Small business CGT concessions – current issues
Tuesday, 28 August 2012
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Introduction

This paper, aimed at an advanced audience, discusses recent developments in relation to the Small Business Capital Gains Tax (CGT) Concessions. The paper is presented as part of The Institute of Chartered Accountants in Australia (Institute) special topics program.

The small business CGT concessions contained within Division 152 of the *Income Tax Assessment Act 1997 (ITAA 1997)* were introduced with effect from 11:45 am on 21 September 1999. The concessions aimed to improve CGT relief available to small businesses to assist in the funding of business expansion as well provide for retirement.

Since their introduction, the concessions have been subject to a number of major reviews by the Board of Taxation and subsequent legislative amendment (most recently in 2007, 2009 and 2011). Although these reviews have sought to simplify the operation of the small business CGT concessions, taxpayers and practitioners alike are currently faced with a myriad of extremely complex and definitional based rules which are a challenge to apply and interpret.

The complexity of these rules was most recently acknowledged by the Henry Review where it was concluded that:

> Small businesses bear a disproportionally higher share of the tax compliance burden. To reduce this burden and to provide small business with greater tax certainty, the existing small business tax concessions should be streamlined and broadened. Access to the small business tax concessions under the small business framework should be extended by increasing the ‘small business entity test’ (turnover test) from $2 million to $5 million.

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1 All section references are to the *Income Tax assessment Act 1997 (ITAA 1997)* unless otherwise stated. References to the ITAA 1936 are to the *Income Tax Assessment Act 1936*

2 *Australia’s Future Tax System Review* (Henry Review)
In addition to changes to the small business entity test, the Henry Review also recommended that a number of changes be made to the concessions themselves, namely:

… the small business entity capital gains tax concessions should be rationalised and streamlined. The active asset 50% reduction and 15-year exemption concessions should be abolished. The lifetime limit for the retirement exemption should be increased and taxpayers who sell a share in a company or an interest in a trust should be able to access the concessions via the turnover test.

What such proposals would mean for taxpayers is not yet known as the Federal Government is yet to act on these proposed measures. As such taxpayers and tax practitioners should monitor future announcements to see whether any major changes are made to the operation of the small business CGT concessions.

Until such time as this occurs we are left to navigate our way through these complex rules.

This paper provides an overview of the key conditions which must be satisfied and a number of recent developments impacting these including the outcome of a number of recent Federal Court and Administrative Appeals Tribunal (AAT) decisions – decisions which highlight the need to take into account all the surrounding facts and circumstances before attempting to apply these concessions. It also addresses the key issue of how to access capital proceeds once an exemption has been claimed.
Small business CGT concessions

To help small business, if certain conditions are satisfied, capital gains (except capital gains from CGT event K7) can be reduced by the various small business CGT concessions contained in Division 152.

Subdivision 152-A contains the basic conditions that must be met in relation to each CGT event. Some of the concessions have additional, specific conditions that must also be satisfied.

There are four main concessions available to eligible small business taxpayers:

1. Small business 15-year exemption (in Subdivision 152-B)
2. 50% ‘active asset’ reduction (in Subdivision 152-C)
3. Retirement concession (in Subdivision 152-D)
4. Small business roll-over (in Subdivision 152-E)

A capital gain that qualifies for the 15 year exemption is disregarded entirely, and applies in priority to the other concessions. If it does not apply, taxpayers then have a choice as to the order in which they apply the remaining concessions.

2.1 The Basic conditions

A taxpayer must satisfy four basic conditions in order to qualify for the small business CGT concessions. These basic conditions are listed in section 152-10, and are common to all concessions. The conditions are as follows:

1. A CGT event happens in relation to a CGT asset of the taxpayers in an income year;
2. The CGT event would have resulted in a gain if not for the application of the small business CGT concessions;

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3 Balancing adjustment events for depreciating assets and certain assets used for Research and Development
4 Does not apply to CGT Events J2, J5, and J6
5 Does not apply to CGT Events J2, J5, and J6
6 Does not apply to CGT Events J5, and J6
7 Not applicable to CGT event D1 (see section 152-12)
3. At least one of the following applies:
   a. The taxpayer is a **small business entity** (‘SBE’) for the income year;
   b. The taxpayer satisfies the **maximum net asset value test**; or
   c. The taxpayer is a partner in a partnership that is a SBE for the income year and the CGT asset is an interest in an asset of the partnership.

4. The CGT asset satisfies the **active asset test**.

Following the enactment of *Tax Laws Amendment (2009 Measures No.2) Act 2009*, access to the small business CGT concessions was extended through the introduction of new non-business owner rules (subsections 152-10(1A) & (1B)).

These rules apply from the 2007/08 financial year, and are as follows:

1. Taxpayers owning a CGT asset that is used in a business carried on by an affiliate or connected entity of the taxpayer may now access the concessions provided the business satisfies the SBE test; and
2. One or more partners owning a CGT asset which is used in a partnership business may access the concessions provided the partnership business satisfies SBE test.

### 2.2 Additional conditions where disposing of shares in a company or an interest in a trust

Where the CGT asset is a share in a company or an interest in a trust (the object company or trust), an additional basic condition must be satisfied ‘just before’ the CGT event occurs. The condition contained in subsection 152-10(2) requires that either:

(i) The taxpayer is a **CGT concessional stakeholder** in the object company or trust; or

(ii) The CGT concessional stakeholders in the object company or trust together have a **small business participation percentage** in the taxpayer of at least 90%.

#### 2.2.1 CGT concessional stakeholder

A CGT concessional stakeholder of a company or a trust is defined at section 152-60 as an individual who:

(a) Is a **significant individual** in the company or trust; or
(b) A spouse of a significant individual in the company or trust, if the spouse has a small business participation percentage in the company or trust that is greater than zero.

2.2.2 Significant individual

In accordance with section 152-55, “an individual is a significant individual in a company or a trust at the time if, at that time, the individual has a small business participation percentage in the company or trust of at least 20%”.

2.2.3 Small business participation percentage

Section 152-65 defines an entities small business participation percentage in another entity to be the sum of its direct and indirect small business participation percentage in the entity.

A direct small business participation percentage is defined in section 152-70 and includes specific requirements for companies, fixed trusts and discretionary trusts. Section 152-75 explains how an entity's indirect small business participation percentage is calculated.

The direct small business participation percentage in a company is defined as the lesser of a shareholder's percentage of voting power, rights to dividends and capital distributions in the company.

Note

Remember when determining the small business participation percentage of a company that redeemable shares are ignored for the purposes of section 152-70.

Regard must always be had to the rights attaching to shares in order to determine whether they are in fact redeemable.

For fixed trusts it is the lesser of the percentage of income or capital distributions the beneficiary is entitled to. A similar test applies for discretionary trusts – although in that instance the relevant percentages are based on the income and capital distributions made during the current income year – which is effectively the year in which the CGT event occurs.

In order to qualify as a significant individual, the individual's direct and indirect small business participation percentage in the company or trust must be at least 20%.
Note

Legislation has recently received Royal Assent which is aimed at ensuring taxpayers can have a non-zero direct small business participation percentage in certain situations. This may occur in situations where shares in a company are held jointly by taxpayers and a discretionary trust has not made a distribution in an income year where the trust had a tax loss or no net income for that year. See Section 10 for further details in relation to these changes.

2.2.4 Interaction of small business participation percentage with trust streaming rules

Subsection 152-70(1) defines the small business participation percentage of a discretionary trust. As noted above this percentage will depend on what income or capital distributions are made by the trust during the year and the extent to which an individual beneficiary is entitled to one or both of them. The percentage will be taken to the lesser of the beneficiary’s entitlement to income or capital distributions.

Example

Assume a trust makes an income distribution of $100 during the year and a capital distribution of $50. Beneficiary A is entitled to $40 of the income distribution and $10 of the capital distribution. Beneficiary A is entitled to 40% of the trust’s income distribution but only 20% of the trust’s capital distribution.

In accordance with subsection 152-70(1), Beneficiary A’s small business participation percentage will be taken to be the smaller of the two percentages, which in this case is 20%.

As the income year in question is the year in which the CGT event occurs, trusts have an opportunity to distribute their trust income and capital in such a way as to ensure that they have a CGT concession stakeholder for the purposes of the small business CGT concessions.

However, post the High Court decision in Commissioner of Taxation v. Bamford [2010] HCA 10 and the introduction of the trust streaming provisions by Taxation Laws Amendment (Measures No 5) Act 2011 care needs to be taken to ensure that this outcome is achieved.

As a starting point it will be essential to understand the Trust Deed’s definition of trust income and what amounts derived by the trust during the year fall within this definition (e.g. are capital gains included?)
Where a capital gain has been derived during the year it will also be important to consider whether it is appropriate to make a beneficiary specifically entitled to this gain especially in light of whether the gain can be distributed as either income or capital by the trust as differing outcomes may result.

Consider the following scenarios which illustrate the potential outcomes that might arise depending upon whether a capital gain is distributed as either income or capital of the trust.

**Example**

**Scenario A**

- Assume that net capital gains are treated as trust income in accordance with the trust deed.

- During the year of income the trust derives a discountable capital gain of $100 and no other income. Total trust income is therefore $50.

- The trustee decides to make Ben specifically entitled to 100% of the capital gain. In order to achieve this the trustee distributes the entire $50 of trust income to Ben and makes a capital distribution of $50. No other capital distributions are made.

In this scenario Ben is entitled to receive 100% of both the income and capital distributions made by the trust during the year. Ben will therefore have a small business participation percentage of 100% (and be considered a CGT concession stakeholder).

**Scenario B**

Instead assume that capital gains do not fall within the definition of trust income. Consequently, the only way in which the trustee may distribute this capital gain to beneficiaries in accordance with the Trust Deed is by way of a capital distribution.

- If the trustee resolves to make Ben specifically entitled to 100% of the capital gain derived by the trust during the year, and this is the only amount of capital distributed by the trust, then Ben will be entitled to 100% of the trust’s capital distributions for the year.

- If the trust makes no distributions of income in that year, Ben will have a small business participation percentage of 100% in the trust and be considered a CGT concession stakeholder.
If, however, the trust also makes distributions of income and no income is distributed to Ben, Ben’s small business participation percentage will be taken to nil despite having received 100% of the trust’s capital distribution.

2.2.5 Operation of the additional conditions contained in subsection 152-10(2) – an example

The following example illustrates the operation of the additional conditions contained in subsection 152-10(2). In each scenario the shares in XYZ Pty Ltd (the object company) are being disposed of.
2.3 Special rules for certain CGT events

The 15 year exemption and active asset reduction do not apply to the following CGT events:

- J2 - Change in relation to replacement asset or improved asset after a roll-over under Subdivision 152-E,
- J5 - Failure to acquire replacement asset and to incur fourth element expenditure after a roll-over under Subdivision 152-E; or
- J6 - Cost of acquisition of replacement asset or amount of fourth element expenditure, or both, not sufficient to cover disregarded capital gain

The small business roll-over does not apply to the following CGT events:

- J5 - Failure to acquire replacement asset and to incur fourth element expenditure after a roll-over under Subdivision 152-E; or
- J6 - Cost of acquisition of replacement asset or amount of fourth element expenditure, or both, not sufficient to cover disregarded capital gain

CGT event D1 (Creating contractual or other rights) also has special conditions. Should a D1 event occur, basic conditions 1 & 4 are not required to be met (subsections 152-10(1)(a) & (d)). Instead, there is an additional requirement that the right created is inherently connected with a CGT asset of the taxpayer that satisfies the active asset test.

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8 Subsection 152-120(4)
Small Business Entity (SBE)

The concept of a Small Business Entity (SBE) was introduced with effect from 1 July 2007 through the Tax Laws Amendment (Small Business) Act 2007, and was aimed at aligning the income tax provisions with the small business CGT concessions. Prior to its introduction, a taxpayer could be a small business taxpayer for the purpose of income tax provisions, but not necessarily for the small business CGT concessions.

If a taxpayer qualifies as a SBE (provided they meet other basic conditions outlined in section 152-10) they are not required to meet the maximum net asset value test and will automatically qualify for the Small Business CGT Concessions.

3.1 Meaning of SBE

The meaning of small business entity is given at section 328-110 and requires a taxpayer to:

1. Carry on a business; and
2. Satisfy the $2 million aggregated turnover test.

Where the taxpayer meets both of these conditions, they will automatically be a SBE. Special rules also apply for passively held assets which are dealt with below.

