Regulation Impact Statement accompanying the New Business Tax System (Capital Gains Tax) Bill 1999 identified affected taxpayers as small business taxpayers disposing of certain CGT assets. In principle, the population of affected taxpayers in any particular year includes both those taxpayers that claimed small business CGT concessions that year as well as those that considered claiming the concessions but did not make a claim in that year. In practice, it is possible to identify the former group from the ATO's tax returns database but it would not be possible to identify the latter group in any reliable way. Thus, this study focuses only on those small business taxpayers that actually claimed the small business CGT concessions in 2002-03.

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181 Compliance costs for taxpayers and administrative costs for the revenue authority.

182 No attempt has been made to estimate the absolute operating costs of the broader tax system.

15.5 The omission of the latter group has only a minimal impact for the following reasons:

- Small business taxpayers that considered claiming the concessions but did not do so in a particular year may eventually claim the concessions in a later year. If this is the case, their learning costs would, in principle, be captured by Part B of the taxpayer questionnaire.[183] Only those that considered claiming the concessions but that never actually make a claim are therefore omitted from this study.

- It was suggested in the focus group interviews[184] that those small business taxpayers that considered claiming the concessions but did not do so in the same year would have incurred only negligible costs. They would simply be told (at virtually no cost) by their tax practitioners that they would not be eligible for the concessions.

- This point has been confirmed by empirical data derived under this Part as well as from the non-commercial losses post-implementation review undertaken by the Board of Taxation in 2004,[185] which suggests small business taxpayers typically rely on their tax practitioners for all aspects of their tax affairs.

15.6 Traditionally, compliance costs arising from a tax change comprise transitional (one-off) and regular (on-going) compliance costs. In the context of the small business CGT concessions, the distinction between transitional and recurrent compliance costs is somewhat blurred. In many instances, for those small business taxpayers that claim the concessions only once, there is no distinction between transitional and recurrent costs. Even for small business taxpayers that claim more than once, their regular compliance costs would not be affected on an ongoing basis — they would only be affected on an occasional basis.

15.7 In addition, to determine whether Division 152 has reduced compliance costs for small business taxpayers at the individual level is, in principle, counterfactual. Those taxpayers that claim small business CGT concessions in the post-1999 situation would not be in a position to identify how Division 152 would have reduced their compliance costs had they made their claims under the pre-1999 legislation.

15.8 In principle, it might be possible to compare the aggregate compliance costs arising from the small business CGT concessions in the pre-1999 and post-1999 situations. But there are two major issues with this approach. First, it would not be possible, in practice, to obtain information to reliably estimate the pre-1999 aggregate compliance costs. The passage of time makes any such estimating process unreliable at best. Secondly, the aggregate compliance costs reflect not only the complexity of the

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183 This is discussed in greater detail below.
184 See Chapter 16.
185 Board of Taxation, Post-implementation review of the quality and effectiveness of the non-commercial losses legislation, June 2004.

legislation but also the number and category of claims made in a particular year. The Board of Taxation has been advised that the number of claims grew from approximately 11,000 in the year ended 30 June 2001 to 20,000 in the year ended 30 June 2003.

15.9 Therefore, in order to analyse the incremental compliance costs arising from Division 152, the research team chose to employ a more qualitative approach. Since most of the compliance costs are incurred (initially) by tax practitioners, it would appear logical to extract qualitative information about compliance costs primarily from relevant tax practitioners.

15.10 Bearing the above discussion in mind, paragraphs 15.13 to 15.20 below set out in greater detail the conceptual framework used to estimate the compliance costs of the small business CGT concessions.

15.11 In order to obtain the compliance cost data and information required for this Part, a combined methodology primarily involving focus groups and mail surveys was employed. The focus groups were designed as a forum in which stakeholders such as business taxpayers, tax practitioners and representatives of tax professional bodies could identify key compliance cost issues relating to the legislation. This qualitative data was then additionally used as the basis for designing and conducting broader mail surveys of business taxpayers and tax practitioners potentially affected by the small business CGT concessions.

15.12 In addition, the submissions to the Board of Taxation on the small business CGT concessions post-implementation review by various taxpayers, tax practitioners and professional organisations were analysed in order to establish whether there were any features that related specifically to the compliance costs of the small business CGT concessions. The qualitative outcomes of this review were also factored into the design of the mail surveys in order to seek to test, empirically, the validity of any contentions made by those submissions.

Conceptual and Estimating Framework

Distinction between transitional and recurrent compliance costs

15.13 The distinction between transitional and recurrent compliance costs for taxpayers is somewhat blurred in the case of the small business CGT concessions. This is because CGT events are essentially non-recurrent in nature. For many affected taxpayers, claiming the small business CGT concessions is a one-off happening so that their transitional and recurrent costs coincide. Even for small business taxpayers that claim the concessions more than once, their recurrent compliance costs would only be occasional. Notwithstanding this blurring, it still makes good sense to separate transitional and recurrent compliance costs for small business taxpayers.

15.14 The distinction between transitional and recurrent costs is, however, more meaningful in the case of tax practitioners who typically incur some learning costs initially and recurrent costs in advising their clients on a more regular basis.

The role of tax practitioners in estimating tax compliance costs

15.15 If all tax practitioners can pass on 100 per cent of their costs (both in terms of their professional hours and out-of-pocket expenses) in advising their clients, then we can focus on taxpayers and ignore tax practitioners in estimating tax compliance costs. While tax practitioners may be able to pass on 100 per cent of some of their costs (for example, costs of obtaining specialist advice) to clients, it has been established that tax practitioners are generally unable to pass on all of their costs (especially learning costs) to clients (especially small business clients). Thus, in estimating tax compliance costs we need to consider both affected taxpayers and tax practitioners. Naturally care must be taken to ensure that double counting does not take place.

Transitional social compliance costs (TSCC)

15.16 The transitional social compliance costs consist mainly of learning costs incurred by taxpayers and tax practitioners. Transitional compliance costs of taxpayers normally include value of time spent on learning about the legislation and fees paid to their tax practitioners. Transitional compliance costs of tax practitioners normally include value of time spent and other non-labour costs. Since tax practitioners typically pass on some of their learning costs to their clients (in the form of one-off fees), simply adding transitional costs of taxpayers and transitional costs of tax practitioners together will result in double counting.

15.17 In view of the fact that tax practitioners are normally unable to pass on all of their transitional costs to their clients, we may write:

$$TSCC = \text{Value of (transitional) time spent by taxpayers} + \text{transitional costs of tax practitioners}$$

Recurrent social compliance costs (RSCC)

15.18 By the same argument, assuming that tax practitioners can pass on only a fraction of their costs to clients, we can also write

$$RSCC = \text{Value of (recurrent) time spent by taxpayers} + \text{recurrent costs of tax practitioners}$$

15.19 Each term on the right hand side of the above equations can be estimated by combining macro-statistics provided by the ATO and sample data derived from the survey. For example:

Value of transitional time spent by taxpayers = $N \times h \times V$

where

N = number of affected taxpayers (derived from the ATO's SUPERX database);

h = average number of hours spent by affected taxpayers on learning about the small business CGT concessions (derived from sample data); and

V = average value of time of affected taxpayers spent on learning about the small business CGT concessions.

15.20 Where data permit, the model can be further refined to enable disaggregation to take place (for example, breaking the number of taxpayers down into discrete groups). This enables a higher degree of precision in the estimating process, and is adopted in this Part wherever possible.

Focus groups

15.21 Focus group research is based on facilitating an organised discussion with a group of representative individuals. Discussion is used to bring out insights and understanding in ways which simple questionnaire items may not be able to tap. The focus groups served the additional purpose of acting as a 'cognitive laboratory' for the development of ideas and items for inclusion in the survey instruments that were in the process of being designed while the focus groups were being conducted.

15.22 Three focus group interviews were held in the period from 18 February to 25 March 2005. The first comprised five national representatives of tax and tax related professional bodies, addressing issues relating to the operating cost implications of the small business CGT concessions. The second and third interviews involved nine tax practitioners from a variety of Sydney and regional accounting and legal practices, all with heavy exposure to the operation of the small business CGT concessions.

15.23 Prior to the focus group study, participants received, in writing, a sheet outlining the project and issues that were to be discussed at the meeting. They were not paid for their involvement, but all were happy to volunteer their time.

15.24 Each focus group used an external professional moderator to facilitate (and not dominate) the discussion and each was attended by at least two members of the research team. The Atax researchers acted primarily as observers in the process, although an opportunity was given for the research team to pose specific questions or make specific comments at the end of each of the sessions.

15.25 Each of the sessions lasted between one and one a half hours, and was deliberately kept small in order to allow plenty of scope for deeper discussion than would have been possible had more participants been involved. It was decided that it would be inappropriate to audio or video record any of the proceedings, and this adoption of 'Chatham House rules' encouraged greater freedom of expression than might otherwise have been the case. Notwithstanding this, it was made clear at the outset that the research team wished to take notes. None of the participants objected to this.

15.26 The principal outcomes of the focus group discussions are detailed in Chapter 16.

15.27 The research team was not able to conduct a focus group study of five or more small business taxpayers that had experience of the small business CGT concessions. This was primarily due to the unwillingness of such taxpayers to participate in such discussions, despite repeated attempts by the research team. As an alternative, a member of the research team contacted several individual business taxpayers to establish their broad views on small business CGT concessions.

Review of submissions to the Board of Taxation

15.28 A total of 20 submissions, mainly from professional and industry organisations and accounting practices with a high small business profile, were made to the Board of Taxation as part of the post-implementation review of the small business CGT concessions. These submissions were analysed by the research team. The submissions received focused primarily on the technical issues associated with the concessions, and the majority made no direct reference to the compliance costs associated with the concessions. Those submissions that did refer to the compliance costs tended to be assertions or based upon anecdotal evidence. A typical statement was that 'compliance costs are still a major issue with regard to the current provisions'.[186]

15.29 However, two of the submissions clearly considered that a high level of compliance costs was self-evident from the complexities, technical issues and unintended consequences in Division 152. CPA Australia noted that '... it is clear that while the changes to the former CGT provisions have improved their coverage and flexibility somewhat, there has been no corresponding reduction in complexity or in the associated compliance costs for taxpayers and their practitioners'. In addition, Hayes Knight referred to the review undertaken by the ATO of a sample of taxpayers that had claimed the small business CGT concessions. Its submission stated that 'a questionnaire that ran to more than fifteen pages suggests that the application of the legislation is complex', and cited this as evidence that the compliance costs for taxpayers would be significant.

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186 The Pharmacy Guild of Australia's submission to the Board of Taxation.

15.30 Other references to compliance costs, where they did appear, tended to be general in nature. One specific aspect of the compliance costs of the concessions was identified, however, in the Grant Thornton submission. It noted that '[p]resently the law imposes an unnecessary compliance burden on taxpayers to determine the value of their net assets', referring to the $5 million maximum net asset value test.

15.31 Finally, one submission identified an issue faced in this review in determining a comparison with the previous small business CGT concessions. It stated that '[i]n the absence of such baseline data it is difficult to determine whether or not the Government's reformed small business capital gains concessions have succeeded or not'.[187]

Mail surveys

15.32 The mail survey method has been widely used in compliance costs studies. It is chosen primarily because it is the most cost-effective way of reaching a large number of targeted respondents residing in a wide geographical area. With the assistance of the ATO, stratified random samples of the population of business taxpayers and tax practitioners can be chosen. Further, respondents have the opportunity to complete the questionnaires at a time and place suitable to them, including access to historical information, if necessary. There is also less risk of the interviewer/researcher influencing responses.

Questionnaire design and testing

15.33 The survey instruments were designed to meet the following objectives:

- User friendliness: the questions were kept short and language simple, wherever possible, to encourage legibility and maximise response rate. The layout reflected suggestions from the ABS Statistical Clearing House and from other stakeholders, as a result of the circulation of drafts of the proposed survey instruments.

- Administrative simplicity: colour coding of the various forms was used to distinguish between first and second mail outs. Data entry number boxes were employed to facilitate ease of data capturing.

- Comprehensiveness: the number of questions was kept to a minimum to encourage responses. However, a large amount of relevant quantitative and qualitative data needed to be collected. This necessitated a six A4-page questionnaire for business taxpayers and a nine A4-page questionnaire for tax practitioners (excluding covering letters from the Board of Taxation and the Commissioner of Taxation).

187 Dr Mark Burton's submission to the Board of Taxation.

- Regulation compliant: the questionnaires have to be compliant with the guidelines of the ABS Statistical Clearing House before an approval number can be granted.

15.34 Using the input from the focus group studies and the review of submissions, and in close consultation with representatives of the Board of Taxation (and the ABS Statistical Clearing House to a lesser extent), two survey instruments were developed — one for taxpayers affected by the small business CGT concessions, and one for tax practitioners with experience of the concessions.

15.35 The first questionnaire was designed to collect both quantitative and qualitative information about the compliance costs relating to Division 152 incurred by small business taxpayers. For the benefit of participants, it distinguished between transitional and recurrent costs. It comprised a general information sheet and four sections, contained in six well-spaced A4 pages. Part A (comprising six questions) elicited background information in 2002-03 about respondents, ranging from the legal form of their business, connected entities, main business activity and annual turnover. Part B (eight questions) focused on the quantification of transitional compliance costs related to the small business CGT concessions, and Part C (five questions) related to the quantification of the recurrent compliance costs of the concessions. The final part of the taxpayer survey (seven questions) sought information of both a qualitative and a quantitative nature. In this part business taxpayers were invited to signal agreement/disagreement (using a five point Likert scale) to various statements about the compliance cost implications of the small business CGT concessions, and — to the extent that these responses suggested that there were significant compliance cost implications — were then invited to quantify those implications. Respondents were also invited to add any further comments. Finally they were asked to estimate the time taken to complete the questionnaire and to voluntarily identify themselves for a post-survey verification exercise.

15.36 The second questionnaire surveyed tax practitioners to identify and determine relevant compliance costs and the extent to which they were able to pass them on to their clients. Again it covered both qualitative and quantitative aspects relating to both the transitional and recurrent compliance costs of the concessions. It contained five sections, and the larger number of questions posed to practitioners compared to business taxpayers (55 as opposed to 26) necessitated a somewhat longer form — nine pages in total.