3.1.1 Carrying on a business

The first condition of eligibility for SBE status is that a taxpayer must be carrying on a business. A business is defined in section 995-1 as “any profession, trade, employment, vocation or calling, but does not include occupation as an employee”. Whether a taxpayer carries on a business is a question of fact and degree. Guidance is provided in the following taxation rulings:

- TR 97/11 – carrying on a business of primary production;
- TR 2005/1 – carrying on a business as a professional artist; and
- TR 2008/2 – carrying on a business in the horse industry.

General factors to consider include whether a profit motive exists, the size of the operation, the repetition of the operation, and whether business records and plans exist.
Receipts of passive income, such as rent, royalties or interest would typically not constitute the carrying on of a business.

3.1.2 Passively held assets – affiliates and entities connected with you

In accordance with section 152-10 (1A), if you do not carry on a business (except as a partner in a partnership), you may be eligible for the concessions if, in the year the CGT event happens:

- Your asset is used, or held ready for use in, or inherently connected with, a business carried on by your affiliate, or an entity connected with you, and
- Your affiliate, or an entity that is connected with you has an aggregated turnover of less than $2 million (i.e. it passes the SBE test).

There are special rules for calculating the aggregated turnover for passively-held assets contained within section 152-48. Any entities that are connected or affiliated with you will be taken to be connected or affiliated with the small business entity.

Similarly, there are special affiliate rules contained within section 152-47 for spouses and children under 18 that apply for passively-held assets in determining whether entities are connected or affiliated with each other.

3.1.3 Passively held assets – partnerships

For passively held assets held in relation to partnerships, subsection 152-10(1B) outlines conditions to be satisfied in order to meet the eligibility criteria to access the concessions. These are:

(a) You are a partner in a partnership; and
(b) The partnership is a SBE for the income year; and
(c) You do not carry on a business in the income year (other than the partnership); and
(d) The CGT asset is not an interest in an asset of the partnership; and
(e) The business you carry on as a partner in the partnership referred to in (a) is the business that you, at a time in the income year, carry on in relation to the CGT asset.
3.2 The aggregated turnover test

The second condition of eligibility for SBE status is that a taxpayer must have an aggregated turnover of less than $2 million. Aggregated turnover is defined by section 328-115 as the sum of the relevant annual turnovers of the taxpayer, its connected entities and affiliates.

In accordance with subsection 328-115(3), aggregated turnover does not include:

- Amounts derived by the taxpayer in dealings with connected entities or affiliates; or
- Amounts derived from dealings between connected entities or affiliates.

These adjustments are required in order to avoid double counting of annual turnovers.

3.2.1 Annual turnover

A taxpayer’s annual turnover is defined in section 328-120(1) as “the total ordinary income that the entity derives in an income year in the ordinary course of carrying on a business”.

3.2.2 What does the phrase ‘in the ordinary course of carrying on a business’ mean?

Paragraphs 2.14 - 2.16 of The Explanatory Memorandum to the Tax Laws Amendment (Small Business) Bill 2007, explains:

2.14 The phrase 'in the ordinary course of carrying on a business' is not defined in income tax law. It must therefore be interpreted according to its ordinary meaning.

2.15 In general, income is derived in the ordinary course of carrying on a business if the income is of a kind that is regularly or customarily derived by the entity in the course of carrying on its business, arising out of no special circumstance or unusual event. Similarly, the income is derived in the ordinary course of carrying on a business if the income, although not regularly derived, is a direct result of the normal activities of the business.

2.16 Ordinary income may be derived in the ordinary course of carrying on a business even if it is not the main type of ordinary income derived by the entity. Similarly, the income does not need to account for a significant part of the entity's overall receipts. It is sufficient that the ordinary income is of a kind derived regularly or customarily in the carrying on of a business.
Generally, amounts derived in the ‘ordinary course of carrying on a business’ will exclude amounts of capital gains (as they are statutory income) and insurance or compensation proceeds in relation to loss or destruction of a capital asset. However, if the insurance or compensation proceeds were received in relation to a loss on revenue account, these amounts would be included in the taxpayer’s annual turnover as they would satisfy income derived in the ordinary course of business⁹.

### 3.2.3 Rules to apply when calculating annual turnover

When calculating annual turnover a taxpayer must apply the following rules:

- Annual turnover must be calculated excluding amounts relating to GST;
- Annual turnover must exclude amounts relating to the sale of retail fuel;
- Amounts derived from dealings with associates must be included at arm’s length (although note that certain amounts derived from dealings with associates are excluded per subsection 328-115(3)); and
- If the business has only traded for part of an income year, the annual turnover must be worked out using a reasonable estimate. Subsection 328-120(5) effectively provides for extrapolating the part year turnover of a business to a full year equivalent where that business is not carried on for the whole of an income year. The intent of the provision is to ensure the true size of the business is taken into account in determining whether the $2 million turnover requirement is satisfied (see ATO ID 2009/49 example below).

**ATO ID 2009/49 – Annual turnover – business carried on part year only**

Where a taxpayer carries on a business for the whole of an income year, and a second business for only part of that income year, the aggregated annual turnover would be worked out using a reasonable estimate of the annual turnover of the second business in addition to the turnover of the original business.

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⁹ Carapark Holdings Ltd v FCT [1967] HCA 5; 115 CLR 653 14 ATD 402
3.2.4 Determining aggregated turnover

Section 328-110 currently provides three methods of determining a taxpayer’s turnover for the purpose of SBE eligibility in relation to Small Business CGT concessions:

1. ‘Look back test’ – the taxpayer will be a SBE if its aggregate turnover was less than $2 million in the income year prior to the current year (paragraph 328-110(1)(b)(i));
2. ‘Look forward test’ – the taxpayer will be a SBE if they carried on a business in the current year, and the aggregated turnover is likely to be less than $2 million. This estimate must be made from the first day of the current year, or where the business commenced during the year, the date of commencement. If the taxpayer carried on business in the previous 2 years and the aggregated turnover for each of those years was $2 million or more, the taxpayer will not be a SBE (paragraph 328-110(1)(b)(ii)); and
3. ‘Actual test’ – the taxpayer will be a SBE if their actual aggregated turnover for the current year, worked out at the end of the year, is less than $2 million (paragraph 328-110(4)).

3.3 Connected entities

The concept of what is a ‘connected entity’ is central to the operation of the SBE test.

In accordance with subsection 328-125(1), an entity is connected with another entity if:

(a) Either entity controls the other; or
(b) Both entities are controlled by the same third entity;

The control test differs depending on the entity type in question.

3.3.1 Direct control of a company

In accordance with paragraph 328-125(2)(b), an entity (the first entity) controls a company if the first entity and/or its affiliates beneficially own, or have the right to acquire the beneficial ownership of equity interests 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.
Note

Always ensure that you are aware of the impact of any ‘side agreements’ between taxpayers. They may impact who has the right to exercise control of the voting power in a company and may give rise to unexpected outcomes. For example, commercial arrangements with third parties may indicate an individual has voting control over his/her spouse’s shares.

3.3.2 Direct control of a trust (other than discretionary trust)

An entity will control a fixed trust where the entity and/or its affiliates beneficially own, or have the right to acquire beneficial ownership of, interests in the fixed trust that carry between them the right to at least 40% (the control percentage) of any distribution of income or capital (paragraph 328-125(2)(a)).

3.3.3 Direct control of a partnership

An entity will control a partnership where the entity and/or its affiliates beneficially own, or have the right to acquire beneficial ownership of, interests in the partnership that carry between them the right to at least 40% (the control percentage) of the net income of the partnership\(^\text{10}\) (paragraph 328-125(2)(a)).

ATO ID 2010/106 - Connected entities – ‘control' of an unadministered deceased estate

The Commissioner does not consider unadministered deceased estates who carry on business in partnership to be connected with each other, regardless of whether the estates have the same executor or beneficiaries.

3.3.4 Direct control of a discretionary trust

The direct control of a discretionary trust is dealt with by subsections 328-125(3) & (4), which provide:

- An entity (the first entity) controls a discretionary trust if a trustee of the trust acts, or could reasonably be expected to act, in accordance with the direction or wishes of the first entity, its affiliates, or the first entity together with its affiliates.

ATO ID 2008/139 – whether an appointer controls a discretionary trust

\(^\text{10}\) Net income of the partnership is determined in accordance with s92 of ITAA 36
The Commissioner is of the view that the person with the power to remove and appoint the trustee of a discretionary trust (i.e. the appointor), controls the trust.

- An entity controls a discretionary trust for an income year if, for any of the 4 income years before that year:
  - The trustee paid income or capital of the trust to the entity and/or its affiliates; and
  - The entity and/or its affiliates received at least 40% (the control percentage) of the income or capital paid or applied by the trustee for that income year.

### Control of discretionary trusts where no distribution is made

Prior to 1 July 2007, if a trust did not have any taxable income from which to make a distribution, the trustee could nominate up to four beneficiaries to be controllers of the trust for that year.

From 1 July 2007, a beneficiary who is a nominated controller is connected with the trust for the purpose of the active asset test only, and not the maximum net asset value test or the aggregated turnover test.

Note recent amendments have extended the application of these rules beyond the active asset test. See Section 10 in relation to recent developments for further details.

#### 3.3.5 Indirect control of an entity

If an entity (the first entity) directly controls another entity (the second entity), and that second entity controls another entity (the third entity), the first entity is deemed to control the third entity for the purposes of the control test (subsection 328-125(7)). Although note that subsection 328-125(8) does limit the operation of this provision in certain situations.

#### 3.3.6 The Commissioner may determine that an entity does not control another entity.

It is important to remember that the Commissioner has a discretion under subsection 328-125(6) to determine that an entity does not control another entity where:

- The control percentage is at least 40%, but less than 50%; and
- The Commissioner considers that the entity is in fact controlled by others.

As with all discretions it would be necessary to apply to the Commissioner in writing for him to exercise this discretion.
Staggered exits

Where an entity is connected with another entity, taxpayers may wish to consider the advantages of a staggered exit where commercially appropriate particularly where the small business CGT concessions are not initially available.

By selling down ownership to a point where the control percentage is below 40% but above 20% (i.e. not connected, but still a CGT concession stakeholder), the taxpayer is no longer required to include the previously connected entities for the purposes of the maximum net asset value test (see Section 4) or the aggregated turnover test (see Section 3) – thereby potentially making it easier for the basic conditions to be satisfied.

3.4 Affiliates

An affiliate is defined to be an individual or company that acts, or could reasonably be expected to act, in accordance with the directions or wishes, or in concert with, the taxpayer in relation to the affairs of the business of the individual or company (section 328-130(1)).

However, individuals or companies are not automatically affiliates merely due to the legal nature of their business or personal relationship (subsection 328-130(2)). For example, partners, co-directors, co-trustees, etc are not necessarily affiliates merely due to their business relationship. Similarly, directors are not necessarily affiliates of the company of which they are a director of, or vice-versa.
Spouses or children under 18 - affiliates for certain passively held assets

With the introduction of Tax Laws Amendment (2009 Measures No.2) Act 2009, section 152-147 was inserted to widen the definition of ‘affiliates’ (from the 2007-08 income year) to automatically include spouses or children under 18 years as affiliates of individuals in circumstances where:

(a) An entity (asset owner) owns a CGT asset, and the asset is used, or is held ready for use, in the course of carrying on a business by another entity (the business entity) or is inherently connected with a business carried on by another entity; and

(b) The business entity is not an affiliate of, or connected with the owner (but for the application of section 152-47).

In such cases, in determining whether the business entity is an affiliate or is connected with the asset owner, spouses or children under 18 years are deemed to be affiliates of an individual. As such their assets and turnovers are included for the purposes of the active asset test (Subdivision 152-A), SBE test (section 328-110), turnover test (sections 328-115 & 120), and the definition of connected entity (section 328-125).

It is important to remember that this rule only applies if the ‘business’ entity is not otherwise an affiliate of, or connected with, the asset-owning entity. This means that if the business entity is an affiliate of the asset-owning entity as a result of applying section 328-130, an individual’s spouse or child (under the age of 18) would not be treated as an affiliate of the individual. Similarly, if the business entity is already connected with the asset-owning entities via section 328-125, these rules would not apply.
Maximum Net Asset Value Test

If a taxpayer is unable to establish that they are a SBE in the year in which the CGT event occurs, they are still able to access the small business CGT concessions if they satisfy the maximum net asset value test (paragraph 152-10(1)(c)(ii)).

4.1 Meaning of maximum net asset value

Section 152-15 states that a taxpayer satisfies the maximum net asset value test if, just before the CGT event, the sum of the following amounts does not exceed $6,000,000:

(a) The net value of the taxpayer’s CGT assets;
(b) The net value of the CGT assets of any entities connected with the taxpayer; and
(c) The net value of the CGT assets of any affiliates of the taxpayer or entities connected with the affiliates (not counting any assets already counted under paragraph (b).

Subsection 152-20(1) defines the ‘net value of the CGT assets’ of any entity to be the amount (whether positive, negative or nil) obtained by subtracting from the sum of the market values of those assets the sum of:

(a) The liabilities of the entity that are related to the assets; and
(b) The following provisions made by the entity:
   i. Provisions for annual leave
   ii. Provisions for long service leave
   iii. Provisions for unearned income; and
Note

There have been a number of changes to the maximum net asset value test since its original introduction including increasing the relevant threshold from $5 million to $6 million with effect from 1 July 2007. Please be aware of this change as a number of cases dealing with the application of the small business CGT concession relate to years in which the $5 million threshold applied.

4.1.1 Assets to include for purpose maximum net asset value test

Assets to be included in determining the net value of the CGT assets are not restricted to business assets. They include all CGT assets of the entity, unless the assets are specifically excluded. Excluded assets include:

- Some interests in connected entities;
  When calculating the net value of the CGT assets of an entity, paragraph 152-20(2)(a) requires taxpayers to exclude the value of interests in entities connected with the taxpayer or the taxpayer’s affiliates to avoid double counting in the net asset value calculation, as the assets underlying these interests are already counted.

Prior to 23 June 2009, the liabilities relating to such disregarded interests were also excluded so that such liabilities were never taken into account in the net asset value calculation. However, this was seen to disadvantage taxpayers as it excluded liabilities which were indirectly related to assets whose gross value has been included in the net asset calculation.

Consequently, for CGT events that happen on or after 23 June 2009, liabilities relating to disregarded interests in entities connected with the taxpayer or the taxpayer’s affiliates are taken into account in calculating the net asset value.
Example

Suppose Danny owns all the shares in ATommi Pty Ltd. The net asset value of ATommi Pty Ltd is $1 million. Danny has net assets of $5.2 million (not counting the value of his shareholding in ATommi Pty Ltd)

Under the [pre June 2009] law, Danny works out his maximum net asset value to be $6.2 million, which includes ATommi Pty Ltd's net asset value of $1 million but excludes the value of Danny's shares in ATommi Pty Ltd.

Danny still owes $500,000 that he borrowed to acquire the shares in ATommi Pty Ltd.

The [pre June 2009] law would exclude from the calculation Danny's $500,000 liability incurred to acquire the shares in ATommi Pty Ltd, resulting in a net asset value of $6.2 million. However, this has excluded a liability that is related (indirectly) to assets whose market value has been included elsewhere in the net asset calculation.

The amendment allows Danny to include the $500,000 liability in the calculation, resulting in a maximum net asset value of $5.7 million.

Some non-business assets of affiliates or connected entities;

A taxpayer is required to include the net value of assets of their affiliates, and entities connected with their affiliates, only if the assets are used, or held ready for use, in a business carried on by the taxpayer or an entity connected with the taxpayer (subsection 152-20(3)).

However, taxpayers are not required to include an asset if it is used in the business of an entity that is connected with them only because of their affiliate (subsection 152-20(4)).

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11 Example 2.10 from the Explanatory Memorandum to Tax Laws Amendment (2009 Measures No 2) Act 2009
Example

Colin operates a newsagency business as a sole trader. Simon carries on his own florist business, which is unrelated to the newsagency business. Simon owns the land and building from which the newsagency is conducted and leases it to Colin. Simon also owns 100% of the shares in SimCo Pty Ltd which carries on another separate business. Simon is connected with SimCo Pty Ltd as he controls the company. Simon regularly consults Colin for advice in his business affairs and acts according to Colin’s wishes, therefore Simon is Colin’s affiliate.

To determine whether he satisfies the maximum net asset value test, Colin includes the market value of the land and building owned by Simon (because it is used in his newsagency business) but does not include Simon’s other assets used in his florist business (because they are not used in the newsagency business). Nor does Colin include SimCo’s assets because those assets are not used in his business and SimCo Pty Ltd is only connected because of his affiliate Simon.

The operation of subsections 152-20(3) and (4) was recently considered by the Federal Court in *White v Commissioner of Taxation* [2012] FCA 109 (White).

The taxpayers, Mr and Mrs White, together owned a total of 58.2% of the issued share capital in the Company. The taxpayers were each other’s small business CGT affiliates in accordance with former section 152-25. In December 2006, the taxpayer’s sold their shares in the Company and applied the 15 year exemption to each of their resulting capital gains.

In determining whether they satisfied the maximum net asset value test, the taxpayers included the value of their shareholding in the Company and otherwise excluded the net value of the assets of the Company. The Commissioner disallowed the 15 year exemption on the basis that the applicants failed the maximum net asset value test. In arriving at that decision, the Commissioner included the net value of the assets of the Company.

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12 Australian Taxation Office’s Advanced Guide to capital gains concessions for small business 2010 -11 (last modified 1 February 2012)
The only issue for determination was whether the maximum net asset value test was passed which rested on whether subsections 152-20(3) and (4) applied to exclude the value of the Company’s assets from the maximum net asset value test.

In concluding that the net value of the assets of the Company should be disregarded under subsection 152-20(4)\(^{13}\), the Court made the following observations:

- The taxpayers each had one small business CGT affiliate for the purposes of Subdivision 152-B – each other.\(^ {14}\)
- The taxpayers each had one relevant connected entity, the Company. The Company was ‘connected’ to each of the taxpayers because between them, they owned enough shares to control it. In other words, each taxpayer together with his or her small business CGT affiliate (being the other taxpayer), beneficially owned shares in the Company that carried between them the right to exercise, or control the exercise of, at least the 40% control percentage of the voting power in the Company (see former subsection 152-30(2)(b) now section 328-125). Each of the taxpayers individually owned insufficient shares to control the Company in the required sense and the Company only became a ‘connected’ entity of each of them because of the other.\(^ {15}\)
- Subsections 152-20(3) and (4) applied in working out the net value of assets of an entity (i.e. the Company) that was ‘connected’ with each taxpayer’s spouse (i.e. affiliate).
- In considering paragraph 152-20(3)(a), the Company’s assets were not held ready for use by either taxpayer in carrying on a business by the taxpayer. Accordingly it did not apply.\(^ {16}\)
- In respect of paragraph 152-20(3)(b), it is necessary to work out the net value of the CGT assets of the Company (being an entity connected with each taxpayer’s spouse) provided that only those assets used (or held ready for use) in the carrying on of a business by the taxpayer or another entity connected with the taxpayer were to be included.

In the present case, the assets of the Company were used in the carrying on of a

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\(^{13}\) White v Commissioner of Taxation [2012] FCA 109 at 47
\(^{14}\) White v Commissioner of Taxation [2012] FCA 109 at 20
\(^{15}\) White v Commissioner of Taxation [2012] FCA 109 at 22
\(^{16}\) White v Commissioner of Taxation [2012] FCA 109 at 40
business by an entity connected with each taxpayer – the Company. Consequently, paragraph 152-20(3)(b) applies to prima facie include the Company’s assets in the net asset value calculations for each taxpayer. Such an outcome was considered consistent with the legislative purpose of the subdivision.\textsuperscript{17}

- However, certain assets included by subsection 152-20(3) may be disregarded if subsection 152-20(4) applies.

Specifically subsection 152-20(4) requires assets which would otherwise be included in the calculation of net value of CGT assets under subsection 152-20(3) to be disregarded if those assets were ‘used, or held ready for use, in the carrying on of a business by an entity that is connected with you only because of your [small business CGT] affiliate’.

The Court held that this section focuses on the fact(s) which gave rise to the ‘connection’. Here the connection (between the Company and taxpayer under consideration) arose only because of the relationship between the taxpayer and that taxpayer’s spouse. Or to put the same point in another way, the taxpayer under consideration was connected with the Company only because his or her spouse had a shareholding which together with the taxpayer’s shareholding exceeded the 40\% control threshold. But for that circumstance, that taxpayer was not connected with the company.\textsuperscript{18}

- Accordingly, the net value of the assets of the Company were to be disregarded under subsection 152-20(4).

\textsuperscript{17} White v Commissioner of Taxation [2012] FCA 109 at 41
\textsuperscript{18} White v Commissioner of Taxation [2012] FCA 109 at 46
• **Assets solely for personal use, superannuation**

If the taxpayer is an individual, they should also disregard the following assets when working out the net value of their CGT assets:

- Assets used solely for the personal use and enjoyment of the individual or their affiliate
- The market value of a dwelling, or an ownership interest in a dwelling, that is the individual's main residence (including any relevant adjacent land) – except to the extent to which it is used to produce assessable income (see discussion below)
- A right to 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 of an approved deposit fund; and
- Insurance policies on their life.

### 4.1.2 Dwellings

An individual only includes in their net assets the current market value of a dwelling to the extent that it is reasonable, having regard to the amount that the dwelling has been used to produce assessable income which gives rise to deductions for interest payments (subsection 152-20(2A)). If the dwelling has never had any income producing use, the value is not included at all (subparagraph 152-20(2)(b)(ii)).

If the dwelling has had some income producing use, the percentage of income producing use is multiplied by the current market value to work out the value of the dwelling that should be included. This will take into account the length of time and percentage of income producing use of the dwelling.
Example

Ben owns a house that has a market value of $750,000 just before applying the net assets test. Ben owned the house for 12 years – for the first three years, 20% of it was used for producing assessable income, for the following two years it was used 40% for producing assessable income, for two years it was used solely as a main residence and for the last five years it was used 10% for producing assessable income.

Ben’s dwelling has had 15.8% income producing use i.e. \(\frac{3}{12} \times 20\% + \frac{2}{12} \times 40\% + \frac{2}{12} \times 0\% + \frac{5}{12} \times 10\%\).

Ben will include $118,750 in his net assets ($750,000 x 15.8%).

Ben has a liability of $500,000 attached to the house. Therefore 15.8% ($79,166) of the liability is also included in the net asset test.

The rules in the net asset test for dwellings also apply to land that would be included for the purpose of the main residence exemption under section 118-120. This exemption allows up to two hectares of land that is adjacent to the dwelling, to the extent that the land is used primarily for private or domestic purposes (paragraph 152-20(2)(b)(ii)).

4.1.3 Including net value of CGT assets of others

When working out whether or not a taxpayer exceeds the $6 million net asset value test, the taxpayer takes into all CGT assets of the taxpayer, the taxpayer’s affiliates and entities connected with the taxpayer (subject to certain exceptions).

When calculating the net asset value of entities connected with the taxpayer or their affiliates, it is important to remember that subsection 152-20(1) requires you to include all of their assets regardless of what interest the taxpayer may have in those entities.

For example in the AAT case Venturi v Federal Commissioner of Taxation [2011] AATA 588 (Venturi) the taxpayer had a 50% interest in a unit trust. As such the unit trust was a connected entity of the taxpayer. However, the taxpayer only took 50% of the value of the unit trust into account for the purposes of the maximum net asset value test ‘as it was not

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\[19\] Example from the ATO’s Advanced Guide to capital gains tax concessions for small business 2010-11 (last modified 1 February 2012)
appreciated that, for the purposes of the concession, [the unit trust] had to be taken into account at its full value.\textsuperscript{20}

### 4.1.4 Does selling price always equate to market value?

The maximum net asset value test requires as a starting point for a taxpayer to determine the market value of each CGT asset held by the taxpayer, their connected entities and certain business assets of affiliates just before the CGT event.

This therefore requires taxpayers to include the market value of the asset(s) which are eventually sold in this calculation.

**Note**

It is always important to fully understand and consider what individual assets are actually being sold as part of a transaction and value them accordingly. If say, an earnout arrangement is contemplated as part of a transaction, it might be advantageous to consider alternative ways of commercially dealing with this potential income source (which would be considered an asset with value). If what is proposed is more akin to an ongoing consultancy arrangement it may be worth exploring whether this creates a better outcome under the CGT concession rules.

The ATO generally considers that the sale price of an asset will be taken to be its market value. However, in each particular case all the relevant facts and circumstances must be taken into account to determine the most appropriate methodology for calculating market value.\textsuperscript{21}

Such an analysis was undertaken in the recent AAT decision, *Syttadel Holdings Pty Ltd and FCT* [2011] AATA 589 (Syttadel).

In Syttadel the taxpayer sold a marina in August 2006 for $8.9 million and applied the small business CGT concessions to the eventual gain by contending that the $5 million maximum net asset value test (now $6 million) was satisfied as the market value of the marina was $4.5 million. The Commissioner did not accept that contention and assessed the taxpayer

\textsuperscript{20} Venturi v Federal Commissioner of Taxation [2011] AATA 588 at 18 and 71

\textsuperscript{21} ATO’s Decision Impact Statement, *Syttadel Holdings Pty Ltd and FCT* [2011] AATA 589
on the basis that the value of the asset was its sale price and, as the maximum net asset value test was exceeded, this precluded concessional treatment.