15.37 A critical difference between the two questionnaires was Part D in the tax practitioner questionnaire (non-existent in taxpayer questionnaire). This Part was designed to seek tax practitioners' view of the legal simplification impact of Division 152 — in other words, to evaluate incremental changes that may or may not have occurred in comparing the pre- and post-1999 situations.

15.38 The questionnaires were sent out to a small number of business taxpayers and tax practitioners for pilot testing, as well as to various stakeholders associated with the

project. No major comments were received as a result of this testing. The questionnaires were then approved by the ABS Statistical Clearing House for distribution.

Sample selection

15.39 The participants of the two surveys were selected from the ATO's SUPERX Database using the following process.

Business taxpayers

15.40 The sample of business taxpayers was chosen according to the following criteria.

- The relevant tax year was 2002-03. The rationale for choosing 2002-03 was that this was the latest year for which the ATO had a complete data set of small business taxpayers.
- The relevant population was the population of Australian small business taxpayers that claimed any of the small business CGT concessions in 2002-03 (roughly 20,000 claimants).
- The population of relevant taxpayers was stratified by reference to four categories of legal form (sole trader, partner, trust and company) and four categories of types of small business CGT concessions claimed (15 year exemption, 50 per cent reduction, retirement exemption and roll-over).
- From each of the 16 cells of the above stratified population, approximately 40 business taxpayers were chosen by the simple, systematic, random sampling method. This gave rise to a mail out sample of 640 business taxpayers.

15.41 Consideration was given to randomly surveying business taxpayers that may not have claimed the small business CGT concessions, but that may have incurred compliance costs in examining Division 152 to determine if it was worthwhile claiming a CGT concession. It was determined, however, that this was not feasible, as it would entail drawing a significantly larger sample with no guarantee that such taxpayers would necessarily fall within that sample. However, the information obtained from the tax practitioner focus group suggests that this group would incur negligible costs so that they can effectively be ignored.

Tax practitioners

15.42 The sample of tax practitioners was also chosen from the stratified population of small business taxpayers mentioned above. From each cell of this stratified population, approximately 40 tax practitioners were selected by the simple, systematic, random sampling method. This gave rise to a mail out sample of 640 tax practitioners.

15.43 Note that the selected tax practitioners were generally not practitioners to the selected sample of taxpayers. Such a relationship, if it existed, was only by coincidence.

Survey distribution

15.44 The mailing of the surveys represented a joint effort by the Atax team, the ATO and the Board of Taxation:

- the Atax research team provided all the questionnaires and reply paid envelopes;
- the ATO supplied the address labels, a covering letter signed by the Commissioner and the mailing service; and
- the Board of Taxation provided another covering letter signed by the Chairman of the small business CGT concessions Working Group and, for the second mail out, a reminder.

15.45 The above combination of independent organisations preserved participants' confidentiality and anonymity. To minimise out-of-frame participants (see below), the printed address labels were checked manually by the ATO. As the survey forms were sent out using ATO envelopes, returned mail was sent back to the ATO.

15.46 The first mail out for business taxpayers and tax practitioners was sent out on Thursday 14 April and Monday 18 April 2005, respectively. This covered 640 taxpayer questionnaires (blue colour) and 640 tax practitioner questionnaires (yellow colour). The contents of a typical envelope consisted of covering letters from the ATO and the Board of Taxation, a questionnaire and a reply paid envelope.

15.47 The second mail out for business taxpayers and tax practitioners was sent out on Thursday 28 April and Monday 2 May 2005, respectively. This again covered 640 taxpayer questionnaires (green colour) and 640 tax practitioner questionnaires (pink colour). The contents of a typical envelope consisted of covering letters from the ATO and the Board of Taxation, a reminder note from the Board of Taxation, a questionnaire and a reply paid envelope.

15.48 While the survey instruments indicated that the cut off date for return of the forms was Friday 13 May 2005 (about a month after the first issue of the surveys), the research team continued to accept and process survey forms on a progressive basis until 5 pm (EST) Monday 13 June 2005.

Response rates

15.49 The response rates for each of the two surveys are contained in Table 15.1. The taxpayer survey achieved a response rate of 25 per cent, while the response rate for the tax practitioner survey was 38 per cent.

Table 15.1: Response rates: taxpayer and tax practitioner surveys

	Business taxpayers	Tax practitioners
Gross sample	640	640
Out-of-frame responses	50	6
Net sample	590	634
Useable responses	148	241
Unusable responses (blank)	1	-
Response rate (per cent)	**25.25**	**38.01**

15.50 The out-of-frame responses were forms that were returned (primarily to the ATO, but including two taxpayer forms that were returned to Atax), usually because the addressee was no longer at that address. The envelopes used by the ATO to send out the surveys contained an ATO return address specific to this project. The ATO is of the opinion that this technique would have ensured that any 'returns' found their way to the one collection point (within Revenue Analysis Branch of the ATO), although it is acknowledged that with such a large organisation there is always the possibility that some returns may have gone astray. The research team is of the opinion, however, that if this did occur, it would not have had any material effect on the response rates for the two surveys.

15.51 The research team had set a target response rate of 30 per cent for each of the surveys at the outset of the project. The tax practitioner response rate is clearly highly satisfactory. The response rate of 25 per cent for the taxpayer survey was below target, and a number of factors may be responsible for this. It became clear from the helpline (see below) and from comments written on unopened surveys that were returned that a number of taxpayers had retired (evidenced by the fact that they were selected from a cohort of taxpayers that had accessed the small business CGT concessions) and were therefore not inclined to respond. Others mistakenly believed that the survey could not apply to them as they were no longer in business.

15.52 Notwithstanding that the 30 per cent target was not met for the taxpayer survey, the research team consider that a response rate of 25 per cent is more than acceptable for the purposes of the project, particularly given the large absolute number of valid responses (148).

Representativeness

15.53 One important aspect of the survey methodology is to ensure, so far as possible, that those that respond to the survey (the effective sample) broadly reflect the categories of those business taxpayers that were surveyed (the mail out sample).

15.54 As noted above, business taxpayers were classified on two criteria — the legal form of the business (four strata) and their claim profile (four strata). As Table 15.2 shows, on the first criterion, the effective sample is highly representative of the mail

out sample: all four categories of legal form are represented by between 20 per cent and 30 per cent of the respondents.

Table 15.2: Relative distribution of business taxpayers by legal form (per cent)

Legal form	Mail out sample	Effective sample
Sole trader	25	20
Partnership	25	29
Company	29	24
Trust	21	25
Other	na	1
All	**100**	**100**

Source: Taxpayer survey.

15.55 Table 15.3 indicates that there was not quite the same correlation of the mail out sample and the effective sample so far as the second criterion for business taxpayers was concerned — the particular concession claimed.

Table 15.3: Relative distribution of business taxpayers by claim (per cent)

Legal form	Mail out sample	Effective sample
15 year exemption	21	9
50 per cent reduction	28	44
Retirement exemption	26	17
Roll-over	25	23
Not stated	na	8
All	**100**	**100**

Source: Taxpayer survey.

15.56 This lack of close correlation is not surprising. Business taxpayers may claim more than one concession, and some concessions are easier to access (for example the 50 per cent reduction) than others (for example the 15 year exemption). Moreover, ATO figures for the comparable year (2002-03) show that the 50 per cent reduction was accessed by just over 90 per cent of claimants, whereas the 15 year exemption was accessed by only 1 per cent of claimants. The research team deliberately selected roughly one quarter of the mail out sample from each claim category in order to ensure that sufficient responses were received in each category to permit comparison and extrapolation. It is therefore satisfied that it has sufficient numbers of responses in each category for meaningful analysis.

15.57 Given that the tax practitioner mail out sample was based upon the business taxpayer stratification, there is no comparable analysis necessary to check for the representativeness of the tax practitioner effective sample.

15.58 The research team is therefore satisfied with the overall representativeness of the sample.

Non-response bias

15.59 Despite the acceptable response rates achieved in the surveys, it is still important to consider whether there is 'response bias' in the study (and — if there is - to attempt to identify its extent and impact). Response bias arises if there are systematic differences in some key areas between respondents and non-respondents. Testing for non-response bias establishes whether, if non-respondents had responded, the outcomes of the survey would have been substantially changed. While there are a variety of methods available to test for non-response bias, the research team decided to employ a wave analysis.

15.60 Wave analysis identifies respondents' answers to certain central questions in the survey by reference to the point of time that they answered the survey. Analysis is then conducted to determine whether responses to the selected questions changed significantly from period to period. The procedure assumes that those that return surveys in the later part of the response period are 'almost non-respondents'.

15.61 A wave analysis was conducted on both the taxpayer and the tax practitioner survey respondents. For the purposes of the analysis, responses were divided into three waves: those that responded early in the survey process, those that responded in the middle of the process, and those that responded late. Certain responses of the early and late groups of business taxpayers and tax practitioners were then statistically compared.

15.62 A chi-square test revealed that, at 1 per cent level of significance, there was no statistically significant difference between the perceptions of early and late taxpayer respondents. The same result was obtained for early and late tax practitioner respondents. In summary, the outcomes of these tests suggest the absence of any non-response bias in the responses to either of the surveys.

Helpline and post-survey data verification

15.63 In order to provide survey participants with every possible assistance, the members of the Atax research team made themselves available on a telephone Helpline throughout the survey period (approximately eight weeks). Any queries were dealt with immediately and consistently, using a structured enquiry form. Four tax practitioners and nine business taxpayers contacted the Helpline.

15.64 A total of 56 business taxpayers and 114 tax practitioners chose to identify themselves. The research team contacted ten business taxpayers for post-survey data verification. Some of the main aspects of this exercise included:

- checking whether or not taxpayers should have been in the sample;
- checking some important questions which were left blank; and
- clarifying data which appeared to be exceptionally large.

15.65 The data verification exercise resulted in very minor changes (usually adding data) prior to data capture.

Data entry

15.66 The survey data was captured by ACU-PUNCH, a professional data entry firm which has successfully assisted Atax in similar tasks in the past. For verified, legible work, ACU-PUNCH guarantees an accuracy rate in excess of 99.9 per cent. This is achieved through independent double keying and verification.

15.67 Once all survey data were appropriately collated, the research team undertook an analysis of the results. The principal outcomes of this analysis of the data from the mail surveys are detailed in Chapter 17 below.

ADMINISTRATIVE COSTS

15.68 The research team explored the costs incurred by the ATO in administering the small business CGT concessions using the following procedures:

- The information provided by the ATO to the Board of Taxation on its administrative costs was carefully examined. This information provided a breakdown of time spent by various levels of ATO staff by reference to the parts of the organisation that were involved in work related to the concessions in the 2003-04 year. The data on time spent, when combined with information about the salaries of different levels of the ATO staff, provided an internal ATO estimate of the administrative costs of the administration of the legislation.

- Five relevant key personnel in the ATO were then contacted by the research team to participate in a focus group discussion designed to explore the process that had been undertaken internally, and in particular to verify the number and level of ATO staff affected by the legislation, and the manner in which they were affected. The discussion also considered other administrative costs that had been (either explicitly or unwittingly) excluded from the internally generated estimate of administrative costs.

- An electronic survey was administered to a sample of 18 ATO staff in order to establish estimates of both incremental and recurrent administrative costs that had arisen as a result of the introduction of the relevant legislation. The size of the sample was determined after discussion with key ATO personnel. The survey also took the opportunity of questioning ATO staff on their perceptions of how the 1999 changes to the concessions had impacted upon the compliance costs of business taxpayers. It should be noted that this was very much an incidental exercise, but was felt to be worthwhile as it might yield useful data for triangulation purposes when compared to data provided by business taxpayers and tax practitioners.

- All of the information obtained from these various stages was then considered by the research team.

15.69 The outcomes of this process relating to administrative costs are detailed in Chapter 18.

CHAPTER 16: FOCUS GROUP OUTCOMES

16.1 The purpose of the three focus groups held with representatives of the professional bodies and with tax practitioners was to assist in identifying relevant compliance cost issues for inclusion in the taxpayer and practitioner questionnaires and, to a lesser extent, to assist with sample selection. In addition, focus groups also helped the research team to gauge the broad views of tax practitioners and professional bodies on compliance cost issues relating to the small business CGT concessions.

16.2 The major issues that the focus groups identified as potentially important, on the basis of their own experience, knowledge and, in the case of professional bodies, contact from members, are summarised below. Issues which were common to both practitioners and professional bodies are discussed first. Issues which were specific to each group are then identified.

COMMON ISSUES DISCUSSED AT FOCUS GROUPS

16.3 There appeared to be a broad consensus among participants around most of the common issues raised at the focus groups. The participants suggested that:

- The small business CGT concessions were comparatively difficult to apply and the various tests (particularly the three threshold tests) could be quite complex to work out in practice. This inevitably had an impact on the compliance costs associated with the concessions.
- The small business 50 per cent reduction was the simplest of the four concessions to apply. The other three concessions (the 15 year exemption, the retirement exemption and the roll-over), which all contained further conditions of varying complexity, were far more difficult to operate in practice.
- The threshold tests, particularly the $5 million net asset value test and its need to identify connected entities, and the controlling individual test, gave rise to relatively high compliance costs.
- The complexity of the legislation was exacerbated by the limited and changing guidance from the ATO.
- The legislation gave rise to learning costs for tax practitioners and these costs could be ongoing.

16.4 In terms of sample selection, all participants confirmed the difficulty of obtaining information about those affected taxpayers that may have incurred compliance costs but did not claim any concessions (and thus were not captured by the ATO tax returns database). Participants in the focus groups suggested it would not be feasible to obtain information about those taxpayers from their tax practitioners for reasons of client confidentiality and because practitioners do not normally itemise their charges to clients.

16.5 While the compliance costs of those taxpayers should not, in principle, be ignored, participants suggested that the costs and time involved in identifying those taxpayers would be prohibitive. It was suggested, therefore, that the research team should focus on those affected taxpayers that are captured by the ATO's tax return database.