The sole issue before the Tribunal was the market value of the marina in July 2006.

In the circumstances of this case, the AAT concluded that the most appropriate methodology for calculating market value (according to the term’s ordinary meaning) was considered to be by way of an objective business valuation – what a desirous buyer would have paid as a fair price to a vendor willing to sell for a fair price but not desirous to sell.22 Both parties accepted that the market value therefore had to take into account the ‘highest and best use’ of the asset23.

However, the AAT rejected the taxpayer’s valuation approach which adopted the market value by reference to offers made, the sum at which a vendor was prepared to sell and a process of separating component parts valued using yield figures that could not be justified24. The Commissioner’s valuation approach of using the conventional ‘capitalisation of operating profit method’ and the ‘direct comparison method’ was accepted as the yield adopted was appropriate based on market evidence and the potential for future growth but considering the marina’s poor condition25.

The market value of the taxpayer’s assets was also at issue in Venturi. There the taxpayer, in June 2006, sold shares in a company which owned, through a series of connected entities, a hotel and a caravan park. In his tax return, the taxpayer disclosed capital gains of $4.9 million which he claimed were eligible for the small business CGT concessions. The Commissioner disallowed the CGT concessions claims on the basis that the taxpayer failed to satisfy the maximum net value asset test.

In affirming the Commissioner’s decision the AAT found that the substantial issue to consider was the market values of the hotel and caravan park.

After reviewing the authorities on market value, the AAT concluded:

22 Per Griffith CJ in Spencer v Commonwealth of Australia (1907) 5 CLR 418 at 432
23 Syttadel Holdings Pty Ltd and FCT [2011] AATA 589 at 13
24 Syttadel Holdings Pty Ltd and FCT [2011] AATA 589 at 20
25 Syttadel Holdings Pty Ltd and FCT [2011] AATA 589 at 23 and 25
It is clear then that a valuer choosing to undertake a valuation by reference to income generating potential of a business must ascertain the income stream which the business may be expected to generate and apply a fair rate of return to that income stream, to determine the amount that a purchaser would be prepared to pay for the business. The valuer must predict the likely future revenue stream as a basis for the valuation.\(^{26}\)

A number of valuations were obtained by the taxpayer in relation to the hotel and caravan park, but only one related to the time just before the relevant CGT event (i.e. sale of shares on 30 June 2006). The AAT noted that the taxpayer could only succeed if the June 2006 valuation (which was the lowest of all the valuations) could be accepted notwithstanding that the value stated in it was considerably less than the other valuations obtained.\(^{27}\)

In concluding that the June 2006 valuation was fundamentally flawed\(^{28}\) and could not be accepted the AAT made the following observations\(^{29}\):

- The 2006 valuation was produced in October 2010, years after the relevant event.
- It was expressed to be a retrospective valuation based on an inspection in October 2007 and prepared for ‘financial accounting purposes’. It was unclear what this meant.
- In accordance with specific instructions, the 2006 valuation was deliberately made so as to eliminate the prospects for the future.
- Although it was said to have been made on a going concern basis, there was no attempt to estimate future profits and relied only on nine months of historical information. Such a valuation was considered worthless as it made no attempt to consider the potential, which is one of the major factors a purchaser would take into account when contemplating its purchase.
- The evidence showed that the actual sale consideration for the shares was arrived at in order to take advantage of the small business CGT concessions, a decision which was based on advice which was later shown to be wrong. The AAT considered that the realisation that the advice was wrong was a factor in commissioning the June 2006 valuation.

\(^{26}\) Venturi v FCT [2011] AATA 588 at 43
\(^{27}\) Venturi v FCT [2011] AATA 588 at 19
\(^{28}\) Venturi v FCT [2011] AATA 588 at 19
\(^{29}\) Venturi v FCT [2011] AATA 588 at 47 - 54
valuation on a basis which the AAT did not consider resulted in a market value valuation. It was considered significant that there was clear evidence that the taxpayer had refused an offer of a considerably larger amount.

The AAT also confirmed that the onus rested with the taxpayer to establish the values at the relevant date for the hotel and caravan park – an onus which the taxpayer had failed to discharge.

**Note**

Although selling price may be considered a good proxy for the market value of CGT assets in certain situations, the decisions in Syttadel and Venturi highlight:

(a) The need to obtain appropriate advice from a qualified valuer before embarking upon a valuation exercise;

(b) What is an appropriate valuation methodology must be determined having regard to the specific facts and circumstances of your situation;

(c) At the end of the day what is an asset’s market value is its market value – taxpayers should not attempt to distort this amount.

### 4.1.5 Liabilities included in the net value of the CGT assets

Taxpayers are able to make adjustments for ‘liabilities’ that are ‘related to the assets’ of the entity.

For these purposes, ‘liabilities’ extend to:

- Legally enforceable debts due for payment
- Presently existing obligations to pay either a sum certain or an ascertainable sum, and
- The following provisions:
  - Provisions for annual leave
  - Provision for long service leave
  - Provisions for unearned income, and
  - Provisions for tax liabilities.

In Tingari the AAT considered whether a commercial bill of $1.65m should be brought to account as a liability of the taxpayer.

In that case, the taxpayer (a mobile home park operator) was not the actual borrower of the funds but instead was jointly and severally liable to repay that loan as the liability was secured by a guarantee and indemnity and a real property mortgage over the land and improvements which constituted the mobile home park.

In finding that the commercial bill was not a liability of the taxpayer, the AAT concluded that the section requires, in effect, a balance sheet view of the net asset position just before the CGT event. However, at that time, no demand had been made on the taxpayer by the lender nor was there any reason to think that the actual borrower would have been unable to satisfy any demand for payment had it been made. The AAT found that the commercial bill was simply a ‘contingent liability’ and was therefore not considered a liability of the taxpayer for the purposes of section152-20. It is noted that the AAT also found that even if it were a relevant liability, it did not ‘relate to’ the assets of the taxpayer.

4.1.6 Liabilities related to the assets

A liability must be ‘related to’ the CGT assets of an entity to be taken into account in determining the value of the CGT assets of the entity. This includes liabilities directly related to particular assets that are themselves included in the calculation, for example, a loan to finance the purchase of business premises. It can also include liabilities not directly related to a particular asset but rather to the assets of the entity more generally, for example, a bank overdraft or other short term financing facility that provides working capital for the operation of the business.

Liabilities that are directly related to an asset that is excluded from the net asset calculation are, however, excluded. Although certain liabilities related to excluded interests in connected entities may be counted (see discussion above).

The recent AAT case of Bell v FCT [2012] AATA 45 (Bell) considered this question of ‘related to’ in addition to what liabilities should be included for the purposes of section152-20.

30 Tingari Village North Pty Ltd and Commissioner of Taxation [2010] AATA 223 at 53 - 55
In Bell, the taxpayer was the beneficiary of a family trust whose principal assets were interests in unit trusts. The taxpayer received all of the distributable income of the trust which included a capital gain in excess of $6 million which had been made by disposing of units in the unit trust. At issue was whether the small business CGT concessions were available to reduce the taxable amount of the capital gain. This turned on whether the maximum net asset value test was passed.

The taxpayer argued that in determining the maximum net asset value test, the capital gain should be reduced by various amounts. The principal reduction was a debt of $2 million owed by the family trust to a unit trust. This debt had arisen to fund the taxpayer’s non-concessional contribution of $1 million to his superannuation fund and to provide funds to his spouse in connection with their family home. The taxpayer contended that this debtor obligation attached to the whole family trust fund and related to the assets of the family trust within the meaning of section 152-20. The Commissioner disputed this.

The taxpayer argued that further amounts reduced the capital gain including a guarantee amount and the balance in a bank account.

The AAT held that the maximum net asset value test had not been met. Specifically, the AAT found the following in relation to each of the liabilities in contention:

- $2 million owed by the family trust to the unit trust.
  The AAT found that the liability related to a discharge of resolutions and obligations to distribute capital. As such the debts incurred to the unit trust arose out of considerations that were independent of the assets of the family trust and too remote for the necessary relationship to exist. The requirement for a liability to be related to an asset taken into the maximum net asset value test does not encompass every conceivable relationship, no matter how remote or tenuous.31

  Incursing a debt so as to preserve or retain assets when the debt funds are used for purposes quite separate from the relevant assets is not a sufficient relationship for the purposes of section 152-20.32

- $600,000 guarantee amount

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31 Tingari Village North Pty Ltd and Commissioner of Taxation [2010] AATA 223 at 55, Bell v FCT [2012] AATA 45 at 19
32 Bell v FCT [2012] AATA 45 at 19
The AAT held that any guarantee liability was a contingent liability and not a presently existing legal obligation. Contingent liabilities are not liabilities for the purposes of the maximum net asset value test. The need to make specific provision allowing provisions for leave and other emerging obligations in the maximum net asset value test gives insight into the type of liabilities that are included, namely, presently existing liabilities.33

- **Offset bank accounts**

  The Commissioner contended that a bank account showed that the taxpayer had a cash asset of $1.2 million which must be taken into account for the purposes of the maximum net asset value test and a loan liability of $1 million which related to the acquisition of a main residence and hence must be excluded.

  The taxpayer contended that there was a single account which was in credit. The loan facility was for $1 million, but because the account was in credit, they were able to draw up to $1.2 million. Put simply, the taxpayer contended that were was a credit balance of $200,000 that was the only relevant asset, and the ability to borrow was not an asset for the purposes of the maximum net asset value test.

  The AAT concluded that the evidence provided by the bank did not support the taxpayer’s contentions. The latest bank statement showed that the balance comprised a Loan Balance and an Offset balance, an amount of interest that would have accrued and an Offset benefit (interest saved) and a net interest accrual for a month. Such a presentation did not suggest a single account.

  The account with the debit balance reflects borrowings used to purchase the taxpayer’s residence. This asset is not included in the maximum net asset value calculation. Accordingly, the debt of $1 million is not included either.

  In finding for the Commissioner, the AAT concluded that the fact of multiple accounts with the one institution, with or without an interest offset link or arrangement, does not of itself make an account with a debit balance a liability related to another account with a credit balance. If funds in the credit balance account are the product of

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33 Bell v FCT [2012] AATA 45 at 22
drawings from the debit balance account, then the liability would relate to the asset. In the present circumstances, the liability had its origins in moneys borrowed to purchase a residence. It is that asset to which it is related.\textsuperscript{34}

### 4.1.7 Adjustments for certain provisions

From 1 July 2006, the maximum net asset value test allows the net asset value of an entity to be reduced by provisions for annual leave, long service leave, unearned income and tax liabilities. Whilst these amounts are not included as liabilities as they are not present legal obligations, they are relevant to the value of the business, having regard to commercial business valuation methods.

**Example 1.4** \textsuperscript{35}

Hanna has CGT assets with a value of $7.2 million, liabilities relating to the assets of $1.1 million and has made provisions for $100,000 of annual leave for her employees, $20,000 for unearned income, and $50,000 for tax liabilities for the financial year. Hanna has a net asset value of $5.93 million.

### 4.1.8 Positive, negative or nil

Prior to 1 July 2006 the test did not allow the possibility of a negative net asset value for an asset. Now the net assets calculation allows an entity to have a negative net asset value, and for that to be taken into account in determining if another entity satisfies the test.

**Example 1.5** \textsuperscript{36}

Ice Cream Co has CGT assets with a value of $2 million and liabilities relating to those assets of $3 million. Ice Cream Co has a net asset value of negative $1 million.

From Example 1.4, Hanna owns 70% of the shares of Ice Cream Co and Ice Cream Co is a connected entity. Net asset value includes the value of connected entities, therefore Ice Cream Co’s net asset value is included in Hanna’s net asset value. Hanna’s net asset value is reduced by $1 million to $4.93 million.

\textsuperscript{34} Bell v FCT [2012] AATA 45 at 30 - 34

\textsuperscript{35} Example 1.4 from the Explanatory Memorandum to Tax Laws Amendment (2006 Measures No 7) Act 2007

\textsuperscript{36} Example 1.5 from the Explanatory Memorandum to Tax Laws Amendment (2006 Measures No 7) Act 2007
4.1.9 ‘Just before’ the CGT event

It is important to remember that the maximum net asset value test focuses on the time ‘just before the CGT event’ that gave rise to the capital gain.

The question of what the net asset value ‘just before’ the sale of a business was considered by the Full Federal Court in *Commissioner of Taxation v Byrne Hotels Qld Pty Ltd* [2011] FCAFC 127 (Byrne).

In Byrne the taxpayer contracted to sell its tavern business and a related entity of the taxpayer, contracted to sell the land on which the business operated. The taxpayer made a capital gain of $4.125 million from the sale business but claimed small business CGT relief in relation to the gain. The taxpayer took the view that it was entitled to these small business concessions because it satisfied the maximum net asset value test because its net asset value ‘just before’ the sale of the business was $4.245 million. This was less than the $5 million limit imposed by the test at that time. The Commissioner disagreed.

The taxpayer was successful at first instance with the AAT finding that the maximum net asset value test had been satisfied. In particular, the AAT found that certain estate agent commissions and legal fees were liabilities even though they were not due to be paid until completion of the sale. The AAT stated that

> *it would make no sense to exclude liabilities that are inextricably connected to the sale where it is the disposal of the asset that creates the CGT event and determines the market value of the asset which in turn allows the extent of the capital gain to be ascertained…. I have no hesitation in choosing an interpretation which makes, in my view, sense of this part of Division 152. The interpretation that I prefer is one that includes within the scope of liabilities those that are on integral part of the sale, that is, liabilities incurred, or to be incurred, in the completion of the contract.*

The Commissioner then appealed to the Full Federal Court contending that the estate agent and legal expenses were not liabilities that could be taken into account in determining net asset value as they did not arise ‘just before’ the sale.

The Full Federal Court’s findings in relation each of these liabilities is outlined below:

- Estate agent fees

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37 The Taxpayer and Commissioner of Taxation [2010] AATA 455 at 32 an 35
The majority of the Full Federal Court held that the AAT had correctly taken into account the estate agency fee paid by the taxpayer.

The majority acknowledged that the estate agent’s entitlement to be paid its agreed commission fee was dependent upon the taxpayer entering into a contract of sale. However, immediately before the signing of the contract of sale, nothing remained to be done by the estate agent as a matter of any performance of its duties or obligations to perfects its entitlement to the agreed commission. The only contingent thing to be done was the formality of reducing to writing the sale which had already been agreed to be done.

Consequently, just before the CGT event, a liability resided in the taxpayer arising out of the pre-existing contract with the estate agent, subject only to the translation of the decision already made to sell the land and business into the act of execution of the contracts. Just before the CGT event the obligation was not ‘truly contingent’ in the sense of being 'uncertain as both a theoretical and a practical matter...Instead, it was in the nature of a primary obligation.'

- Legal expenses
  The Full Federal Court held that it was necessary to split the legal fees into fees for work done prior to and following the ‘just before’ time.
 
  The Full Federal Court agreed with the AAT that costs incurred prior to the ‘just before’ time were liabilities that existed as at that time because all the work had been performed and all that remained to be done was for an invoice to be prepared and sent for the fees payable. The only event or contingency that needed to occur for the fees to become due and payable was for the taxpayer to be sent an invoice. Even though an invoice had not been sent, the taxpayer already had an existing obligation to pay the solicitors’ fees for the work done prior to ‘just before’ time. This was considered a liability for the purposes of subsection 152-20(1).39

  However, as at the ‘just before’ time, the taxpayer had no existing legal or equitable obligation to pay fees to its solicitors for work which had not yet been performed.

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38 Commissioner of Taxation v Byrne Hotels Qld Pty Ltd [2011] FCAFC 127 at 122
39 Commissioner of Taxation v Byrne Hotels Qld Pty Ltd [2011] FCAFC 127 at 67 & 68
There was no existing contractual obligation that the solicitors could enforce against the taxpayer to ensure payment of such fees. Consequently, the legal fees that related to work done on or after the CGT event were not liabilities for the purposes of subsection 152-20(1).40

It is noted that Full Federal Court remitted the matter back to the AAT to determine whether the husband and wife directors of the taxpayer were affiliates of the taxpayer and whether their assets should be taken into account when determining whether the maximum net asset value test was satisfied.

40 Commissioner of Taxation v Byrne Hotels Qld Pty Ltd [2011] FCAFC 127 at 73
Note

When determining what liabilities to adjust for in the net asset value calculation the recent AAT and Federal Court decisions outlined above highlight the importance of understanding the surrounding facts and circumstances of all items appearing on the balance sheet. In particular always ensure that you understand:

- The circumstances in which a debt / liability arose (e.g. what were the funds used for, what assets were acquired? See Bell)
- Any terms and conditions attaching to the obligation. It is a presently existing obligation to pay either a sum certain or an ascertainable sum or is it a mere contingency.
- Guarantees and indemnities – has the obligation to make good actually arisen? (see Tingari)
- Estate agent fees – has the work been performed? What events still need to occur in order to pay fees (See Byrne)
- Legal expenses – has the work been performed? If so, when? (See Byrne)
- Whether all separate assets and liabilities have been identified? (e.g. offset bank accounts – see Bell)
- How final amounts have been arrived at. Always ensure that you can appropriately reconcile amounts appearing on the balance sheet back to the underlying supporting documentation.
The Active Asset test

Section 152-35 sets out the conditions that must be satisfied in order to pass the active asset test.

The active asset test is satisfied if:

- The taxpayer has owned the asset for 15 years or less and the asset was an active asset of theirs for a total of at least half of the test period; or
- The taxpayer has owned the asset for more than 15 years and the asset was an active asset of theirs for a total of at least 7.5 years during the test period.

In this context the test period:

- Begins when the taxpayer acquired the asset, and
- Ends at the earlier of:
  - The CGT event, and
  - When the business ceased, if the business in question ceased in the 12 months before the CGT event (or such longer time as the Commissioner allows).

Importantly:

- The periods in which the asset is an active asset do not need to be continuous. However, they must add up to the minimum periods specified above.
- The asset does not need to be an active asset just before the CGT event.

Example

Jodie ran a florist business from a shop that she has owned for eight years. She ran the business for five years, and then leased it to an unrelated party for three years before selling. The shop satisfies the active asset test because it was actively used in Jodie’s business for more than half the period of ownership, even though the property was not used in the business just before it was disposed of.
5.1 What is an active asset?

A CGT asset is an active asset for the purposes of section 152-40 if it is owned by the taxpayer and is:

- Used or held ready for use in a business carried on (whether alone or in partnership) by the taxpayer, their affiliate, or an entity connected with them; or
- An intangible asset that is inherently connected with a business carried on (whether alone or in partnership) by the taxpayer, their affiliate or another entity that is connected with them carries on (for example goodwill).

5.1.1 Shares and trust interests may also be active assets

Subsection 152-40(3) provides that a CGT asset is also an active asset at a given time if owned by the taxpayer, and:

- 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
- The total of the following is 80% or more of the market value of all the assets of the company or trust:
  - The market values of the active assets of the company or trust, and
  - The market value of any financial instruments of the company or trust that are inherently connected with a business that the company or trust carries on, and
  - Any cash of the company or trust that is inherently connected with such a business.

The 80% test will be taken to have been met:

- where breaches of the threshold are only temporary in nature (subsection 152-40(3B)), and
- in circumstances where it is reasonable to conclude that the 80% threshold has been passed (subsection 152-40(3A)).

As outlined above, the active asset test requires a CGT asset to have been an active asset for at least half of a particular period. Consequently, for a share in an Australian resident company to meet this requirement, the company must satisfy the 80% test for that same period.
5.1.2 Interests in holding entities

An interest in an entity that itself holds interests in another entity that operates a business may be an active asset, depending on the successive application of the 80% test at each level.

**Example 41**

Ben owns 100% of the shares in Holding Co which, in turn, owns 100% of the shares in Operating Co (both are resident companies). The only assets of Holding Co are the shares in Operating Co and all of Operating Co’s assets are active assets.

As Operating Co satisfies the 80% test, the shares owned by Holding Co in Operating Co are active assets. As those shares are the only assets owned by Holding Co, Holding Co also satisfies the 80% test. Therefore the shares owned by Ben in Holding Co are also active assets.

If Ben sold the shares in Holding Co, all the small business concessions may potentially apply to any gains made.

If Holding Co sold its shares in Operating Co, the small business concessions may apply as Ben is a CGT concessional stakeholder in Operating Co as well as having a small business participation percentage in Holding Co of at least 90%.

If Operating Co sold its active assets, Operating Co may be entitled to the small business concessions as Ben is a significant individual and CGT concessional stakeholder in Operating Co as a result of his direct and indirect small business participation percentage.

5.1.3 Assets that cannot be active assets

Subsection 152-40(4) states that the following CGT assets cannot be active assets (even if they are used, or held ready for use, in the course of carrying on a business):

- Shares in companies or interests in trusts, other than those that satisfy the 80% test
- Financial instruments, such as loans, debentures, bonds, futures and other contracts and share options (unless they are inherently connected with a business, in which case they count towards the satisfaction of the 80% test)

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41 ATO’s Advanced Guide to capital gains tax concessions for small business 2010-11 (last modified 1 February 2012)
Assets where its main use is to derive interest, an annuity, rent, royalties or foreign exchange gains (unless the main use for deriving rent was only temporary or the asset is an intangible asset that you have substantially developed or improved so that its market value has been substantially enhanced).

Shares and trust interests in widely-held entities unless held by a CGT concession stakeholder in the widely held entity.

Note that trade debtors are not considered to be financial instruments for the purposes of the active asset exclusions. Rather, they are a business facilitation mechanism that assists in the conduct of the business and are inherently connected with the business. Accordingly trade debtors can be included in the value of active assets when calculating the 80% test.

5.1.4 Assets whose main use is to derive rent

One of the key exclusions from the active asset test are those assets whose main use is to derive rent.

Whether an asset’s main use is to derive rent will depend on the particular circumstances of each case. The term ‘rent’ has been described as referring to the payments made by a tenant or lessee to a landlord of lessor for exclusive possession of the leased premises. As such, a key factor in determining whether an occupant of premises is a lessee paying rent is whether the occupier has right to exclusive possession.

This question was addressed in two recent AAT decisions, Vaughan and Commissioner of Taxation [2011] AATA 758 (Vaughan) and Tingari.

The taxpayers in Vaughan were a married couple who were in the business of running child care centres. They owned a number of properties in Sydney that were used for this purpose. In 1997, they decided they wanted to give up the day-to-day operation of the businesses and entered into agreements with individuals who took over the operation of each centre. This case concerned a property in Merrylands which was taken over by a young couple with no experience in running child care centres. The couple relied heavily on the taxpayers for advice for a number of years before a new lease was negotiated with ABC Learning Centres in 2003. The taxpayers retained ownership of the property and received regular payments under the arrangement with the young couple and the subsequent lease to ABC Learning Centres until the property was sold in 2008.
Relief under Division 152 in relation to the capital gain arising on the sale of the property was only available if the taxpayers were able to characterise the Merrylands property as an active asset within the meaning of section 152-40.

It was agreed between the parties that the property was an active asset since its acquisition in 1991 until the property was leased to the young couple in 1997 – i.e. for a period of six years. The period when the property was leased to ABC Learning Centres was also not in issue.

However, the question arose as to whether the property was an active asset during the period when the property was leased to the young couple (i.e. 1997 – 2003). Central to the issue was the legal characterisation of the arrangement entered into with the couple.

In concluding that the arrangement with the young couple between 1997 and 2003 was properly characterised as a lease and therefore the payments received under the agreement were properly characterised as rent\textsuperscript{42}, the AAT made the following observations:

- The arrangement was recorded in a document that was described as a lease and stamped on the basis that it was a lease\textsuperscript{43}.
- The agreement contained many if not all of the conventional terms one might expect in a commercial lease in relation to this sort of property – including a clause which suggested that the lessees would be entitled to quiet enjoyment and possession of the property provided they observed the terms of the lease\textsuperscript{44}.
- The arrangement was not a licence to conduct business or a franchise or some other agreement. There was no reference to the name of the business in the lease – although the taxpayers did remain as registered owners of the business name for reasons that were not clear. However, other matters that one might expect to see in an agreement to licence or franchise a business, such as provisions governing intellectual property, were also absent from the written agreement\textsuperscript{45}.

\textsuperscript{42} Vaughan and Commissioner of Taxation [2011] AATA 758 at 12
\textsuperscript{43} Vaughan and Commissioner of Taxation [2011] AATA 758 at 5
\textsuperscript{44} Vaughan and Commissioner of Taxation [2011] AATA 758 at 6
\textsuperscript{45} Vaughan and Commissioner of Taxation [2011] AATA 758 at 8 and 12
• The taxpayers received a lump-sum payment when ABC Learning Centres took over the property. The payment of this amount appears to be consistent with the conclusion that it was made in return for assigning the lease.46
• The AAT concluded that the taxpayers were the landlords, albeit they generously provided their time and expertise to the tenants. The payments they received under the terms of the agreement were properly characterised as rent.47

As the property was therefore not considered to be an active asset post 1997 until its sale in 2008 (as it was a rental property), the AAT held that the property did not satisfy the active asset test as it had only been an active asset for a six years. This was not long enough to satisfy the requirements in subsection 152-35(1). Accordingly the taxpayers were not able to claim relief under Subdivision 152.