Issues specific to tax practitioners

16.6 Issues specific to tax practitioners included:

- In general, tax advice relating to the small business CGT concessions did not constitute a high percentage of the fees of accounting practices.
- If a tax practitioner is not working with the concessions regularly, doing research on the concessions when the needs arise can be problematic and costly (that is, it is not 'off the top of the head' advice). As a result it was not always easy to provide quality advice to clients.
- Many clients approached tax practitioners when they were planning to sell their businesses. They often automatically thought that they would be eligible for the concessions, only to find out that in fact they did not satisfy the various conditions. It was often difficult to explain the legislation to clients.
- Tax practitioners could pass on 100 per cent or most of their ongoing costs to clients. However, tax practitioners could only pass on some of their learning costs to clients.
- Clients have become increasingly more fee resistant. They are, however, willing to pay for specialist advice if necessary.

Issues specific to tax professional bodies

16.7 Issues specific to professional organisations were:

- The small business CGT concessions were a big concern to members of professional organisations. Inquiries about the concessions from members have been regular and relatively more frequent than other tax provisions.

- Many of the enquiries are related to the $5 million maximum net asset value test (including the identification of connected entities), and the conditions are in general regarded as being inflexible.

- Professional organisations have held seminars on the concessions and these educational events have been well attended.

Other focus group comments and suggestions

16.8 In addition to the above comments on the compliance cost aspects of the small business CGT concessions as currently operating, the focus groups also made some other suggestions for improvement of the operation of the legislation (with a resultant reduction in compliance costs). These included suggestions relating to the better definition of terms and concepts.

16.9 There is a fine line in this regard between suggestions that go to policy, technical operation or compliance costs, although obviously greater technical clarity or minor policy simplification (not going to the core operation of the provisions) can reduce compliance costs.

16.10 Specific matters mentioned in this regard were:

- Tax practitioners, especially those in small suburban and regional practices, would like clearer guidelines from the ATO. It would also be helpful if the various technical terms were better defined. This may be particularly beneficial to small tax practitioners that currently need to go to tax specialists for advice at times.

- The $5 million net asset value test was introduced more than five and a half years ago. It was not CPI indexed.

- There is a desire for the legislation to be made easier to understand, to apply and to be explained.

- Business structure is critically important to a taxpayer's ability to access the concessions, and there are a number of equity issues that relate to this. The controlling individual test favours certain business structures compared to others.

- Notwithstanding technical issues around the understanding, operation and application of the concessions, tax practitioners welcome the legislation as they can be the bearer of good news to their clients.

CHAPTER 17: SURVEY OUTCOMES

17.1 This section summarises the major outcomes of the taxpayer and tax practitioner surveys. In addition, it combines quantitative data obtained from the surveys with other information at a macro level to estimate the aggregate compliance costs (transitional and recurrent) arising from the small business CGT concessions and analyses the qualitative data obtained from the tax practitioner survey to study the incremental impact of the 1999 small business CGT concessions.

AGGREGATE COMPLIANCE COSTS

17.2 The surveys justify the research team's initial hypothesis that the majority of affected taxpayers have little direct exposure to the legislation. Such exposure as does exist is strongly filtered by their tax practitioners. Many of the compliance cost implications of the small business CGT concessions are, in fact, borne by tax practitioners. The survey results suggest that the tax practitioners have not been able to pass on to their clients almost 60 per cent of their transitional costs relating to the concessions, and they also continue to carry about 56 per cent of the recurrent compliance costs of the concessions.

17.3 In contrast, affected business taxpayers do not appear to incur high compliance costs at the individual level. The average transitional (learning) compliance costs were found to be about $681 and recurrent compliance costs (effectively the costs of claiming the concessions) were estimated at $1,261 per claimant. The amounts are not insignificant, but the results do lend support to the contention that those small businesses affected incur relatively minor compliance costs in relation to the small business CGT concessions.

THE BUSINESS TAXPAYER SURVEY

Main quantitative findings

17.4 Taxpayers were selected to participate in the survey because they made a claim for at least one category of the small business CGT concessions in the 2002–03 tax year. In spite of this, about 20 per cent of the 148 respondents either heard about the legislation after 30 June 2004 or never heard about it. This percentage is likely to be even higher among non-respondents. Moreover, 35 per cent (52 of the respondents) thought that their business had not considered making a claim for the concessions.

17.5 This strongly suggests that despite the important benefits of the concessions, many claimants are not directly exposed to the legislation. The ATO's data indicated that there were 20,382 small business CGT concessions claimants in 2002–03. The survey results suggest that at least 4,076 of them were not aware that they were exposed to the concessions in the year of claiming.

Transitional compliance costs for business taxpayers

17.6 The majority of taxpayer participants in the survey first learned about the small business CGT concessions from their tax practitioners (112 out of 148 or about 76 per cent). Extrapolating these figures to the relevant population, over 15,424 business taxpayers (out of the 20,382) first learned about the legislation from their tax practitioners.

17.7 The data from the survey suggests that those respondents (including their employees) spent, on average, 8 hours in learning about those concessions in 2002-03. Multiplying the time spent with the gross imputed wage rate of $37 per hour,[188] the average value of time spent is estimated at $296. However, some refinement needs to be made in the society-wide aggregation of compliance costs (see paragraphs 17.38-17.49) before extrapolating for the entire population of claimants.

17.8 Just over half of business taxpayers (75 out of 148 or 51 per cent) had to pay in order to learn about the legislation. For those that had to pay, the average fee to tax practitioners was $679. When spread across the entire sample, the average fee per taxpayer was $385.

17.9 Combining the value of time spent by business taxpayers ($296) and the fees paid to practitioners ($385), the average transitional costs to taxpayers that incurred such costs were about $681 in 2002-03.

17.10 It is obviously a subjective assessment as to whether an average cost per business taxpayer of $681 expended in learning about the concessions represents a significant sum or not for the taxpayer concerned. Clearly the overall level of the turnover of the business and the value of the tax benefits ultimately obtained will have a bearing on that assessment. Some guidance as to whether such transitional costs are perceived to be significant can be gleaned from responses to one of the attitudinal questions contained in the survey. Sixty respondents (40 per cent) agreed/strongly agreed that their transitional compliance costs relating to the small business CGT concessions were small while 33 (23 per cent) disagreed/strongly disagreed. This would tend to suggest that, overall, the transitional costs of the concessions are not considered to be unduly significant.

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188 This hourly rate is obtained by (i) using the gross imputed wage rate of $29 per hour for medium-size sole traders in 1994-95 (see Evans et al, 1997, page 38); and (ii) indexing it by an annual growth factor of 3.1 per cent based on the ABS's wage cost index (ABS, 2002).

Recurrent compliance costs for business taxpayers

17.11 The survey respondents and their employees (where relevant) spent on average 3.4 hours in 2002-03 in recurrent costs in complying with the requirements of the small business CGT concessions. Combining this data with the assumed gross wage rate of $37 per hour, this time loss corresponds to $126 compliance costs per taxpayer in that year.

17.12 For the 50 participants that responded to the relevant question, the tax practitioner fees relating to claims for the small business CGT concessions incurred by taxpayers are estimated to be $1,046 on average in 2002–03.

17.13 For those taxpayers that needed to undertake asset valuations for the purpose of claiming the small business CGT concessions, the average costs are estimated to be $536 in 2002–03. When spread across the entire sample, the average cost was $45.

17.14 For those taxpayers that incurred other incidental costs for the purpose of claiming small business CGT concessions, the average costs are estimated to be $580 on average in 2002-03. For the entire sample, the average cost was $44.

17.15 The aggregation of the recurrent value of time spent by such taxpayers ($126), the tax practitioner fees ($1,046), and the asset valuation ($45) and other incidental costs ($44), produces an average recurrent cost for taxpayers exposed to the small business CGT concessions of about $1,261 in 2002-03.

17.16 Fifty two respondents (35 per cent) disagreed/strongly disagreed that their compliance costs in claiming the small business CGT concessions were significant while 26 (18 per cent) agreed/strongly agreed. Again, this suggests that business taxpayers did not, overall, consider that their recurrent costs were significant.

17.17 Table 17.1 summarises the transitional and recurrent compliance costs for taxpayers that had been affected by the small business CGT concessions in 2002-03.

Table 17.1: Average compliance costs for business taxpayers (small business CGT concessions) in 2002-03

	Average time spent (hours)	Average value of time ($)	Average fees paid to practitioners ($)	Average other direct costs ($)	Average compliance costs ($)
Transitional	8	296	385	-	681
Recurrent	3.4	126	1,046	89	1,261

Source: Taxpayer survey.

Main qualitative findings

17.18 The taxpayer survey also elicited data of a more qualitative nature. The relatively small number of responses underpinning these data may make it inappropriate to regard these outcomes as anything more than tentative.

Comprehensibility of the small business CGT concessions

17.19 Sixty six respondents (44 per cent) agreed or strongly agreed with the proposition that the 'small business CGT concessions are difficult to understand'; only 29 (19 per cent) disagreed or strongly disagreed. This would tend to confirm the notion that business taxpayers are not comfortable with complex tax technical provisions, a conclusion reinforced by the fact that 45 per cent of respondents were 'neutral/don't knows' when faced with the statement that 'The TaxPack's explanation of the small business CGT concessions is clear'.

Behavioural change

17.20 Few taxpayers (15 per cent or 22 respondents) identified that they had to rearrange their business affairs or otherwise modify the operation of their businesses as a result of the small business CGT concessions. In contrast, 78 per cent or 116 respondents had made no such changes.

The Tax Practitioner Survey

Main quantitative findings

17.21 The survey established that for an average tax practice per year:

- about 64 clients obtained advice on small business CGT concessions;
- of those 64 clients, 66 per cent (or 42 clients) obtained advice in respect of an actual CGT event; and
- of those clients that obtained advice in respect of an actual CGT event, a further 67 per cent (or 28 clients) actually qualified for the small business CGT concessions each year.

Transitional compliance costs for practitioners

17.22 Table 17.2 summarises the tax practitioners' experience with transitional compliance costs.

Table 17.2: Average transitional costs ($) of tax practitioners by cost category and number of clients

	Number of clients				
	100 or less	101–500	501–1,000	1,001 or more	All
Number of respondents	12	72	61	93	238
Value of time spent ($)	8,298	7,688	11,659	15,136	11,462
Direct costs of seminars ($)	347	608	756	947	766
Software costs ($)	46	42	75	51	54
Other ($)	53	144	164	187	161
Total ($)	**8,744**	**8,482**	**12,654**	**16,321**	**12,443**

Source: Tax Practitioner Survey.

Notes:
(a) The two smallest practice sizes (20 clients or less and 21 to 100 clients) have been combined due to small number of observations (a total of 12 for both categories).
(b) Totals may not add up due to rounding.
(c) The values in the 'All' column were based on 238 respondents (3 respondents did not reveal their numbers of clients). Thus, these values are not identical to those average values (which were based on 241 or varying number of respondents, depending on the questions).

17.23 Table 17.2 shows that on average the transitional costs incurred by tax practitioners were in the order of $12,000 per practitioner, but that it varied with the size of the practice — the larger the practice (measured by the number of clients) the higher the average transitional costs. Hence for very small practices the average transitional costs of the small business CGT concessions were less than $9,000, while for the largest practices the average was more than $16,000. This outcome is not surprising.

17.24 The value of time spent is by far the largest component of the transitional compliance costs of tax practitioners, and it is therefore useful to identify the transitional time spent by tax practitioners in greater detail. This is summarised in Table 17.3, which shows that the most significant elements were 'Reading & self learning' and 'Attending external training'.

Table 17.3: Breakdown of transitional time spent (hrs) by tax practitioners by activity and number of clients

	Number of clients				
	100 or less	101–500	501–1,000	1,001 or more	All
Reading (hrs)	16.25	17.65	27.69	32.28	25.87
Discussing (hrs)	7.83	7.35	14.33	16.54	12.75
Internal training (hrs)	15.00	2.36	5.36	9.55	6.58
External seminar (hrs)	18.33	14.51	15.03	15.08	15.06
Instructing (hrs)	8.83	4.48	6.51	7.65	6.46
Software related (hrs)	9.20	2.92	1.77	2.31	2.29
Other (hrs)	0.00	0.33	1.28	1.15	0.88
Total (hrs)	**75.44**	**49.6**	**71.97**	**84.56**	**69.89**

Source: Tax Practitioner Survey.

17.25 It is important to note that any estimated transitional costs are highly sensitive to the value attributed to the time of the tax practitioners. In this study, as in most other compliance cost studies, the rate used is the GST exclusive chargeable rate claimed by practitioner respondents. The breakdown of the GST exclusive chargeable rate claimed by size of practice is presented in Table 17.4.

Table 17.4: Chargeable rate ($/hr) by number of clients

	Number of clients				
	100 or less	101–500	501–1,000	1,001 or more	All
General Rate ($/hr)	123	156	162	169	161
CGT Specific Rate ($/hr)	110	155	162	179	164

Source: Tax Practitioner Survey.

17.26 The general chargeable rate is based on various categories, while the specific chargeable rate is based on actual dollar figures for CGT specific work, yet they virtually coincide. This has increased the research team's confidence in the internal integrity of the data. The research team has decided to use the CGT specific GST exclusive chargeable rate in this study.

17.27 Tax practitioners claimed that it was difficult to pass their transitional costs on to their clients in general. More than one fifth of tax practitioners who responded stated that they were unable to pass any transitional costs on to their clients. Only about 11 per cent of tax practitioners who responded stated that they were able to pass their full transitional costs on to their clients.

17.28 Table 17.5 suggests that, overall, tax practitioners were only able to pass on 42 per cent of their transitional costs of the small business CGT concessions to their clients. Smaller practices (100 or less clients category) appeared to be more successful in this (though still not able to pass on more than 70 per cent of the costs), while the larger practices in general showed a lesser capacity to pass on transitional costs.

Table 17.5: Percentage of transitional costs passed on to clients by tax practitioners (based on number of clients)

	Number of clients				
	100 or less	101–500	501–1,000	1,001 or more	All
Percentage	70	38	46	39	42

Source: Tax Practitioner Survey.

17.29 Some confirmation of this general inability to pass on the transitional costs was gleaned from other responses to the survey. More than 76 per cent of practitioners disagreed or strongly disagreed with the statement 'My practice has been able to pass on all of its transitional costs of small business CGT concessions to its clients', and those respondents subsequently suggested that on average they could only pass on 29 per cent of their transitional costs.