In Tangari, the taxpayer was the owner and operator of a mobile home park. The taxpayer acquired the land and improvements constituting the park in February 1996. The taxpayer sold the park in November 2005. When determining the amount of capital gain to include in its income tax return, the taxpayer applied the small business CGT concessions.

At issue before the AAT was whether the mobile home park was an active asset. The Commissioner contended that the park was an asset whose main use in carrying on business was to derive rent. Whereas the taxpayer argued that the park is more in the nature of a business of offering accommodation and other services to those who resided in the park.

The park contained 77 mobile home sites at the time of sale – all but one of the sites were occupied by mobile homes. Under the Residential Parks Act 1998 (NSW), a moveable dwelling on a resident site is not regarded as a fixture and the resident is able to sell it separately from the site. The site continues to be owned by the park owner.

The taxpayer had entered into a site agreement with each of the residents of the park. Each site agreement was in the form of the standard agreement contained in the Residential Parks Regulation 1999 (NSW).

In finding that the park did not constitute an active asset, the AAT made the following observations:

46 Vaughan and Commissioner of Taxation [2011] AATA 758 at 11
47 Vaughan and Commissioner of Taxation [2011] AATA 758 at 12
The test to be applied is whether or not ‘in substance and effect’ exclusive possession has been granted by the instrument in question. If it is, it is a lease. If not, it is a mere licence.48

Although the park contained various facilities for use by residents (e.g. a community hall) and carried out certain general maintenance (e.g. Mowing lawns, clearing gutters, collection of rubbish) none of these benefits were identified in the tenancy agreement and were not considered legally enforceable incidents of the right to occupy a site. They were not sufficient to establish that exclusive possession was absent. Their primary purpose was to attract more potential residents to the park. They were considered remote from any comparison with the kind of personal services commonly provided by hotels, boarding or lodging house keepers and the like.49

The site agreement entered into between the taxpayer and each resident of the park conferred on the resident a right to exclusive possession of the sites and thus amounted to a lease.50

Accordingly, the main use of the park was to ‘derive rent’. The park was therefore not an ‘active asset’ under section 152-40.

It is noted that the ATO in their Decision Impact Statement stated that the AAT’s decision in Tingari was consistent with Taxation Determination, TD 2006/78. This taxation determination considered the circumstances in which a premises used in providing accommodation would satisfy the active asset test.

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48 Tingari Village North Pty Ltd and Commissioner of Taxation [2010] AATA 233 at 27
49 Tingari Village North Pty Ltd and Commissioner of Taxation [2010] AATA 233 at 42 and 43
50 Tingari Village North Pty Ltd and Commissioner of Taxation [2010] AATA 233 at 44
Note

The decisions in Vaughan and Tingari highlight the importance of:

- Understanding the terms and conditions of any agreement entered into between parties for the use of an asset prior to entering into those agreements.

- Where the use of an asset is governed by specific legislation and/or regulations (e.g. Residential Parks Act 1998 (NSW)) ensure that you aware of the implications of complying with these rules.

- Discussing up front the potential operation of the small business CGT concessions with taxpayers who are considering changing the use of assets. Although a sale may not be currently contemplated what actions you take now may have a bearing on whether the concessions are available in the future.
The 15 year exemption

The 15 year exemption is contained at Subdivision 152-B. If a taxpayer satisfies the exemption, they will be entitled to disregard the whole of the capital gain in relation to the CGT event. The taxpayer will not be required to apply any of the other concessions, or apply capital losses against the gain.

The 15 year exemption applies in priority to all of the other concessions (section 152-215).

Effective distributions of pre-CGT capital gains

The 15 year exemption may be applied to pre-CGT capital gains to effectively enable a tax-free distribution of the capital gain without having to wind up a company or vest a trust (potentially triggering CGT events E4 or G1).

Retirement exemption – CGT cap

Taxpayers may use the 15 year exemption as a method of increasing the amount of funds held within superannuation. Amounts contributed under the 15-year exemption up to the CGT cap amount (currently $1.205 million) are excluded from the non-concessional caps.

6.1 Satisfying the 15 year exemption

Whether the taxpayer is an individual, company or trust, they are required to satisfy the following conditions:

(a) Satisfy the basic conditions in subdivision 152-A (see Section 2.1 for further discussion); and
(b) Have owned the CGT asset continuously for a 15 year period ending just before the CGT event.

6.1.1 Individuals

If the taxpayer is an individual, the following conditions must also be satisfied before they are able to disregard any capital gain arising from the CGT event:

(a) The taxpayer is at least 55 years of age at the time of the CGT event and the event happens in connection with the taxpayer’s retirement; or
(b) The taxpayer is permanently incapacitated at the time of the CGT event; and
(c) If the CGT asset is a share in a company or an interest in a trust, the company or trust must have a significant individual for a total of at least 15 years (even if the 15 years was not continuous and it was not always the same significant individual) during the time in which they owned the CGT asset.

6.1.2 Companies & trusts

If the taxpayer is a company or trust, the following additional conditions must also be satisfied:

(a) The entity had a significant individual for a total of at least 15 years (even if the 15 years was not continuous and it was not always the same significant individual) during which the entity owned the CGT asset.

(b) An individual who was a significant individual of the entity just before the CGT event was at least 55 years of age at the time of the CGT event, and the event happened in connection with the individual’s retirement or was permanently incapacitated at the time (s152-110(1)(d));

Exception for discretionary trust with tax losses or no taxable income

Note that where the entity was a discretionary trust that had tax losses or no taxable income for an income year section 152-120 has historically applied to deem the discretionary trust to have a significant individual. However, a number of shortcomings were identified with the operation of section 152-120. Legislation is currently awaiting Royal Asset which seeks to repeal section 152-120 and amend section 152-70. See Section 10 for further details in relation to the amendments.

Where these conditions are satisfied the capital gain is treated as non assessable non exempt income of the company or trust (subsection 152-110(2)).

6.1.3 Meaning of “in connection with retirement”

Section 152-105 requires the CGT event to be ‘in connection with’ the individual taxpayer’s retirement. Similarly, section 152-110 requires the CGT event to be in ‘connection with’ the significant individual’s retirement.

There is no definition of ‘in connection with retirement’ included within the legislation, and as such whether this condition will be satisfied is a question of fact and degree.

The Explanatory Memorandum to the introducing legislation makes the following comments in relation to this requirement:
One of the requirements of this concession for an individual small business taxpayer is that they must be either permanently incapacitated at the time of the CGT event, or at least 55 years old and using the capital proceeds for their retirement (emphasis added).\textsuperscript{51}

Although the Explanatory Memorandum suggests that one indicator might be that the capital proceeds are used for the individual’s retirement (a phrase which is actually used in the legislation at section 152-300) it provides little insight into the intended meaning of this phrase.

Limited guidance\textsuperscript{52} is provided by the ATO as to their interpretation of the likely scope of the phrase. In particular the ATO note:

- Whether a CGT event happens in connection with an individual’s retirement depends on the particular circumstances of each case:
- There would need to be at least a significant reduction in the number of hours the individual works or a significant change in the nature of their present activities to be regarded as a retirement;
- It is not necessary for there to be a permanent and everlasting retirement from the workforce - the small business concessions does not specifically deny a taxpayer the opportunity of further work should they wish to perform it.

The following examples (including the outcome of a recent Private Binding Ruling) highlight that whether a CGT event is ‘in connection with retirement’ will heavily depend on the particular circumstances of each individual taxpayer.

\textsuperscript{51} Paragraph 1.68 of the Explanatory Memorandum to the New Business Tax System (Capital Gains Tax) Bill 1999
\textsuperscript{52} ATO’s Advanced Guide to capital gains tax concessions for small business 2010-11 (last modified 1 February 2012)
ATO Private Ruling 3755- “In connection with retirement”

Facts:

The taxpayer and spouse each owned 1 ordinary share in a private company. Both shares were acquired on 1 April 1986. The taxpayer was over 55 and had officially retired. The taxpayer and their spouse intended to sell their share in the company to their son and daughter-in-law for a price to be determined. The taxpayer wished to take advantage of the 15 year retirement exemption contained in subdivision 152-B of ITAA 1997. The basic conditions in subdivision 152-A of ITAA 1997 were satisfied, and the taxpayer and his spouse had each owned their share in the company for at least 15 years. At all times during the ownership period of the share, the company had a controlling individual (s152-50). The market value of the company’s active assets was more than 80% of the total value of all assets owned by the company.

The taxpayer applied for a private ruling to determine whether the sale of the shares were ‘in connection with retirement’, pursuant to paragraph 152-105(d)(i) of ITAA 1997.

Ruling:

The ATO was satisfied that the sale of the share was an event that was in connection with retirement of the taxpayer.

Explanation:

The ATO concluded that

‘Subdivision 152-B of the Income Tax Assessment Act 1997 does not define what is meant by “in connection with a taxpayer’s retirement” nor does it give any indication of the ‘degree’ of retirement required in order to take advantage of this connection. It could be argued that “in connection with” means that the capital gain arising from the disposal of active assets is to be used to provide funds for a person’s retirement rather than to precipitate retirement at the time of the CGT event. The words used in the EM53 support this interpretation. Nor does the Subdivision indicate how long before or after the CGT event retirement is to take place.”

53 Explanatory Memorandum (EM) to the New Business Tax System (Capital Gains Tax) Bill 1999
Example 54

A small business operator, over 55 years old, sells his business. Under the terms of the sale, he agrees to be employed by the new owner for a few hours each week for two years. The sale of the business would be in connection with the small business operator's retirement. He has permanently or indefinitely ceased being self-employed and has commenced gainful employment on a much reduced scale with another party, although still performing similar activities.

Example 55

A small business operator and spouse are both pharmacists, are both over 55 years old and carry on business through two pharmacies. They sell one (and make a capital gain) and, accordingly, reduce their working hours from 60 hours a week each to 45 and 35 hours a week respectively. There has been some change to their present activities in terms of hours worked and location. But there has not been a significant reduction in the number of hours or a significant change in the nature of their activities and, therefore, there has been no 'retirement'.

If, on the other hand, one spouse reduced their hours to nil (stopped working), there would be a significant reduction in the number of hours that spouse was engaged in the business activities. That sale would, therefore, be in connection with retirement of that spouse.

These examples provide some guidance as to the likely scope of the term "in connection with retirement". A CGT event may also be "in connection with retirement", even if it occurs some time before retirement. Again this will be very much fact specific.

54 ATO’s Advanced Guide to capital gains tax concessions for small business 2010-11 (last modified 1 February 2012)
55 ATO’s Advanced Guide to capital gains tax concessions for small business 2010-11 (last modified 1 February 2012)
Example

A small business operator, over 55 years old, sells some business assets as part of a wind-down in business activity ahead of selling the business. Within six months, she sells the business and ends her present activities. If it can be shown that the earlier CGT event was integral to the business operator’s plan to cease her activities and retire, the CGT event may be accepted as happening in connection with retirement.

ATO Private Ruling 54551 - “In connection with retirement”

Facts:

The taxpayer was over 55 years of age and owned 50% of shares in a private resident company, of which he was also the managing director. The taxpayer informed the company that they intended to sell equity and retire in the middle of the 2005 income year. The company employed a new person to take over the duties previously performed by the taxpayer. The new managing director was suddenly ill and was unable to perform their duties. For that reason, the taxpayer had to take over the running of the business again until the new managing director fully recovered from the illness.

In the Ruling application the taxpayer advised that the new managing director’s health was getting better and that they had returned to work (1-2 days per week). The taxpayer also advised that in the event that the new managing director was unable to perform their duties then the company will employ someone else and the taxpayer will still retire by the end of the 2006 income year.

The taxpayer satisfied the basic conditions for small business relieved (including the maximum net asset value test, the active asset test and the controlling individual and concession stakeholder test).

The taxpayer applied for a private ruling in relation to whether they could still sell the shares at the end of 2005 and qualify for the small business 15 year exemption on the basis that the sale of the shares was “connected with” the taxpayers retirement.

Ruling:

ATO’s Advanced Guide to capital gains tax concessions for small business 2010-11 (last modified 1 February 2012)
The ATO ruled that the taxpayer can sell shares in a private company, before the taxpayer’s retirement, and still qualify for the small business 15 year exemptions under section 152-105 of the ITAA 1997.

Explanation:

Even though the sale occurred before actual retirement, the ATO was satisfied that the sale met the last condition outlined in section 152-105 ITAA 1997, and it was made “in connection with retirement” as in this case the taxpayer was over 55 years of age and had planned to retire by July 2005 but for the illness of the new managing director.

Similarly, the words ‘in connection with’ can apply where the CGT event occurs sometime after retirement. Again, this type of case would depend on its own particular facts.

6.1.4 Exclusions and exemptions

As noted previously, the 15 year exemption is contained at Subdivision 152-B cannot be applied to CGT events J2, J5 or J6.

6.2 Consequences of applying the 15-year exemption

6.2.1 Payments to CGT concessional stakeholders

If a capital gain made by a company or trust is disregarded under the 15 year exemption, any distributions made by the company or trust of that exempt amount to an individual who was a CGT concession stakeholder of the company or trust just before the event (directly or through one or more interposed entities) within two years of the CGT event will not be included in the assessable income of the CGT concession stakeholder (or any interposed entities) (section 152-125).

6.2.2 CGT concession stakeholder participation percentage

The total payments made to each CGT concession stakeholder must not exceed an amount determined by multiplying the CGT concession stakeholder’s control percentage by the exempt amount.

For a company or trust (where entities have entitlements to all of the income or capital of the trust), the CGT concession stakeholder’s participation percentage is the stakeholder’s small
business participation percentage in the company or trust just before the CGT event (paragraph 152-125(2)(a)).

For a trust (where entities do not have entitlements to all of the income or capital of the trust), the CGT concession stakeholder’s participation percentage is worked out in accordance with paragraph 152-125(2)(b), as follows:

\[
\frac{\text{Number of CGT concession stakeholders of the trust just before the CGT event}}{100}
\]

The following example illustrates this process where distributions are made by a company.

**Example**

Joe is a significant individual of Company X, owning 60% of the shares in the company. Joe’s wife Anne owns the remaining 40% of shares in the company. The company makes a capital gain of $10,000, which it can disregard under the small business 15 year exemption as Joe is 56 and both Joe and Anne are planning to retire.

Six months after the CGT event, the company distributes the amount of the exempt capital gain to the shareholders. As CGT concession stakeholders, Joe and Anne both qualify for the small business 15 year distribution exemption. The amount that is exempt is calculated as follows:

For Joe: 60% of $10,000 = $6,000

For Anne: 40% of $10,000 = $4,000

If it is decided to distribute $8,000 each to Joe and Anne, they can exclude from their assessable incomes for the income year an amount of $6,000 and $4,000 respectively. The balance is likely to be assessable as a dividend.

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57 ATO’s Advanced Guide to capital gains tax concessions for small business 2010-11 (last modified 1 February 2012)
6.2.3 Application to pre-CGT assets

The 15 year exemption may also be used to enable tax-effective distributions made from pre-CGT capital gains without having to wind up a company or vest a trust (potentially triggering CGT events E4 or G1), provided the taxpayer meets the requirements of section 152-125.

These are:

- The company or trust would have been able to disregard the capital gain under the 15-year exemption had the asset been acquired on or after 20 September 1985 (i.e. pre-CGT); and
- One or more payments (whether directly or indirectly) in relation to the exempt amount were made within two years after the CGT event to a CGT concession stakeholder of the taxpayer just before the CGT event.

6.2.4 Interaction with superannuation

A distribution of an exempt amount under the 15 year exemption is not required to be contributed to superannuation.

However, should an individual wish to contribute to superannuation, they may contribute the small business CGT proceeds arising from a CGT event where the 15 year exemption applied up to their lifetime CGT cap amount (see sections 292-100 and 292-105). These contributions are effectively treated as exempt from a person’s non-concessional contributions cap.

This exemption recognises that many small business people invest in their business rather than make regular contributions into superannuation and later use the equity in their business to fund their retirement.\(^{58}\)

A contribution will only count towards the CGT cap if the person notifies their superannuation provider before, or when, the contribution is made. This will ensure that the superannuation provider is able to accept the contribution and that it is not reported against the non-concessional contributions cap but is instead reported correctly against the CGT cap. It also provides the person with the choice as to whether all or part of a contribution uses their non-concessional contributions cap or their CGT cap. (subsection 292-100(9)).\(^{59}\)

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\(^{58}\) Paragraph 1.100 of the Explanatory Memorandum to Tax Laws Amendment (Simplified Superannuation) Act 2007

\(^{59}\) Paragraph 1.102 of the Explanatory Memorandum to Tax Laws Amendment (Simplified Superannuation) Act 2007
Where the individual has the CGT event, the contribution must be made no later than the day that individual is required to lodge their tax return for the financial year in which the CGT event occurred or 30 days after the day the individual person received the capital proceeds, whichever is later. Where the capital proceeds are received and contributed in instalments, each instalment is a separate contribution which must be made within the above timeframes. (paragraphs 292-100(2)(b) and (7)(b)).

A CGT concession stakeholder of an entity that had a capital gain disregarded under Subdivision 152-B is also entitled to use the CGT cap in the above circumstances. However, the entity must make a payment to the CGT concession stakeholder within two years of the CGT event and that individual must make a contribution within 30 days of that payment for the contribution to qualify for the CGT cap (subsection 292-100(8)).

The CGT cap amount is indexed annually. For the 2011-12 income year, the CGT cap amount is $1.205m. A person’s CGT cap is reduced by the amount of each contribution they elect to be covered by the exemption from the non-concessional contributions cap. Any excess over the CGT cap amount will be counted as a non-concessional superannuation contribution.

### Note

The retirement exemption limit of $500,000 (discussed in Section 8) counts towards the CGT cap amount. Up to $500,000 of capital gains (as opposed to capital proceeds) that are disregarded by Subdivision 152-D are allowed under the cap.

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60 Paragraph 1.103 of the Explanatory Memorandum to Tax Laws Amendment (Simplified Superannuation) Act 2007
61 Paragraph 1.104 of the Explanatory Memorandum to Tax Laws Amendment (Simplified Superannuation) Act 2007
62 Paragraph 1.99 of the Explanatory Memorandum to Tax Laws Amendment (Simplified Superannuation) Act 2007
The 50% active asset reduction

The small business 50% active asset reduction is contained at Subdivision 152-C. If a taxpayer satisfies the conditions in relation to the basic small business CGT concessions (outlined in Section 2), they will automatically qualify for the 50% active asset reduction, unless the taxpayer elects not to use it.

If a taxpayer satisfies the basic conditions, this reduction gives a further 50% reduction to any capital gain that remains after applying any prior year net capital losses, and the CGT discount (if applicable).

Warning: Use by companies or unit trusts (post-CGT)

Where a capital gain of a post-CGT company or unit trust is reduced under the CGT small business 50% reduction, and the amount of the reduction is subsequently distributed, the amount of the distribution may be an unfranked assessable dividend (by a company) or a CGT event C2 if the company is liquidated. In the case of a unit trust, the distribution will give rise to CGT event E4 (if distributed) or C2 (if vested).

Section 152-220 allows for a taxpayer to choose whether to apply the 50% active asset reduction. In cases involving post-CGT companies or unit trusts, taxpayers should consider this choice.

7.1 Satisfying the 50% active asset reduction

If a taxpayer satisfies the basic conditions contained in section 152-10, they will automatically qualify for the 50% active asset reduction (section 152-205), unless the taxpayer chooses for it not to apply.

7.1.1 Exclusions and exemptions

The 50% active asset reduction contained at Subdivision 152-C cannot be applied to CGT events J2, J5 or J6. Further, it will not apply if the taxpayer qualifies for and elects the 15 year exemption (section 152-215) which operates to exempt the entire gain.
7.2 Consequences of applying the reduction

The 50% active asset reduction will apply where a taxpayer satisfies the basic conditions for relief and has not applied the 15 year exemption. The concession may be applied in combination with the small business roll-over concession, the retirement exemption and the general 50% discount (provided the asset was held for a period of 12 months or more).

If the taxpayer is an individual or a trust, and they have applied the general 50% CGT discount (Division 115) and the small business 50% active asset reduction, the capital gain is effectively reduced by 75%.

Example

Lana operates a small manufacturing business and disposes of a CGT asset that she has owned for three years and has used as an active asset of the business. She makes a capital gain of $17,000 from the CGT event, and qualifies for the CGT discount and for the small business 50% active asset reduction. Lana also has a capital loss in the income year of $3,000 from the sale of another asset. She calculates her net capital gain for the year as follows:

\[
\begin{align*}
\text{Net Gain} &= 17,000 - 3,000 = 14,000 \\
\text{Net Gain} &= 14,000 - (50\% \times 14,000) = 7,000 \\
\text{Net Gain} &= 7,000 - (50\% \times 7,000) = 3,500
\end{align*}
\]

Her net capital gain for the year is $3,500 (assuming the small business retirement exemption does not apply). If Lana chooses the rollover or the retirement exemption, some or all of the remaining capital gain would be disregarded.

\[63\] ATO’s Advanced Guide to capital gains tax concessions for small business 2010-11 (last modified 1 February 2012)
7.2.1 Rules for beneficiaries where trusts dispose of the asset

The trust streaming rules introduced by *Taxation Laws Amendment (Measures No.5) Act 2011* which apply from the 2010-11 income years amended the existing rules contained in Subdivision 115-C.

Broadly, if a trust makes a capital gain, its net capital gain for the income year is calculated by reducing any capital losses against the gains, and then by any relevant concession. The net capital gains is then included in the net income of the trust.

A beneficiary who is ‘specifically entitled’ to a capital gain will generally be assessed on that gain, regardless of whether the benefit they receive or are expected to receive is income or capital of the trust. Capital gains to which no beneficiary is specifically entitled will be allocated proportionately to beneficiaries based on their present entitlement to income of the trust estate (excluding capital gains and franked distributions to which any entity is specifically entitled). This is called the adjusted Division 6 percentage.

Where concessions have been applied by a trust, special rules exist that enable these concessions to be passed onto the beneficiaries of the trust who are entitled to a share of the trust’s net capital gain.

In particular, a beneficiary must ‘gross up’ their share of any capital gain received from a trust. The net capital gain is ‘grossed up’ as follows:

1. Multiplying the amount received by 2 if the trust has applied either the 50% active asset reduction or the general CGT discount; or
2. Multiplying the amount received by 4 if the trust has applied both the 50% active asset reduction and the general CGT discount.

The beneficiary must then apply the following order to their share of trust capital gains:

1. The trust capital gains are first reduced by any capital losses of the beneficiary; and
2. The remaining gain (after applying capital losses) is then reduced by the 50% general CGT discount (unless the beneficiary is a company), and the small business 50% active asset reduction.
Example

A unit trust makes a capital gain of $10,000 when it disposes of an active asset. The trust has no capital losses. If all of the conditions for the CGT discount and the small business 50% active asset reduction are satisfied, the trust’s net capital gain is $25,000 (no other concessions apply).

Assume there is one individual beneficiary presently entitled to the net income of the trust. The beneficiary also has a separate capital loss of $10,000.

The beneficiary works out their net capital gain as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of trust net capital gain</td>
<td>$ 25,000</td>
</tr>
<tr>
<td>Gross up this amount by multiplying by 4</td>
<td>$100,000</td>
</tr>
<tr>
<td>Deduct capital losses</td>
<td>$ 10,000</td>
</tr>
<tr>
<td></td>
<td>$ 90,000</td>
</tr>
<tr>
<td>Apply 50% CGT discount</td>
<td>$ 45,000</td>
</tr>
<tr>
<td></td>
<td>$ 45,000</td>
</tr>
<tr>
<td>Apply 50% reduction</td>
<td>$ 22,500</td>
</tr>
<tr>
<td><strong>Net capital gain</strong></td>
<td><strong>$ 22,500</strong></td>
</tr>
</tbody>
</table>

7.1.2 Fixed trust distributions

Note that for beneficiaries of fixed trusts, the distribution of the small business 50% active asset reduction amount is treated as a non-assessable amount for the purposes of CGT event E4 (section 104-70).

The payment of the amount will firstly reduce the cost base of the beneficiary’s interest in the trust. If the cost base is reduced to nil, a capital gain may arise in respect of the beneficiary’s interest in the trust. This capital gain may qualify for the CGT discount (after applying any capital losses) if the interest in the trust has been owned by the beneficiary for at least 12 months. Accessing the capital proceeds is discussed further at Section 11.

If the trust is not fixed (i.e. a discretionary trust) CGT event E4 will not apply.

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64 ATO’s Advanced Guide to capital gains tax concessions for small business 2010-11 (last modified 1 February 2012)
7.1.3 Treatment of shareholders where companies dispose of assets

An important contrast to draw between the 50% active asset reduction and the 15-year and retirement exemptions is that unlike the other Subdivisions, Subdivision 152-C does not deal with the distribution of proceeds from a company to its shareholders.