17.30 In summary, therefore, average transitional costs for tax practitioners were approximately $12,500; were comprised primarily of the time costs involved in learning about the small business CGT concessions (generally through personal research and attendance at external seminars); and the costs were largely absorbed by their practices rather than charged to their clients.

17.31 Almost 60 per cent of respondents agreed/strongly agreed that their transitional compliance costs arising from the small business CGT concessions were significant while 17 per cent disagreed/strongly disagreed. This would tend to suggest that transitional compliance costs were seen as far more significant by practitioners compared to business taxpayers.

Recurrent compliance costs for practitioners

17.32 Tables 17.6 and 17.7 summarise the tax practitioners' experience with recurrent compliance costs. The first table suggests that, on average, tax practitioners incurred recurrent compliance costs of $4,873 relating to the small business CGT concessions. For the smallest practices the average was just under $2,000, while for the larger practices the figure was closer to $6,000. Table 17.7 shows that the practices absorb up to 56 per cent of all recurrent costs relating to the concessions — on average they can only pass on 44 per cent of such costs to their clients.

Table 17.6: Average recurrent costs ($) of tax practitioners by cost category and number of clients

	Number of clients				
	100 or less	101–500	501–1,000	1,001 or more	All
Value of time spent ($)	1,971	4,100	5,179	5,402	4,737
Other ($)	0	24	180	209	135
Total ($)	**1,971**	**4,124**	**5,359**	**5,611**	**4,873**

Source: Table 5–4 and Tax Practitioner Survey.

Table 17.7: Percentage of recurrent costs passed on to clients by tax practitioners (based on number of clients)

	Number of clients				
	100 or less	101–500	501–1,000	1,001 or more	All
Percentage	22	41	52	44	44

Source: Tax Practitioner Survey.

17.33 As with transitional costs, tax practitioners also found it difficult to pass on their recurrent costs to their clients: 60 per cent disagreed/strongly disagreed that they were able to charge clients for all their time while only 26 per cent agreed/strongly agreed. Tax practitioners' overall ability to pass on transitional costs (42 per cent) and recurrent costs (44 per cent) are practically the same. Note, however, that in contrast to the transitional costs, larger practices tend to possess a greater ability to pass on their recurrent costs to clients than smaller practices.

17.34 Almost half of the tax practitioners who responded (44 per cent) also incurred costs of specialist advice on behalf of their clients as summarised in Table 17.8. It is assumed that all of these costs are passed on to clients — an assumption that was borne out in the focus group discussions with tax practitioners, where they indicated that this would be normal practice, involving the prior agreement of the client to meet those costs of specialist tax advice.

Table 17.8: Average annual costs ($) of tax specialist advice by number of clients

	Number of clients				
	100 or less	101–500	501–1,000	1,001 or more	All
Number of clients	1	2	3	3	3
Costs per client ($)	275	766	437	534	566
Total ($)	**321**	**1,489**	**1,506**	**1,527**	**1,499**

Source: Tax Practitioner Survey.
(Note that totals are derived by multiplying the precise number of clients, which may not be an integer.)

Main qualitative findings

17.35 The tax practitioner survey also obtained data of a more qualitative nature.

17.36 Tax practitioners identified a number of factors as potentially leading to high recurrent small business CGT concessions compliance costs. On a scale of 0 to 10 (where 0 implies no impact and 10 enormous impact), those factors scored from 5 to 8. In terms of the three most significant factors, practitioners specifically identified the complexity of the legislation (mean score of 8), the length of the legislation (mean score of 7) and the controlling individual test (mean score of 7). The $5 million maximum net asset value test only received a mean score of 6 — in contrast with an 8 from ATO officers (see Chapter 18).

17.37 76 per cent of respondents disagreed/strongly disagreed with the proposition that 'the small business CGT concessions are easy to understand and apply' while only 22 per cent agreed and 0 per cent strongly agreed.

Aggregating transitional and recurrent compliance costs

17.38 Combining the business taxpayer and tax practitioner survey results with the macro-statistics provided by the ATO, it is possible to extrapolate the sample results to the entire economy. It is important, however, to bear in mind that the aggregate estimates are indicative rather than precise.[189]

189 For a number of reasons the empirical data deriving from compliance cost studies have always been regarded as indicative or 'ball park' figures rather than precise point estimates. The reasons include factors like the method of sample selection, the need for respondents to recall historical

Transitional social compliance costs

17.39 The transitional social compliance costs (TSCC) of the small business CGT concessions can be aggregated using the estimating framework explained in paragraphs 15.16 to 15.17. It involves estimating the aggregate transitional costs of business taxpayers and of tax practitioners separately.

17.40 The aggregate value of the transitional compliance costs of business taxpayers is derived by classifying taxpayers by reference to their business turnover, shown in Table 17.9.

Table 17.9: Aggregate transitional compliance costs of taxpayers (by reference to business turnover)

	Annual turnover ($)			
	$100,000 or less	$100,001 to $1,000,000	$1,000,000 or more	All
N	8,776	9,342	2,265	20,382
Value of time spent ($)	112	338	1,110	296
Tax practitioner fees ($)	209	497	701	385
Cost per claimant ($)	320	835	1,815	681
Aggregate costs ($)	**2,810,714**	**7,796,512**	**4,110,295**	**14,717,522**

Sources: Table 17–1 and ATO data.

Notes:

(a) N is derived by multiplying the total number of claimants in 2002–03 by the percentage distribution of taxpayer respondents by business turnover found in the sample.

(b) The imputed hourly wage rate used to determine the values of time spent by taxpayers are $24, $37 and $59 for small, medium and large businesses, respectively.

(c) Aggregate costs for 'All' is the addition of all aggregate costs, rather than the number multiplied by average cost.

17.41 Table 17.9 also implies that the aggregate value of transitional time spent by business taxpayers is about $6.6 million. (This can be calculated by multiplying N by the value of time for each of the three categories of business size.)

17.42 The aggregate value of transitional compliance costs of tax practitioners is derived by classifying tax practitioners by reference to their number of clients shown in Table 17.10.

Table 17.10: Aggregate transitional costs ($) of tax practitioners by number of clients

	Number of clients				
	100 or less	101–500	501–1,000	1,001 or more	All
Number	10,308	5,814	4,065	1,561	21,748
Average cost ($)	8,744	8,482	12,654	16,321	12,443
Total costs ($)	90,133,152	49,314,348	51,438,510	25,477,081	216,363,091

Sources: Table 17–2 and ATO data.

data, the imputation of subjective values to certain aspects. See, for example, the discussion in Chapters 5 and 6 of Evans et al (2001) and in Chapter 17 of Sandford (1995).

17.43 Adding the aggregate value of transitional time spent by business taxpayers ($6.6 million) and the aggregate transitional costs of tax practitioners ($216.4 million), the TSCC of the small business CGT concessions are estimated to be about $223 million.

17.44 A number of points need to be made about this estimate of the economy-wide transitional costs. First, it is important to note that this estimate is very sensitive to the value of the chargeable rate that tax practitioners consider appropriate. For example, by halving the chargeable rate claimed by tax practitioners, the TSCC of the small business CGT concessions will also reduce by (almost) 50 per cent. The research team has followed conventional compliance cost estimation practice in using the self-reported charge out rate given by practitioners, but there are a large number of alternative methods of valuing time that may be equally valid or appropriate.[190]

17.45 Secondly, this estimate is likely to overestimate the true TSCC because of the way in which tax practitioners were selected. The practitioners selected are more likely to be exposed to small business CGT concessions clients than practitioners chosen at random from the population of all tax practitioners.

17.46 For these reasons, the estimate of the economy wide transitional compliance costs of these measures is likely to be at the upper end of the range of possible estimates.

17.47 The figure of $223 million is clearly material in an absolute sense. To put things in perspective, however, it may be worthwhile to compare the TSCC of the small business CGT concessions with those of the GST and with those of the non-commercial losses provisions.

17.48 The TSCC of the GST for business taxpayers have been estimated by Tran-Nam and Glover[191] to range from $8 to $10 billion. It is important to stress that this GST aggregate estimate does not fully reflect the transitional costs borne by tax practitioners. Even so, the TSCC of the small business CGT concessions represent less than 2.5 per cent of the GST transitional costs. By way of further comparison, the Board of Taxation's first post-implementation review suggested that the economy wide transitional compliance costs for the non-commercial losses provisions were about $62 million, or one quarter of the estimate for the TSCC of the small business CGT concessions.

17.49 Intuitively, it does not seem unreasonable that the economy wide transitional costs of the small business CGT concessions would be higher than those for the non-commercial losses provisions (by a factor of about four), but very significantly lower than those for the introduction of the GST (roughly one fortieth of that figure).

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190 See, for example the discussion in Pope, quoted in Sandford, 1995, pages 114-118.
191 See Tran-Nam and Glover 2005.

Recurrent social compliance costs (RSCC)

17.50 The recurrent social compliance costs (RSCC) of business taxpayers and tax practitioners are also aggregated separately.

17.51 The aggregate recurrent compliance costs for business taxpayers, classified by their business turnover, are summarised in Table 17.11.

Table 17.11: Aggregate recurrent compliance costs of taxpayers (by reference to business turnover)

	Annual turnover ($)			
	$100,000 or less	$100,001 to $1,000,000	$1,000,000 or more	All
N	8,776	9,342	2,265	20,382
Value of time ($)	42	154	346	126
Tax practitioner fees ($)	944	938	1,638	1,046
Other costs ($)	27	75	387	89
Cost per claimant ($)	1,013	1,167	2,371	1,261
Aggregate costs ($)	**8,890,088**	**10,899,638**	**5,370,512**	**25,160,238**

Sources: Table 17–1 and ATO data.

17.52 Table 17.11 also implies that the aggregate value of recurrent time spent by taxpayers and other incidental costs is about $4.4 million. (This can be calculated by multiplying N by the value of time for each of the three categories of business size.)

17.53 The aggregate values of recurrent compliance costs of tax practitioners by reference to their number of clients are shown in Table 17.12.

Table 17.12: Aggregate recurrent costs ($) of tax practitioners by number of clients

	Number of clients				
	100 or less	101–500	501–1,000	1,001 or more	All
Number	10,308	5,814	4,065	1,561	21,748
Average cost ($)	1,971	4,124	5,359	5,611	4,873
Total costs ($)	20,317,068	23,976,936	21,784,335	8,758,771	105,978,004

Sources: Table 17–6 and ATO data.

17.54 Adding the aggregate value of the recurrent time spent by business taxpayers and other incidental costs ($4.4 million) to the aggregate recurrent costs of tax practitioners ($106 million), the economy-wide recurrent compliance costs of the small business CGT concessions are estimated to be about $110 million.

Incremental compliance costs

17.55 In order to assess the simplification impact of the 1999 small business CGT concessions the research team employed an indirect and qualitative approach since it was not possible to estimate the numerical incremental compliance costs of the legislation.

17.56 This indirect method focused upon tax practitioners in order to seek their views about the compliance cost implications of the introduction of the small business CGT concessions in 1999. Tax practitioners were approached because, as has been shown, they initially carry most of the compliance costs relating to the legislation. Further, by working directly with the legislation, they would be able to assess through their own experience whether the 1999 legislation has reduced compliance costs.

17.57 Tax practitioners were asked a series of hypothetical questions comparing the post-1999 small business CGT concessions and the pre-1999 counterparts.

17.58 The results are clear.

- Virtually all tax practitioner participants (237 out of 241 or more than 98 per cent) replied to this part of the survey, suggesting they held firm views about these questions.
- An overwhelming majority of respondents (191 out of 237 or more than 80 per cent) indicated that for a typical client they would spend more time now compared with the situation before 1999. About 18 per cent (44 respondents) suggested that they were likely to spend the same amount of time now compared with the situation before 1999. Only 1 per cent (2 respondents) considered that they were likely to spend less time on the concessions post-1999 compared to pre-1999. Those able to quantify the additional time involved (186 respondents) suggested an average of an additional two hours per typical case.
- The majority of respondents (123 out of 237 or about 52 per cent) also indicated that their clients were likely to spend more time now compared with the situation before 1999. About 43 per cent (104 respondents) suggested that their clients were likely to spend the same amount of time now compared with the situation before 1999. Only 3 per cent (8 respondents) considered that their typical clients were likely to spend less time on the concessions post-1999 compared to pre-1999. Tax practitioners also suggested that on average each client would spend two hours more on the small business CGT concessions.

17.59 As a check, another part of the tax practitioner survey gave practitioner participants an opportunity to offer their views on the statement that 'the post 1999 small business CGT concessions are easier to understand and apply than the small business CGT concessions that existed before 1999'. Again, 46 per cent of respondents

disagreed/strongly disagreed with the statement compared with 19 per cent who agreed/strongly agreed.

17.60 The qualitative findings suggest that the introduction of the small business CGT concessions has not reduced the complexity and the associated compliance costs for taxpayers and their practitioners, although it must be noted that the benefits of the concessions have also increased.

CHAPTER 18: ADMINISTRATIVE COSTS

18.1 In addition to its evaluation of the compliance costs of the small business CGT concessions, the research team was asked to consider the administrative costs of these legislative provisions. More particularly, the research team was asked to consider 'the number and nature of staff affected by the relevant legislation and the manner in which they are affected', and to provide a 'reliable estimate of the incremental administration labour costs that have arisen as a result of the introduction of the relevant legislation'.

18.2 In this context, administrative costs are taken to be the ATO's costs of administering (in the sense of running and maintaining) the small business CGT concessions (for example, staff and related costs, costs of accommodation and office expenses etc). No attempt is made to assess the administrative costs of the initial legislative enactment of the concessions, or of the judicial costs of administration of the tax dispute system (the courts etc) as they relate to the small business CGT concessions.

18.3 The Explanatory Memorandum and Regulation Impact Statement that accompanied the introduction of the revised small business CGT concessions in Division 152 in 1999 did not provide any quantitative assessment of the likely administrative costs (incremental or absolute) of the concessions. The only comment (in paragraph 4.18 of both documents) was that these measures (along with the other measures introduced at the same time as part of the implementation of the recommendations of the Review of Business Taxation) 'are not expected to give rise to any significant increase in administration costs'.

18.4 The ATO has estimated that the aggregate costs of administering the small business CGT concessions in 2003-04 were roughly $2.3 million. The ATO notes that it does not have staff working exclusively on administration of the concessions. Accordingly, an estimate was made of the proportion of time staff from a number of relevant areas spent on concessions issues. This detailed information on time spent by staff at different levels was then put through the ATO's absorption costing model. This process associated each staff level with a corresponding salary figure (based on the median for that grade) so that a total cost for such activities in a particular year could be obtained. The cost estimate included:

- direct labour costs plus on costs such as superannuation benefits, etc; and
- accommodation, desktop services and IT infrastructure and support.

18.5 The ATO notes that a number of costs are not included. Specifically, the ATO's estimate does not include 'other direct supplier costs such as consultants, contractors, training, transport, office operations, postage, bulk printing, technology, legal/compensation' [payments]; nor does it include 'other indirect costs such as fleet, internal skilling services, ICT training courses, graduates, cadets, mainframe, disk storage, tape storage, mobile computers, EDS variable charges, EDS help desk and litigation services'.

18.6 As explained in Chapter 15, the research team evaluated the process undertaken by the ATO by initially conducting a focus group discussion with five key ATO administrators, followed by a targeted survey sent to 18 ATO staff members from various Business Lines and Market Segments that regularly deal with the small business CGT concessions.

OUTCOMES OF THE FOCUS GROUP DISCUSSION

18.7 The focus group discussion was conducted on 24 May 2005 with ATO representatives from each of the internal areas with direct exposure to the administration of the small business CGT concessions.[192] It was conducted by two members of the research team. After initial introductions and an outline of the purpose of the meeting, the research team led the ATO representatives through a structured questionnaire that sought to understand and verify the processes undertaken by the ATO in deriving its estimate of the administrative costs of the concessions.

18.8 The principal outcomes were as follows:

- The research team was overall satisfied as to the integrity of the process undertaken by the ATO in seeking to identify the numbers of staff involved within the organisation in dealing with the small business CGT concessions. The process undertaken by the ATO attempted to be both comprehensive and inclusive.
- The research team noted that the request for data sent out by the ATO drew nil responses for 2003-04 from two organisational areas that might have been expected to have staff involved in small business CGT concessions work: the Personal Tax (PTax) area and the Micro Market segment.
  - The ATO representatives explained that although up to half of the claimants of the concessions (that is, individuals) might notionally 'belong' to PTax, the administrative work relating to the concessions (such as compliance activity, legal advice, the provision of private binding rulings etc) would have been dealt with by other organisational areas that did identify staff working on the small

192 The Losses and CGT Centre of Expertise, the SME Market Segment, the Small Business Compliance Interpretation area and the Contact (Call) Centres.

business CGT concessions. In addition, PTax involvement with the concessions would be minimal or limited as a result of most cases going through on a self assessment basis.

– The nil return from the Micro Market segment was more interesting, as this area of the organisation dealt with businesses with income up to $2 million and might therefore be thought to be an area in which work on the small business CGT concessions was taking place in 2003-04. The response had, however, been carefully checked with the relevant segment and the nil response had been confirmed.

- The research team was also satisfied with the process through which an estimate of the administrative costs was derived using the absorption costing model once the numbers and levels of relevant staff had been identified.
- The research team recognised that the estimate derived did not claim to be comprehensive, as it (quite explicitly) excluded a number of specific costs (such as training, and the preparation of educational and compliance publications and products) that were either impossible or too difficult to quantify.

18.9 At the conclusion of the focus group discussion the research team made arrangements for the conduct of an electronic survey with up to 20 ATO staff members of varying levels and from varying areas in order to seek further information about the administrative costs of the small business CGT concessions.

OUTCOMES FROM THE ADMINISTRATIVE COSTS SURVEY

18.10 The electronic survey of ATO staff was initially negotiated and piloted with some of the key ATO administrators who had participated in the focus group discussions, and, after some revision, was sent to the sample population of 18 ATO officers on 7 June 2005. All 18 officers responded by 16 June 2005.

18.11 The respondents were evenly spread across the organisational areas that dealt with the small business CGT concessions, and were representative of all levels of staff dealing with the concessions, with staff at the APS 6 level constituting about half of the respondents. Most respondents were relatively experienced at working with the concessions — over half had more than three years of experience and one in five had dealt with both the pre-1999 and post-1999 provisions.

18.12 Over 70 per cent were dealing with the concessions on a daily basis, and a further 22 per cent dealt with them at least once a week. All dealt with them on at least a monthly basis. Most respondents (77 per cent) disagreed that 'The small business CGT concessions constitute a small fraction of my work', which tends to confirm the conclusion that most of the sample were heavily and regularly involved in work directly related to the concessions. Further confirmation can be derived from the fact

that on average the respondents spend about 55 hours per month on an ongoing basis (roughly one third of their working hours) in dealing with the concessions.

18.13 The respondents identified that their initial learning about the small business CGT concessions had taken considerable time: the average (mean) amount of time involved in all such activities (which included reading and self learning; discussing with colleagues; and attending internal and external training) was in the region of 30 days. The largest component of this time (roughly 60 per cent) was 'discussing with colleagues'. Most (14 out of 15 respondents who expressed a positive or negative view) disagreed with the statement that 'My time spent in learning about the small business CGT concessions was insignificant', which again tends to confirm this conclusion that the learning costs were significant.

18.14 In addition, nearly three quarters of the staff were involved in delivering internal training on the concessions. The average of the annual hours involved in delivering on-going training for those who responded to this part of the survey was approximately 17 days.

18.15 Reassuringly, 15 out of the 18 respondents did not think they would need further training on the concessions, and most (72 per cent) agreed that they had received adequate training in this area. This level of comfort with their training may, in part, explain why many respondents agreed that 'The small business CGT concessions are easy to understand and administer'.

18.16 The respondents were generally satisfied that all learning and ongoing administrative costs relating to the concessions had been covered in the survey. The only suggestions for additional costs were some very minor costs relating to travel and accommodation to train other teams, and the costs of preparing and updating ATO products on the concessions.

18.17 The small number of respondents who had experiences of the administration of both the pre-1999 and post-1999 concessions necessitates a cautious approach to any extrapolation of data in this area. As a general indication, however, four out of six respondents who ventured an opinion suggested that they would typically spend more time on post-1999 small business CGT concessions cases compared to pre-1999 cases; this compared to only one respondent who considered less time would be spent, and one who thought the amount of time would be the same. (Incidentally, seven out of ten respondents considered that taxpayers would spend more time if a concessions issue arose after 1999 compared to the position before 1999.)

18.18 The survey also sought more information relating to the comparison of the pre and post-1999 situation. Again the data need to be treated cautiously, and are largely ambivalent in their suggestions. For example, most respondents (12 out of 18) were either neutral or did not know whether the post-1999 concessions were easier to administer compared to those that existed before, with only two respondents agreeing that this was the case and four disagreeing.

18.19 The survey of ATO officers sought their views on the key 'drivers' of the administrative costs related to the concessions, and their responses broadly mirror the outcomes of a comparable question asked of tax practitioners (in relation to compliance costs). For example, ATO officers identified the complexity of the legislation as being a key driver (with a mean score of 7 out of 10); for tax practitioners this item ranked highest and scored 8. Interestingly, however, tax administrators viewed the $5 million maximum net asset value test as the most significant factor driving administrative costs, with a score of 8. In comparison, tax practitioners were a little more sanguine about this factor, scoring it 6 and only ranking it fourth, behind the complexity of the legislation, the length of the legislation and the controlling individual test.

18.20 Based on the outcomes of the focus group and the electronic survey, the research team is satisfied that the initial ATO estimate that the aggregate ongoing administrative costs of the small business CGT concessions were roughly $2.3 million in the 2003-04 year is a reasonable estimate. This view is subject to the following qualifications:

- The estimate is based on the assumption that all relevant ATO members of staff directly or indirectly involved in administering the small business CGT concessions have been correctly identified. The research team accepts the ATO view that this is the case, and notes that the ATO has specifically followed up on two areas (PTax and the Micro Market segment) where staff were not initially identified and where assurances have been given that there was no direct involvement by such staff in the relevant year.

- The estimate is further based on the assumption that the absorption costing model used by the ATO appropriately captures related staff costs and relevant on-costs. The research team has neither requested nor been offered the precise details of that model, but is satisfied from its knowledge of the broad principles involved and its discussions with key ATO staff that the model is appropriate and comprehensive.

- The estimate explicitly excludes a number of items that the ATO suggests are either impossible or too difficult to calculate with any degree of precision. One obvious example is the cost of educational products related to the concessions. The extensive list of exclusions provided by the ATO suggests that the costs of these excluded items might not be insignificant and would have the effect, if it were possible for them to be calculated and included, of increasing the administrative costs of the small business CGT concessions.

- The estimate may also have unwittingly excluded some other costs (for example, relating to internal training on the concessions). But the research team is satisfied that this category of costs is unlikely to be significant and would not have any material effect on the estimate provided by the ATO.

- The estimate relates only to the 2003-04 year. The evidence of the survey tends to suggest that by 2003-04 the administrative costs may have been settling down

(despite increased numbers of claims). The estimate does not identify the transitional costs that may have occurred in the years immediately after the introduction of the revised concessions in 1999.

CHAPTER 19: CONCLUSIONS ON COMPLIANCE AND ADMINISTRATIVE COSTS

19.1 Five main conclusions can be drawn from the analysis of responses to the business taxpayer, tax practitioner and ATO officer surveys, combined with the information from the focus groups, the information from the ATO on administrative costs, and other data made available to the research team.

19.2 Firstly, business taxpayer compliance costs arising from the small business CGT concessions at the individual level are not significant, particularly in view of the tax benefits that are now available under the legislation. The evidence from the surveys suggests that, at the individual level, a typical claimant incurred $681 on transitional costs and $1,261 on actually claiming the concessions.

19.3 Moreover, about 20 per cent of 2002–03 claimants had never heard about the small business CGT concessions. In fact, most business taxpayers rely entirely on their tax agents to consider and deal with the impact of the concessions, as was evident in the small number of hours they and their employees spent in claiming the concessions. Only about 18 per cent of claimants regarded their compliance costs in claiming the concessions as significant. This leads on to the second major conclusion.

19.4 As in other cases in the recent wave of tax reform, tax practitioners appear to have borne most of the transitional and recurrent compliance costs that do arise. In particular, the evidence suggests that tax practitioners are able to pass on to their clients less than half of the transitional and recurrent costs that their practices incur in dealing with the small business CGT concessions.

19.5 The majority of tax practitioners generally considered the concessions difficult to understand and apply, citing the overall complexity of the legislation as the leading compliance cost driver. On average, tax practices spent more than $12,000 on transitional costs and about $5,000 on recurrent costs, although there were significant differences according to size of practice. This strongly suggests that the small business CGT concessions raise compliance cost issues for practitioners rather than for business taxpayers.

19.6 The third conclusion derived from the study is that aggregate (economy-wide) transitional and recurrent compliance costs associated with the small business CGT concessions are significant in absolute terms, largely reflecting that burden borne by tax practitioners. At the aggregate level, transitional and recurrent social compliance costs were estimated at up to $223 million and $110 million, respectively. While these

figures are significant in absolute terms, they fit comfortably within the broader picture of tax compliance costs derived in other empirical studies. However, it needs to be acknowledged that the value and accessibility of the concessions have increased.

19.7 Fourthly, the ATO has been able to cope with the small business CGT concessions without undue administrative costs. ATO officers surveyed felt that they have become increasingly more confident in working with the legislation. On a recurrent basis, an internal ATO estimate puts the annual administrative costs of the concessions at about $2.3 million in 2003–04. Although this estimate may have omitted a few minor categories of administrative costs, it may be safely concluded that the administrative costs are not an issue in the operation of the concessions.

19.8 Finally, it can be concluded that while the small business CGT concessions have widened the scope of tax benefits to small businesses, the 1999 legislation may not have reduced the compliance costs for accessing these concessions. An overwhelming majority of tax practitioners perceived that they spend more time on the concessions per client now compared with the pre-1999 situation. Tax practitioners also felt that their clients would also have to spend more time per claim compared with the pre-1999 situation, although it must be noted that the benefits of the concessions have also increased.

19.9 These conclusions suggest that the small business CGT concessions are a tax practitioner rather than a business taxpayer issue so far as compliance costs are concerned.

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APPENDIX A: DIVISION 152 OF THE *INCOME TAX ASSESSMENT ACT 1997*

DIVISION 152 — SMALL BUSINESS RELIEF

This appendix contains Division 152 of the *Income Tax Assessment Act 1997.*

Division 152—Small business relief

Guide to Division 152

152-1 What this Division is about

To help small business, if the basic conditions for relief are satisfied, capital gains can be reduced by the various concessions in this Division. Those basic conditions are in Subdivision 152-A. Some of the concessions have additional, specific conditions that must also be satisfied.

The 4 available small business concessions are:

(a) the 15-year exemption (in Subdivision 152-B);

(b) the 50% reduction (in Subdivision 152-C);

(c) the retirement concession (in Subdivision 152-D);

(d) the roll-over (in Subdivision 152-E).

A capital gain that qualifies for the 15-year exemption is disregarded entirely and is not taken into account under the method statement in subsection 102-5(1). By contrast, the other concessions are only activated by step 4 of that method statement. This means that you must apply all available capital losses against your capital gains (under steps 1 and 2) before you can reduce them using those 3 concessions.

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

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Subdivision 152-A—Basic conditions for relief under this Division

Guide to Subdivision 152-A

152-5 What this Subdivision is about

This Subdivision sets out some basic conditions for relief. If the basic conditions are satisfied, then a small business entity may be able to reduce its capital gains using the small business concessions in this Division.

The 3 major basic conditions are:

(a) a limit of $5,000,000 on the net value of assets that the business and related entities own;

(b) the CGT asset must be an active asset;

(c) if the asset is a share or interest in a trust, there must be a controlling individual just before the CGT event and the entity claiming the concession must be a CGT concession stakeholder in the company or trust.

Some of the concessions have additional, specific conditions that also must be satisfied. For example, the 15-year exemption applies only if you have held the CGT asset for at least 15 years and you retire.

The small business concessions (apart from small business roll-overs and the small business retirement exemption) are not available for CGT events J2 and J3.

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

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Basic conditions for relief

152-10 Basic conditions for relief

(1) A *capital gain (except a capital gain from *CGT event K7) you make may be reduced or disregarded under this Division if the following basic conditions are satisfied for the gain:

(a) a *CGT event happens in relation to a *CGT asset of yours in an income year;

Note: This condition does not apply in the case of CGT event D1: see section 152-12.

(b) the event would (apart from this Division) have resulted in the gain;

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

(c) you satisfy the maximum net asset value test (see section 152-15);

(d) the CGT asset satisfies the active asset test (see section 152-35).

Note: This condition does not apply in the case of CGT event D1: see section 152-12.

(2) If the *CGT asset is a *share in a company or an interest in a trust, there are 2 additional basic conditions:

(a) the company or trust satisfies the controlling individual test (see section 152-50);

(b) you are a *CGT concession stakeholder in the company or trust.

Example: Ann and her spouse Brett carry on a business through a company in which Ann owns 40% of the shares and Brett 60%. Ann sells her shares and wants to claim the small business concessions. The condition in paragraph (a) is satisfied because Brett's 60% makes him a controlling individual of the company. The condition in paragraph (b) is satisfied because Ann is a CGT concession stakeholder in the company, in that Ann owned some shares just before the CGT event and was the spouse of a controlling individual (Brett) at that time.

(3) In addition to the basic conditions in this section, some of the concessions in this Division have extra conditions that must be satisfied for the concession to be available. These extra conditions are set out in the relevant Subdivisions.

(4) Subdivisions 152-B and 152-C do not apply to *CGT events J2 and J3.

Note: Those CGT events are about previous applications of the roll-over in Subdivision 152-E.

152-12 Special conditions for CGT event D1

(1) Paragraphs 152-10(1)(a) and (d) do not apply in the case of *CGT event D1.

(2) Instead, it is a basic condition that the right you create that triggers the *CGT event must be inherently connected with a *CGT asset of yours that satisfies the active asset test (see section 152-35).

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

Maximum net asset value test

152-15 Maximum net asset value test

You satisfy the maximum net asset value test if, just before the *CGT event:

(a) the sum of the following amounts does not exceed $5,000,000:

(i) the *net value of the CGT assets of yours;

(ii) the net value of the CGT assets of any entities *connected with you;

(iii) the net value of the CGT assets of any *small business CGT affiliates of yours or entities connected with your small business CGT affiliates (not counting any assets already counted under subparagraph (ii)); and

Note: Some assets aren't included in the definition of ***net value of the CGT assets***: see subsections 152-20(2) and (3).

(b) if you are a partner in a partnership and the CGT event happens in relation to a *CGT asset of the partnership—the net value of the CGT assets of the partnership does not exceed $5,000,000.

152-20 Meaning of *net value of the CGT assets*

(1) The ***net value of the CGT assets*** of an entity is the amount (if any) by which the sum of the market values of those assets exceeds the sum of the liabilities of the entity that are related to the assets.

(2) In working out the ***net value of the CGT assets*** of an entity:

(a) disregard *shares, units or other interests (except debt) in another entity that is *connected with the first-mentioned entity or with a *small business CGT affiliate of the first-mentioned entity; and

(b) if the entity is an individual, disregard:

(i) assets being used solely for the personal use and enjoyment of the entity, or the entity's *small business CGT affiliate; and

(ii) a *dwelling of the individual, or an *ownership interest in such a dwelling, if the individual uses the dwelling to

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

produce assessable income to any extent but does not satisfy paragraph 118-190(1)(c) (about deductibility of interest); and

(iii) a right to, or to any part of, any allowance, annuity or capital amount payable out of a *superannuation fund or an *approved deposit fund; and

(iv) a right to, or to any part of, an asset of a superannuation fund or of an approved deposit fund; and

(v) a policy of insurance on the life of an individual.

(3) Subsection (4) applies in working out the ***net value of the CGT assets*** of an entity that is:

(a) your *small business CGT affiliate; or

(b) *connected with your small business CGT affiliate.

(4) Disregard assets of that entity that are not used, or held ready for use, in the carrying on of a *business (whether alone or jointly with others) by:

(a) you; or

(b) an entity *connected with you (unless the connection with you is only because of your *small business CGT affiliate).

Example: You and your husband decide to sell a florist's business that you jointly carry on. Your husband also wholly owns a company that carries on a newsagency business. You yourself have no other involvement with the newsagency business.

You need to work out whether you satisfy the maximum net asset value just before the sale. For this purpose, you disregard the newsagency company's assets. This is because, even though the company is "connected" with you, in that your small business CGT affiliate (ie your husband) owns it (see section 152-30), this connection arises *only because* your husband controls the company.

152-25 Meaning of *small business CGT affiliate*

(1) A person is a ***small business CGT affiliate*** of yours if:

(a) you are an individual and the person is your *spouse or *child under 18 years; or

(b) the person acts, or could reasonably be expected to act, in accordance with your directions or wishes, or in concert with you.

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

(2) Another partner in a partnership in which you are a partner is not your ***small business CGT affiliate*** only because the partner acts, or could reasonably be expected to act, in concert with you in relation to the affairs of the partnership.

152-30 Meaning of *connected with* the entity

(1) An entity is ***connected with*** another entity if:

(a) either entity controls the other entity in the way described in this section; or

(b) both entities are controlled in that way by the same third entity.

Control of entity: 40% or more of rights

(2) An entity (the ***first entity***) controls another entity if the first entity, its *small business CGT affiliates or the first entity together with its small business CGT affiliates:

(a) except where the other entity is a discretionary trust—beneficially own, or have the right to acquire the beneficial ownership of, interests in the other entity that carry between them the right to receive at least 40% (the ***control percentage***) of any distribution of income or capital by the other entity; or

(b) if the other entity is a company—beneficially own, or have the right to acquire beneficial ownership of, shares in the company that carry between them the right to exercise, or control the exercise of, at least 40% (the ***control percentage***) of the voting power in the company; or

(c) if the other entity is a discretionary trust:

(i) are the trustee or trustees of the trust (other than the Public Trustee of a State or Territory); or

(ii) have the power to determine the manner in which the trustee or trustees of the trust exercise the power to make any payment of income or capital to or for the benefit of beneficiaries of the trust.

Note: There are further rules relating to discretionary trusts in subsections (4) to (6C).

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

(3) If the control percentage in subsection (2) or (5) is at least 40%, but less than 50%, then the Commissioner may determine that the first entity does not control the other entity if the Commissioner is satisfied, or thinks it reasonable to assume, that the other entity is controlled by an entity other than, or by entities that do not include, the first entity or any of its *small business CGT affiliates.

Exception for trusts

(4) Paragraph (2)(c) does not apply if:
- (a) a beneficiary of the trust mentioned in that paragraph controls the trust in the way described in this section; and
- (b) that beneficiary is not a *small business CGT affiliate of any of the trustees of that trust or of a person who has the power of determination mentioned in subparagraph (2)(c)(ii).

Control of discretionary trust

(5) An entity (the ***first entity***) controls a discretionary trust if, for any of the 4 income years before the income year for which relief is sought for a *CGT event under this Division:
- (a) the trustee paid to, or applied for the benefit of:
  - (i) the first entity; or
  - (ii) one or more of the first entity's *small business CGT affiliates; or
  - (iii) the first entity and one or more of the first entity's small business CGT affiliates;

  any of the income or capital of the trust; and
- (b) the amount paid or applied is at least 40% (the ***control percentage***) of the total amount of income or capital paid or applied by the trustee for that income year.

(6) An entity does not control a discretionary trust because of subsection (5) if the entity is:
- (a) an *exempt entity; or
- (b) a *deductible gift recipient.

(6A) The trustee of a discretionary trust may, for an income year for which the trust had a *tax loss and for which the trustee did not pay

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

or apply any income or capital of the trust, nominate not more than 4 beneficiaries as being controllers of the trust.

Note: The trust might not have had the funds to make a distribution for that income year, which would prevent it from being controlled in that year. The trustee may wish to make the nomination to ensure that a relevant CGT asset is treated as an active asset (see section 152-40).

(6B) This section has effect as if each nominated beneficiary controlled the trust during the relevant income year in the way described in this section.

(6C) A nomination must be in writing and signed by the trustee and by each nominated beneficiary.

Indirect control of entity

(7) This section applies to an entity that directly controls a second entity as if it also controlled any other entity that is directly, or indirectly by any other application or applications of this section, controlled by the second entity.

(8) However, if an entity (the ***first entity***) controls an entity of a kind referred to in subsection (9) (the ***public entity***), this section does not, merely because of subsection (7), apply to the first entity as if it controlled any other entity that is controlled by the public entity.

(9) The kinds of entities are:

(a) a company *shares in which (except shares that carry the right to a fixed rate of *dividend) are listed for quotation in the official list of an *approved stock exchange; or

(b) a *publicly traded unit trust; or

(c) a *mutual insurance company; or

(d) a *mutual affiliate company; or

(e) a company (other than one covered by paragraph (a)) all the shares in which are beneficially owned by one or more of the following:

(i) a company covered by paragraph (a);

(ii) a publicly traded unit trust;

(iii) a mutual insurance company;

(iv) a mutual affiliate company.

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

Active asset test

152-35 Active asset test

A *CGT asset satisfies the active asset test if the asset was an *active asset of yours:

(a) just before the earlier of:
   (i) the *CGT event; and
   (ii) if the relevant business ceased to be carried on in the last 12 months or any longer period that the Commissioner allows—the cessation of the business; and

(b) during at least half of the period beginning at the later of:
   (i) when you acquired the asset; and
   (ii) if you have owned the asset for more than 15 years—15 years before the time that applies under paragraph (a);

and ending at the time that applies under paragraph (a).

152-40 Meaning of *active asset*

(1) A *CGT asset is an ***active asset*** at a given time if, at that time, you own it and:

(a) use it, or hold it ready for use, in the course of carrying on a *business; or

(b) it is an intangible asset that is inherently connected with a business that you carry on (for example, goodwill or the benefit of a restrictive covenant); or

(c) it is used, or held ready for use, in the course of carrying on a business by:
   (i) your *small business CGT affiliate; or
   (ii) another entity that is *connected with you.

(2) Subsection 392-20(1) is disregarded in determining, for the purposes of subsection (1) of this section, whether an entity is carrying on a *business.

Note: An entity would be taken to be carrying on a primary production business under subsection 392-20(1) if the business is carried on by a trust and the entity is presently entitled to trust income.

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

(3) A *CGT asset is also an ***active asset*** at a given time if, at that time, you own it and:

(a) it is either a *share in a company that is an Australian resident at that time or an interest in a trust that is a *resident trust for CGT purposes for the income year in which that time occurs; and

(b) the total of:

(i) the market values of the active assets of the company or trust; and

(ii) any *capital proceeds that the company or trust received, during the 2 years before that time, from *CGT events happening to its active assets and that the company or trust holds in the form of cash or debt pending the acquisition of new active assets;

is 80% or more of the market value of all of the assets of the company or trust.

Note: Paragraph 152-35(b) requires a CGT asset to have been an active asset over a period of time. For a share in an Australian resident company to meet this requirement, the company would have to satisfy the 80% test in this subsection throughout that same period.

Exceptions

(4) However, the following *CGT assets cannot be ***active assets***:

(a) interests in an entity that is *connected with you, other than *shares and interests covered by subsection (3);

(b) shares in companies, other than shares covered by subsection (3);

(c) interests in trusts, other than interests covered by subsection (3);

(d) financial instruments (such as loans, debentures, bonds, promissory notes, futures contracts, forward contracts, currency swap contracts and a right or option in respect of a share, security, loan or contract);

(e) an asset whose main use in the course of carrying on the *business mentioned in subsection (1) is to derive interest, an annuity, rent, royalties or foreign exchange gains unless:

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

(i) the asset is an intangible asset and has been substantially developed, altered or improved by you so that its market value has been substantially enhanced; or

(ii) its main use for deriving rent was only temporary.

Example: A company uses a house purely as an investment property and rents it out. The house is not an ***active asset*** because the company is not using the house in the course of carrying on a business. If, on the other hand, the company ran the house as a guest house the house would be an ***active asset*** because the company would be using it to carry on a business and not to derive rent.

152-45 Continuing time periods for involuntary disposals

Asset compulsorily acquired, lost or destroyed

(1) If a *CGT asset is an asset (the ***new asset***) you acquired to satisfy the requirement in subsection 124-70(2) or 124-75(2) for a roll-over under Subdivision 124-B, then the active asset test in section 152-35 applies as if:

(a) you had acquired the new asset when you acquired the old asset; and

(b) the new asset had been your *active asset at all times when the original asset was your active asset; and

(c) the new asset had not been your active asset at all times when the original asset was not your active asset.

Note 1: Subdivision 124-B allows you to choose a roll-over if your CGT asset is compulsorily acquired, lost or destroyed.

Note 2: If this subsection applies to a CGT asset, then section 152-115 (which is about continuing time periods) will apply for the 15-year exemption.

Assets replaced during FSR transition (same owner roll-overs)

(1A) If a *CGT asset is an asset (the ***new asset***) you acquired in a situation covered by section 124-880, 124-885 or 124-890, then the active asset test in section 152-35 applies as if:

(a) you had acquired the new asset when you acquired the original asset; and

(b) the new asset had been your *active asset at all times when the original asset was your active asset; and

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

(c) the new asset had not been your active asset at all times when the original asset was not your active asset.

Note 1: Subdivision 124-O provides a roll-over for certain CGT assets that come to an end as a result of an FSR transition.

Note 2: If this subsection applies to a CGT asset, then section 152-115 (which is about continuing time periods) will apply for the 15-year exemption.

Assets replaced during FSR transition (new owner roll-overs)

(1B) If a *CGT asset is an asset (the ***new asset***) acquired in a situation covered by section 124-900, 124-905 or 124-910, then the active asset test in section 152-35 applies as if:

(a) the new owner had acquired the new asset when the original owner acquired the original asset; and

(b) the new asset had been the *active asset of the new owner at all times when the original asset was the original owner's active asset; and

(c) the new asset had not been the active asset of the new owner at all times when the original asset was not the original owner's active asset.

Note 1: Subdivision 124-O provides a roll-over for certain CGT assets that come to an end as a result of an FSR transition.

Note 2: If this subsection applies to a CGT asset, then section 152-115 (which is about continuing time periods) will apply for the 15-year exemption.

Marriage breakdowns

(2) If you were the transferee of a *CGT asset for which there has been a roll-over under Subdivision 126-A, then you may choose that the active asset test in section 152-35 applies as if:

(a) you had acquired the asset when the transferor acquired the asset; and

(b) the asset had been an *active asset of yours at all times when the asset was an active asset of the transferor; and

(c) the asset had not been an active asset of yours at all times when the asset was not an active asset of the transferor.

Note 1: Section 103-25 tells you when the choice must be made.

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

Note 2: There is a roll-over under Subdivision 126-A if CGT assets are transferred because of a marriage breakdown.

Note 3: If you don't make the choice, the time of acquisition is simply the time of the transfer.

Note 4: Making the choice here has certain consequences for the 15-year exemption: see section 152-115.

Controlling individual test

152-50 Controlling individual test

An entity satisfies the controlling individual test if the entity had at least one *controlling individual just before the *CGT event.

152-55 Meaning of *controlling individual*

Companies

(1) An individual is a ***controlling individual*** of a company at a time if, at that time, the individual holds the legal and equitable interests in *shares, other than *redeemable shares, that carry (between them) the right to exercise at least 50% of the voting power in the company and receive at least 50% of any *dividend the company may pay and of any distribution of capital the company may make.

Trusts

(2) An individual is a ***controlling individual*** of a trust (where entities have entitlements to all the income and capital of the trust) at a time if, at that time, the individual is beneficially entitled to at least 50% of the income and capital of the trust.

(3) An individual is a ***controlling individual*** of a trust (where entities do not have entitlements to all the income and capital of the trust) at a time if, during the income year in which the time occurs:
- (a) the trust made a distribution of income or capital, or both; and
- (b) the individual was beneficially entitled to at least 50% of the total of the distributions of income made by the trust during the income year; and

*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

(c) the individual was beneficially entitled to at least 50% of the total of the distributions of capital made by the trust during the income year.

CGT concession stakeholder

152-60 Meaning of *CGT concession stakeholder*

CGT concession stakeholder of a company or trust means:

(a) a *controlling individual of the company or trust; or

(b) in the case of a company—a spouse of a controlling individual of the company, if the spouse holds the legal and equitable interests in any amount of shares in the company; or

(c) in the case of a trust mentioned in subsection 152-55(2)—a spouse of a controlling individual of the trust, if the spouse is beneficially entitled to any of the income or capital of the trust; or

(d) in the case of a trust mentioned in subsection 152-55(3)—a spouse of a controlling individual of the trust, if, during the income year referred to in that subsection, the trust made a distribution of income or capital to which the spouse was beneficially entitled.

Subdivision 152-B—Small business 15-year exemption

Guide to Subdivision 152-B

152-100 What this Subdivision is about

> A small business entity can disregard a capital gain arising from a CGT asset that it has owned for at least 15 years if certain conditions are met. Capital losses are not affected.

*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

Also, any amount of income a company or trust derives from a CGT event covered by this Subdivision is neither assessable income nor exempt income. If the company or trust makes payments to its CGT concession stakeholders that are attributable to the exempt amount, the payments will not be taken into account in determining the taxable income of the company, trust or recipient.

The main conditions are that:

- the basic conditions for relief in Subdivision 152-A are satisfied;
- the entity continuously owned the asset for the 15-year period leading up to the CGT event;
- if the entity is an individual, the individual retires or is permanently incapacitated;
- if the entity is a company or trust, the entity had a controlling individual throughout the period of ownership and the individual who was the controlling individual just before the CGT event retires or is permanently incapacitated.

The Subdivision also allows time periods to continue to run if there has been a roll-over because of marriage breakdown or compulsory acquisition.

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152-105 15-year exemption for individuals

If you are an individual, you can disregard any *capital gain arising from a *CGT event if all of the following conditions are satisfied:

*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

(a) the basic conditions in Subdivision 152-A are satisfied for the gain;

(b) you continuously owned the *CGT asset for the 15-year period ending just before the CGT event;

Note: Section 152-115 allows for continuation of the period if there is an involuntary disposal of the asset.

(c) if the CGT asset is a *share in a company or an interest in a trust—at all times during the whole period for which you owned the CGT asset, the company or trust had a *controlling individual (even if it was not the same controlling individual during the whole period);

Note: There is an exception for discretionary trusts that have tax losses in an income year: see section 152-120.

(d) either:

(i) you are 55 or over at the time of the CGT event and the event happens in connection with your retirement; or

(ii) you are permanently incapacitated at the time of the CGT event.

152-110 15-year exemption for companies and trusts

(1) An entity that is a company or trust can disregard any *capital gain arising from a *CGT event if all of the following conditions are satisfied:

(a) the basic conditions in Subdivision 152-A are satisfied for the gain;

(b) the entity continuously owned the *CGT asset for the 15-year period ending just before the CGT event;

Note: Section 152-115 allows for continuation of the period if there is an involuntary disposal of the asset.

(c) at all times during the whole period for which the entity owned the asset, the entity had a *controlling individual (even if it was not the same controlling individual during the whole period);

Note: There is an exception for discretionary trusts that have tax losses in an income year: see section 152-120.

(d) an individual who was a controlling individual of the company or trust just before the CGT event either:

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

(i) was 55 or over at that time and the event happened in connection with the individual's retirement; or

(ii) was permanently incapacitated at that time.

(2) Any *ordinary income or *statutory income the company or trust *derives from a *CGT event that would be covered by subsection (1) (assuming the event gave rise to a *capital gain, even if it didn't) is neither assessable income nor *exempt income.

Exception

(3) However, subsection (2) does not apply to income *derived by a company or trust as a result of a *balancing adjustment event occurring to a *depreciating asset:

(a) whose decline in value is worked out under Division 40; or

(b) deductions for which are calculated under Division 328.

152-115 Continuing time periods for involuntary disposals

Asset compulsorily acquired, lost or destroyed

(1) If a *CGT asset is an asset (the ***new asset***) you acquired to satisfy the requirement in subsection 124-70(2) or 124-75(2) for a roll-over under Subdivision 124-B, then paragraphs 152-105(b) and 152-110(1)(b) and (c) (the 15-year and controlling individual rules) apply as if you had acquired the new asset when you acquired the original asset.

Note: Subdivision 124-B allows you to choose a roll-over if your CGT asset is compulsorily acquired, lost or destroyed.

Assets replaced during FSR transition (same owner roll-overs)

(1A) If a *CGT asset is an asset (the ***new asset***) you acquired in a situation covered by section 124-880, 124-885 or 124-890, then paragraphs 152-105(b) and 152-110(1)(b) and (c) (the 15-year and controlling individual rules) apply as if you had acquired the new asset when you acquired the original asset.

Note: Subdivision 124-O provides a roll-over for certain CGT assets that come to an end as a result of an FSR transition.

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

Asset replaced during FSR transition (new owner roll-overs)

(1B) If a *CGT asset is an asset (the ***new asset***) acquired in a situation covered by section 124-900, 124-905 or 124-910, then paragraphs 152-105(b) and 152-110(1)(b) and (c) (the 15-year and controlling individual rules) apply as if the new owner had acquired the new asset when the original owner acquired the original asset.

Note: Subdivision 124-O provides a roll-over for certain CGT assets that come to an end as a result of an FSR transition.

Marriage breakdowns

(2) If you made the choice mentioned in subsection 152-45(2) for a *CGT asset, then paragraphs 152-105(b) and (c) and 152-110(1)(b) and (c) (the 15-year and controlling individual rules) apply as if you had acquired the asset when the transferor acquired it.

Note: There is a roll-over under Subdivision 126-A if CGT assets are transferred because of a marriage breakdown.

152-120 Discretionary trusts need not have a controlling individual in a loss year

Paragraphs 152-105(c) and 152-110(1)(c) do not apply for a trust of the kind mentioned in subsection 152-55(3) in relation to an income year during which the trust did not make a distribution of income or capital, if the trust had a *tax loss for that income year.

Note: This is because the trust might not have had the funds to make a distribution during that income year, which would prevent it from having a controlling individual in that year.

152-125 Payments to company's or trust's CGT concession stakeholders are exempt

(1) This section applies if:

(a) under section 152-110, a *capital gain of a company or trust is disregarded; or

(b) under section 152-110, an amount of income is treated as neither assessable income nor *exempt income of the company or trust; or

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

(c) paragraph (a) of this subsection would have applied to an amount except that the *capital gain was disregarded anyway because the relevant *CGT asset was *acquired before 20 September 1985.

In this section, that amount is called the ***exempt amount***.

(2) Any payment the company or trust makes (whether directly or indirectly through one or more interposed entities) within 2 years after the *CGT event to an individual who was a *CGT concession stakeholder of the company or trust just before the event is not taken into account in determining the taxable income of the company or trust, the individual or any of the interposed entities.

(3) However, subsection (2) applies only to the extent that the total of the payments made by the company or trust to a particular *CGT concession stakeholder for an exempt amount does not exceed the following limit:

$$\text{Stakeholder's control percentage} \times \text{Exempt amount}$$

where:

stakeholder's control percentage means:

(a) in the case of a company—the percentage of the interests in *shares in the company of the kind mentioned in subsection 152-55(1) held by the CGT concession stakeholder just before the *CGT event; or

(b) in the case of a trust mentioned in subsection 152-55(2)—the percentage of the income and capital of the trust to which the CGT concession stakeholder was beneficially entitled just before the CGT event; or

(c) in the case of a trust mentioned in subsection 152-55(3) that had a single CGT concession stakeholder just before the CGT event—100%; or

(d) in the case of a trust mentioned in subsection 152-55(3) that had 2 CGT concession stakeholders just before the CGT event—50% each.

*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

Subdivision 152-C—Small business 50% reduction

Guide to Subdivision 152-C

152-200 What this Subdivision is about

> This Subdivision tells you how to apply the small business CGT concessions mentioned in step 4 of the method statement in subsection 102-5(1).
>
> A capital gain is reduced by 50% if the basic conditions in Subdivision 152-A are satisfied.
>
> If the capital gain has already been reduced by the discount percentage, the 50% reduction under this Subdivision applies to that reduced gain.
>
> The capital gain may be further reduced by the small business retirement exemption or a small business rollover, or both.
>
> None of these rules apply if the 15-year exemption already applies to the capital gain, since such a gain is disregarded anyway.

Table of sections

152-205 You get the small business 50% reduction
152-210 You may also get the small business retirement exemption and small business roll-over relief
152-215 15-year rule has priority
152-220 You may choose not to apply this Subdivision

152-205 You get the small business 50% reduction

The amount of a *capital gain remaining after applying step 3 of the method statement in subsection 102-5(1) is reduced by 50%, if the basic conditions in Subdivision 152-A are satisfied for the gain.

Example: For an individual (other than one who opts to claim indexation instead of the discount), the discount percentage that applies under step 3 of the method statement is 50%. Therefore, the combined effect of the

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

discount percentage and this section would be to reduce the original capital gain by a total of 75%.

For an individual who opts to claim indexation, or a company, there is no discount percentage, so the individual or company would simply get the 50% reduction under this section.

152-210 You may also get the small business retirement exemption and small business roll-over relief

(1) The *capital gain, as reduced under section 152-205, may also qualify for:

(a) the small business retirement exemption (see Subdivision 152-D); or

(b) a small business roll-over (see Subdivision 152-E);

or both.

(2) If it qualifies for both of those concessions, you may choose which order to apply them in.

152-215 15-year rule has priority

This Subdivision does not apply to a *capital gain to which Subdivision 152-B (15-year exemption) applies.

Note: Under that Subdivision, such a gain is entirely disregarded, so there is no need for any further concession to apply.

152-220 You may choose not to apply this Subdivision

You may choose not to apply the reduction mentioned in section 152-205 to a particular *capital gain.

Note: Making this choice might allow a company or trust to make larger tax-free eligible termination payments under the small business retirement exemption: see section 152-325.

*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

Subdivision 152-D—Small business retirement exemption

Guide to Subdivision 152-D

152-300 What this Subdivision is about

> You can choose to disregard a capital gain from a CGT event happening to a CGT asset of your small business if the capital proceeds from the event are used in connection with your retirement.
>
> There is a lifetime limit of $500,000 for all choices that can be made in respect of an individual under this Subdivision.
>
> The concession in section 152-205 (small business 50% reduction) applies before this one. For an additional concession, see also Subdivision 152-E (small business roll-over).

Table of sections

152-305 Choosing the exemption
152-310 Consequences of choice
152-315 Choosing the amount to disregard
152-320 Meaning of *CGT retirement exemption limit*
152-325 Company or trust conditions
152-330 15-year rule has priority

152-305 Choosing the exemption

Individual

(1) If you are an individual, you can choose to disregard all or part of a *capital gain if:

(a) the basic conditions in Subdivision 152-A are satisfied for the gain; and

(b) if you were under 55 just before you received an amount of *capital proceeds from the *CGT event—an amount equal to the *eligible termination payment mentioned in subsection 152-310(2) is rolled over (within the meaning of Subdivision

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

AA of Division 2 of Part III of the *Income Tax Assessment Act 1936*) except by being paid as mentioned in paragraph 27A(12)(c) of that Act.

Note 1: Section 103-25 tells you when the choice must be made.

Note 2: Paragraph 27A(12)(c) of the *Income Tax Assessment Act 1936* deals with payments to life companies to purchase certain annuities.

Company or trust

(2) A company or a trust (except a public entity—see subsection (3)) can also choose to disregard such an amount if:

(a) the basic conditions in Subdivision 152-A are satisfied for the *capital gain; and

(b) the entity satisfies the controlling individual test (see section 152-50); and

(c) the company or trust conditions in section 152-325 are satisfied.

Note: Section 103-25 tells you when the choice must be made.

(3) Public entities of a kind referred to in subsection 152-30(9) cannot make the choice.

152-310 Consequences of choice

Consequences in all cases

(1) If the individual, company or trust makes the choice mentioned in section 152-305 for any part of the *capital gain from the *CGT asset, that part of the capital gain equal to its *CGT exempt amount is disregarded.

Additional consequence for an individual

(2) This Act applies to you as if the *capital proceeds from the *CGT event (to the extent of the asset's *CGT exempt amount) were an *eligible termination payment made to you at the later of:

(a) when you made the choice; and

(b) when you received the amount.

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

Note: For the rules about eligible termination payments, see Subdivision AA of Division 2 of Part III of the *Income Tax Assessment Act 1936*.

(3) In working out those *capital proceeds, disregard the market value substitution rule (see section 116-30).

(4) The amount of that *eligible termination payment is, for the purposes of Subdivision AA of Division 2 of Part III of the *Income Tax Assessment Act 1936*, a CGT exempt component.

Additional consequences for a company or trust

(5) Any *eligible termination payment or part of one the company or trust makes to comply with section 152-325:
   (a) is, for the purposes of Subdivision AA of Division 2 of Part III of the *Income Tax Assessment Act 1936*, a CGT exempt component; and
   (b) cannot be deducted from the company's or trust's assessable income.

152-315 Choosing the amount to disregard

(1) You can choose to disregard all or part of each *capital gain to which this Subdivision applies.

Note 1: You make capital gains equal to any parts that you do not choose to disregard.

Note 2: Section 103-25 tells you when the choice must be made.

(2) However, the choice must be made in a way that ensures that:
   (a) for an individual—your *CGT retirement exemption limit is not exceeded; or
   (b) for a company or trust—the CGT retirement exemption limit of each individual for whom the choice is made is not exceeded.

(3) The amount chosen for the asset is its ***CGT exempt amount***.

(4) The *CGT exempt amount must be specified in writing.

(5) If a company or trust is making the choice and it has 2 *CGT concession stakeholders, it must specify in writing the percentage

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

of each *CGT asset's *CGT exempt amount that is attributable to each of those stakeholders. One of the percentages may be nil, but they must add up to 100%.

Example: Daryl is a controlling individual of a company. The company specifies 90% for Daryl under subsection (5) (which means that the percentage specified for the other stakeholder must be 10%). Daryl's retirement exemption limit is $500,000.

To determine whether subsection (2) is complied with, Daryl would take 90% of the asset's CGT exempt amount, add that to amounts previously specified in choices made by or for him under this Subdivision and see whether the total exceeds $500,000.

Note: Subsections (4) and (5) are exceptions to the general rule about choices in section 103-25.

152-320 Meaning of *CGT retirement exemption limit*

(1) An individual's ***CGT retirement exemption limit*** at a time is $500,000 reduced by the *CGT exempt amounts of *CGT assets specified in choices previously made by or for the individual under this Subdivision.

(2) If the individual was one of 2 *CGT concession stakeholders of a company or trust, and the company or trust made a choice for the individual, only the individual's percentage (see subsection 152-315(5)) of the assets' *CGT exempt amounts is taken into account under subsection (1) for that choice.

152-325 Company or trust conditions

(1) Each time a company or trust receives an amount of *capital proceeds from a *CGT event for which it makes a choice under this Subdivision, the company or trust must make an *eligible termination payment in relation to each of its *CGT concession stakeholders.

(2) If there are 2 such stakeholders, the amount of each such *eligible termination payment is to be worked out by reference to each individual's percentage (see subsection 152-315(5)) of the relevant *CGT exempt amount.

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

(3) The payment must be made by the later of:
   (a) 7 days after it makes the choice; and
   (b) 7 days after it receives an amount of *capital proceeds from the *CGT event.

(4) In working out those *capital proceeds, disregard the market value substitution rule (see section 116-30).

(5) The amount of the *eligible termination payment, or the sum of the amounts of the eligible termination payments, required to be made under subsection (1) must be equal to the lesser of:
   (a) the amount of *capital proceeds received; and
   (b) the relevant *CGT exempt amount.

(6) If this section requires the company or trust to make 2 or more *eligible termination payments to a single stakeholder (whether or not by the same time), the company or trust may meet that requirement by making one payment or by making separate payments.

(7) If a stakeholder is under 55 just before receiving an *eligible termination payment under subsection (1), an amount equal to that payment must be rolled over (within the meaning of Subdivision AA of Division 2 of Part III of the *Income Tax Assessment Act 1936*) except by being paid as mentioned in paragraph 27A(12)(c) of that Act.

Note: Paragraph 27A(12)(c) of the *Income Tax Assessment Act 1936* deals with payments to life companies to purchase certain annuities.

152-330 15-year rule has priority

This Subdivision does not apply to a *capital gain to which Subdivision 152-B (15-year exemption) applies.

Note: Under that Subdivision, such a gain is entirely disregarded, so there is no need for any further concession to apply.

*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

Subdivision 152-E—Small business roll-over

Guide to Subdivision 152-E

152-400 What this Subdivision is about

> A small business roll-over allows you to defer the making of a capital gain from a CGT event happening in relation to one or more small business assets if you acquire replacement assets.
>
> The concession in section 152-205 (small business 50% reduction) applies before this one. For an additional exemption, see also Subdivision 152-D (small business retirement exemption).

Table of sections

152-405 Basic principles for the small business roll-over
152-410 When you can obtain the roll-over
152-415 What the roll-over consists of
152-420 Replacement asset conditions
152-425 Rules where an individual who has obtained a roll-over dies
152-430 15-year rule has priority

152-405 Basic principles for the small business roll-over

(1) You can choose to obtain a roll-over if the basic conditions in Subdivision 152-A are satisfied for the capital gain.

(2) You must acquire a replacement asset within the period from one year before to 2 years after the happening of the last CGT event in the income year for which you obtain the small business roll-over.

(3) The form of the roll-over is that the capital gain is disregarded to the extent that it does not exceed the cost base of the replacement asset.

(4) You will make a separate capital gain if a CGT event subsequently happens to the replacement asset or if its status changes in particular ways.

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

152-410 When you can obtain the roll-over

You can choose to obtain a roll-over under this Subdivision for a *capital gain if:

(a) the basic conditions in Subdivision 152-A are satisfied for the gain; and

(b) within the period starting one year before, and ending 2 years after, the last *CGT event during the year for which you choose a small business roll-over, you choose one or more *CGT assets as replacements (the ***replacement asset***); and

(c) the replacement asset satisfies the conditions set out in section 152-420.

Note: Paragraph (b) is an exception to the general rule about choices in section 103-25.

152-415 What the roll-over consists of

If you choose the roll-over, so much of the *capital gain that would have remained apart from the roll-over as does not exceed the total of the first and second elements of the *cost base of the replacement asset is disregarded.

Note: If there is an amount of the capital gain that cannot be so disregarded, you make a capital gain equal to that amount.

Example: The original capital gain was $100. You have reduced it to $25 under other concessions (apart from the roll-over). If the total of the first and second elements of the cost base of the replacement asset is $20, you can disregard $20 under this section, leaving a final capital gain of $5.

152-420 Replacement asset conditions

(1) For an asset to be eligible to be a replacement asset, you must *acquire it during the period starting one year before, and ending 2 years after, the happening of the last *CGT event in the income year for which you obtain the small business roll-over.

Extension of time if all reasonable steps taken

(2) This time limit does not apply to the extent that your *capital proceeds for the *CGT event are increased under subsection 116-45(2) after that time is up. Instead, you have until 12 months

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

after you receive those additional proceeds to *acquire a replacement asset the first and second elements of the *cost base of which are at least equal to the value of those additional proceeds.

Note 1: If you do not acquire a replacement asset with a sufficiently large cost base within the new time limit, your roll-over will be reduced accordingly under section 152-415.

Note 2: Section 116-45 applies if you do not receive your capital proceeds despite having taken all reasonable steps to get them.

(3) The Commissioner may extend the time limits under subsections (1) and (2).

Type of replacement asset allowed

(4) A replacement asset must be an *active asset when it is *acquired or an active asset by the end of 2 years after the last *CGT event during the year for which you choose a small business roll-over.

Note: If a replacement asset is an active asset and its status subsequently changes, you may make a capital gain: see section 104-185 (CGT event J2). Special rules apply if you die: see section 152-425.

(5) If a replacement asset is a *share in a company or an interest in a trust, you, or an entity *connected with you, must be a *controlling individual of the company or trust just after you *acquire the share or interest.

Example: Joseph owns 50% of the shares in Company A and Company B. He is therefore a controlling individual of the companies (see section 152-55). The companies are connected with Joseph (see section 152-30) because he controls both of them.

Company A owns land which it leases to Joseph for use in a business. It sells the land at a profit and buys shares in Company B.

The replacement asset test is satisfied because Joseph is *connected with* Company A and is a *controlling individual* of Company B.

Note: If a replacement asset is a share in a company and the status of the company changes, or you or an entity connected with you ceases to be its controlling individual, you may make a capital gain: see section 104-190 (CGT event J3). Special rules apply if you die: see section 152-425.

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*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

152-425 Rules where an individual who has obtained a roll-over dies

(1) If a replacement asset that formed part of the estate of an individual who has died has devolved to the deceased's *legal personal representative and:

(a) the status of the replacement asset did not change in any of the ways covered by subsection 104-185(1) while the deceased owned it; or

(b) if the replacement asset is a *share in a company or an interest in a trust, the circumstances of the company or trust did not change in any of the ways covered by section 104-190 while the share or interest was in the hands of the deceased;

then, for the purposes of this Subdivision, anything done or not done by the deceased in relation to the asset is treated as though it had been done or not done by the legal personal representative.

(2) If the replacement asset has passed to a beneficiary of the deceased individual and:

(a) the status of the replacement asset did not change in any of the ways covered by subsection 104-185(1) while the deceased owned it; or

(b) if the replacement asset is a *share in a company or an interest in a trust, the circumstances of the company or trust did not change in any of the ways covered by section 104-190 while the share or interest was in the hands of the deceased or the deceased's *legal personal representative;

then, for the purposes of this Subdivision, anything done or not done by the deceased or by the deceased's legal personal representative in relation to the asset is treated as though it had been done or not done by the beneficiary.

*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

152-430 15-year rule has priority

This Subdivision does not apply to a *capital gain to which Subdivision 152-B (15-year exemption) applies.

Note: Under that Subdivision, such a gain is entirely disregarded, so there is no need for any further concession to apply.

*To find definitions of asterisked terms, see the Dictionary, starting at section 995-1.

APPENDIX B: SUBMISSIONS RECEIVED

The Board received submissions on the post-implementation review of Division 152 from the following parties.

Appleton, Richard

Australian Chamber of Commerce and Industry

Australian Forest Growers

Burton, Dr Mark, Law School, University of Canberra

Cedar Sales

CPA Australia

Department of Agriculture, Fisheries and Forestry

Grant Thornton

Hayes Knight

Hepworth & Co Pty Ltd

Housing Industry Association

Leung, Bill - Lowenstein Sharp Pty Ltd

National Farmers' Federation

National Institute of Accountants

Nissen Kestel Harford

Taxation Institute of Australia

Taxpayers Australia

The Institute of Chartered Accountants in Australia

The National Tax and Accountants' Association

The Pharmacy Guild of Australia

Appendix C: Members and Charter of the Board of Taxation, conflict of interest declaration

Members

The members of the Board of Taxation are:

Chairman

Mr Richard F.E. (Dick) Warburton, AO

Deputy Chairman

Mr Chris Jordan, AO

Members

Mr Brett Heading

Mr Keith James

Mr Eric Mayne

Mr Curt Rendall

Ms Jane Schwager

Ex officio members

Mr Michael Carmody, AO (Commissioner of Taxation)

Dr Ken Henry (Secretary to the Treasury)

Mr Peter Quiggin (First Parliamentary Counsel)

Secretariat

Members of the Board's Secretariat who contributed to this report were Mr Bruce Paine (Secretary), Mr Vernon Joice, Ms Elaine Abery and Mr Mike Kooymans.

Charter

Mission

Recognising the Government's responsibility for determining taxation policy and the statutory roles of the Commissioner of Taxation and the Inspector-General of Taxation, the Board's mission is to contribute a business and broader community perspective to improving the design of taxation laws and their operation.

Membership

The Board of Taxation will consist of up to ten members.

Up to seven members of the Board will be appointed by the Treasurer, for a term of up to three years, on the basis of their personal capacity. It is expected that these members will be appointed from within the business and wider community having regard to their ability to contribute at the highest level to the development of the tax system. The Chairman will be appointed by the Treasurer from among these members of the Board. If the Treasurer decides to appoint a Deputy Chairman, he or she will also be appointed from among these members of the Board. Members may be re-appointed.

The Secretary to the Department of the Treasury, the Commissioner of Taxation and the First Parliamentary Counsel will also be members of the Board. Each may be represented by a delegate.

Function

The Board will provide advice to the Treasurer on:

- the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design;
- improvements to the general integrity and functioning of the taxation system;
- research and other studies commissioned by the Board on topics approved or referred by the Treasurer; and
- other taxation matters referred to the Board by the Treasurer.

Relationship to other boards and bodies

From time to time the Government or the Treasurer may establish other boards or bodies with set terms of reference to advise on particular aspects of the tax law. The Treasurer will advise the Board on a case-by-case basis of its responsibilities, if any, in respect of issues covered by other boards and bodies.

Report

The Chairman of the Board will report to the Treasurer, at least annually, on the operation of the Board during the year.

Secretariat

The Board will be supported by a secretariat provided by the Treasury, but may engage private sector consultants to assist it with its tasks.

Other

Members will meet regularly during the year as determined by the Board's work program and priorities.

Non-government members will receive daily sitting fees and allowances to cover travelling and other expenses, at rates in accordance with Remuneration Tribunal determinations for part-time public offices.

The Government will determine an annual budget allocation for the Board.

Conflict of interest declaration

All members of the Board are taxpayers in various capacities. Some members of the Board derive income from director's fees, company dividends, trust distributions or as a member of a partnership.

The Board's practice is to require members who have a material personal interest in a matter before the Board to disclose the interest to the Board and to absent themselves from the Board's discussion of the matter, including the making of a decision, unless otherwise determined by the Chairman (or if the Chairman has the interest, the other members of the Board).

The Board does not regard a member as having a material personal interest in a matter of tax policy that is before the Board merely because the member's personal interest may, in common with other taxpayers or members of the public, be affected by that tax policy or by any relevant Board recommendations.