As the capital gain arising from the disposal of the underlying asset will not be taxed in full by the company if the 50% active asset reduction applies, any dividends subsequently paid to shareholders will likely be taxed at top marginal rates as the legislation does not operate to treat the dividend payment as exempt income in the hands of the shareholder.

As the company will only pay tax on 50% of the capital gain (assuming no capital losses or other exemptions are available) it will ordinarily be unable to generate sufficient franking credits to enable the ensuing dividend payment to be fully franked (subject of course to any existing franking credits the company might have).

Consequently, where companies are looking to return capital proceeds to their ultimate shareholders, the question should be asked as to whether one of the other concessions should be applied in priority to the 50% active asset reduction.

See Section 11 for commentary regarding accessing capital proceeds.
The retirement exemption

The retirement exemption is dealt with in Subdivision 152-D. If a taxpayer satisfies the requirements in Subdivision 152-D (and does not qualify for the 15 year exemption under Subdivision 152-B) they may choose to disregard all or part of a capital gain, up to the lifetime ‘CGT retirement exemption limit’ of $500,000.

Taxpayers may choose to apply the small business retirement exemption:

- When they have not qualified for the 15 year exemption;
- After the small business 50% active asset reduction has been applied (if chosen);
- Instead of the applying the small business 50% active asset reduction;
- In relation to CGT event J2, J5 or J6; or
- Instead or in conjunction with the small business roll-over concession

Consider use of roll-over concession before retirement exemption

As the retirement exemption can be applied to CGT events J5, J6 and J2, taxpayers may wish to apply the roll-over concession before the retirement exemption especially where the individual is close to 55. Where a taxpayer fails to acquire a replacement asset within the replacement period, the retirement exemption may then be applied to the resulting capital gains tax event (J5, J6 or J2). This may act to defer the payment requirements of the retirement concessions.

Retirement exemption – CGT cap

Taxpayers may wish to apply the retirement exemption as a method of increasing the amount of funds held within superannuation. Amounts contributed under the retirement exemption (up to the maximum $500,000 lifetime limit) are excluded from the non-concessional caps.
8.1 Satisfying the retirement exemption

When considering the small business retirement exemption it is important to remember that whilst the specific provisions contained in Subdivision 152-D make no specific reference to the ‘in connection with retirement’ requirement, the overriding intention of the Subdivision as explained in section 152-300 is to ensure that the ‘capital proceeds from the [CGT] event are used in connection with [the taxpayer’s] retirement’. No termination of employment is therefore specifically required in order to qualify for this exemption.

Note

Unlike the 15-year exemption, the retirement exemption does not require any payments to be made in ‘connection with retirement’. As such, where the taxpayer is under 55, has access to other small business concessions sufficient to reduce the taxable capital gain to nil, and is not intending on retiring within the foreseeable future, applying the retirement exemption may be attractive.

8.1.1 Individuals

If the taxpayer is an individual, the conditions listed at section 152-305(1) must be satisfied in order to access the retirement exemption. These are as follows:

- The taxpayer must satisfy the basic conditions in subdivision 152-A (see Section 2 for further details); and
- If the taxpayer is under 55 (just before they make the choice to apply the retirement exemption), an amount equal to the CGT exempt amount must be contributed to a complying superannuation fund or Retirement Savings Accounts (RSA); and
- The contribution must be made by:
  - For CGT events J2, J5 or J6, when the taxpayer made the choice; or
  - For all other relevant CGT events, the later of when the taxpayer made the choice and when they received the proceeds.

It is essential that taxpayers pay the amount into a complying superannuation fund or RSA by the relevant date. Failure to immediately contribute the amount will mean the conditions are not satisfied and the retirement exemption will not be available.

For taxpayers 55 years and over (at the time the choice is made), there is no requirement to contribute to a complying superannuation fund or RSA.

8.1.2 Company or trust
If the taxpayer is company or a trust, the conditions listed at subsection 152-305(2) and 152-325 must be satisfied in order to access the retirement exemption. These are as follows:

- The taxpayer must satisfy the basic conditions in subdivision 152-A (see Section 2 for further discussion);
- The entity satisfies the significant individual test (see Section 2 for further details) (section 152-50);
- A written record must be kept which includes the CGT concession stakeholders percentage of the exempt amount;
- A payment is made to at least one CGT concession stakeholder worked out by reference to each individual's percentage of the exempt amount; and
- The payment must be made by (s 152-325(4)):
  - For CGT events J2, J5 or J6, within 7 days of the taxpayer making the choice;
  - or
  - For all other relevant CGT events, within 7 days of the later of when the taxpayer made the choice and when they received the proceeds.
- The payment must be equal to the lesser of the exempt amount or the amount of capital proceeds (or amount of capital gain disregarded where rollover relief is applied) (s 152-325(5));

Where the CGT concession stakeholder is under 55 just before the payment is made, the company or trust must make the payment to a complying superannuation fund or a Retirement Savings Account (RSA) belonging to the concession stakeholder (paragraph 152-325(7)). Further, the company or trust must notify the trustee of the fund or the RSA provider, at the time the contribution is made, that the contribution is in accordance with section 152-325(7).

8.1.3 Making the choice

In accordance with s 103-25, the choice must be made in writing by the day the taxpayer lodges their income tax return for the income year in which the relevant CGT event happened, or within a further time allowed by the Commissioner.

8.1.4 Receiving proceeds in instalments

Where a taxpayer receives the capital proceeds from the CGT event in instalments, the conditions noted above for individuals (see section 152-305) and companies and trusts (see 152-325) must be satisfied for each instalment in succession (up to the relevant CGT exempt amount).
8.1.5 Capital gains events J2, J5, & J6

Unlike the 15 year exemption and the 50% active asset reduction, the retirement exemption may be applied to capital gains arising from CGT events J2, J5, or J6 where a taxpayer has previously applied the CGT small business rollover.

As the basic requirements would have already been met to satisfy the CGT small business rollover, there is no requirement for the basic conditions (section 152-10) to be met at the time the J2, J5 or J6 CGT events occur.

8.2 Consequences of applying the retirement exemption

If a taxpayer satisfies the conditions of the retirement exemption and elects to apply the small business retirement exemption to a capital gain, they may disregard the portion of the gain to which the retirement exemption was applied (section 152-310(1)). This portion is referred to as the CGT exempt amount and is capped to an individual’s lifetime CGT retirement exemption limit of $500,000 (section 152-320).

An individual’s lifetime CGT retirement exemption limit of $500,000, is reduced by any previous CGT exempt amounts the individual has disregarded under the retirement exemption.

Note

For a company or trust with eight CGT concession stakeholders for example (four significant individuals and their four spouses where the spouse has a business participation percentage greater than zero) the limit is effectively $4 million ($500,000 for each stakeholder).

A company or trust may determine the percentage of the exempt amount attributable to each stakeholder, having regard to each stakeholder’s retirement exemption limit (or remaining limit) to ensure that this amount is not exceeded (subsection 152-315(5)). The following example is included as a note to subsection 152-315(5) in the legislation.
Example in legislation to subsection 152-315(5)

Daryl is a significant individual in a company. The company specifies 90% for Daryl under subsection (5) (which means that the percentage specified for the other stakeholders 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.

8.2.1 Exceeding the CGT retirement exemption limit

Where payments are made to a complying superannuation fund that exceed an individual’s lifetime CGT retirement exemption limit, the amount which exceeds the limit contributes towards the individual’s non-concessional caps.

8.2.2 Payment made by company or trust

Where a company or trust has made a payment relating to the small business retirement exemption to a CGT concession stakeholder, the exempt amount is not an allowable deduction to the company or trust (section 152-310(2)(b)). Further, the amount received by the CGT concession stakeholder is not assessable nor exempt income of the CGT concession stakeholder to whom the payment was made (section 152-310(2)(a)).

8.2.3 Where payments are made through interposed entities

Where a payment is made through an interposed entity to a CGT concession stakeholder (or another interposed entity), the payment cannot be deducted from the paying entity’s assessable income nor is it assessable income to the receiving entity (section 152-310(3)).

8.2.4 Payments no longer fall within potential operation of Division 7A

Prior to the introduction of Tax Laws Amendment (2009 Measures No.2) Act 2009, where a payment was made by a company or trust under the retirement exemption to a CGT concession stakeholder who was an employee of that entity, the payment was deemed to have been made in consequence of the termination of the employment of the stakeholder. If the payment from a private company to the employee CGT concession stakeholder was excessive, section 109 ITAA 1936 may potentially operate to deem the excessive remuneration as a dividend.
As a result of the introduction of *Tax Laws Amendment (2009 Measures No.2) Act 2009*, such payments made on or after 23 June 2009 are no longer deemed to be in consequence of termination of employment for the purposes of section 109 ITAA 1936 (see subsections 152-325(9) – (11)).

**8.2.5 Interaction with superannuation**

A taxpayer is entitled to reduce their capital gain by the CGT retirement exemption limit of $500,000 (section 152-320). For taxpayers under 55 an amount equal to the CGT exempt amount must be contributed to a complying superannuation fund or RSA within certain timeframes. For taxpayers aged 55 year and older, this amount is not required to be contributed to a complying superannuation fund.

Any excess over the CGT retirement exemption limit will be counted as a non-concessional superannuation contribution.

Note that the retirement exemption limit of $500,000 counts towards the CGT cap amount (currently $1.205 million) mentioned in Section 6.
The small business roll-over exemption

The small business roll-over concession is dealt with in Subdivision 152-E. If a taxpayer satisfies the requirements in Subdivision 152-E, they may choose to defer all or part of a capital gain.

Taxpayers may choose to apply the small business retirement exemption:

- When they have not qualified for the 15 year exemption;
- After the small business 50% active asset reduction has been applied (if chosen);
- Instead of the applying the small business 50% active asset reduction; or
- Instead or in conjunction with the small business retirement exemption.

**Note**

The application of the small business roll-over concession has the potential to act as a deferral mechanism.

Where a taxpayer satisfies the conditions for the small business roll-over exemption, the amount of the capital gain relating to the roll-over is automatically disregarded. If the taxpayer then fails to acquire a replacement asset within the replacement period CGT events J5, J6 or J2 will apply. In such cases, the taxing point is deferred by up to two years.

### 9.1 Satisfying the small business roll-over exemption

To qualify for the small business roll-over exemption, a taxpayer must satisfy the basic conditions in Subdivision 152-A (see Section 2 for further details). Further to the basic conditions, a taxpayer must ensure the roll-over conditions are met.

In order for a taxpayer to defer all or part of a capital gain, the roll-over conditions must be satisfied by the end of the replacement asset period. This period starts one year before and ends two years after the last CGT event that occurred in the income year in which they choose the roll-over. If the rollover conditions are not met within the replacement asset period the gain will become assessable.
To satisfy the roll-over conditions, a taxpayer must:

- Acquire one or more CGT assets as replacement assets, or make a capital improvement to one or more existing assets, or both, within the replacement period;
- Ensure the asset being acquired or improved is an active asset at the end of the replacement asset period;
- Where the replacement asset is a share in a company or an interest in a trust, ensure that at the end of the replacement asset period:
  - The taxpayer or an entity connected with the taxpayer, is a CGT concession stakeholder in the company or trust;
  - The CGT concessional stakeholders in the company or trust have a small business participation percentage in the interposed entity of at least 90%;
- Ensure that the capital gain that is being rolled over is not more than the sum of the following:
  - The amount paid to acquire the replacement asset;
  - Any incidental costs incurred in acquiring the asset, which can include giving property; and
  - The amount expended on capital improvement to one or more assets that were acquired or already owned.

**Example**

Jordan owns 50% of the shares in Company A and Company B. He is, therefore, a CGT concession stakeholder in both companies. The companies are connected with Jordan because he controls both of them.

Company A owns land which it leases to Jordan for use in a business. It sells the land at a profit and buys shares in Company B as replacement assets. All of Company B’s assets are active assets.

The replacement asset test is satisfied because the shares are active assets and Jordan is connected with Company A and is a CGT concession stakeholder in Company B.

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9.2 Consequences of failing the roll-over conditions

9.2.1 CGT Event J5

CGT event J5 (section 104-197) occurs where a taxpayer chooses to obtain a roll-over, and by the end of the replacement asset period the taxpayer:

- Has not acquired a replacement asset, or made a capital improvement to an existing asset;
- Had acquired a replacement asset or capital improvement, however it was not their active asset (e.g. it was sold, become trading stock, or is no longer used in the business);

CGT event J5 will also occur where the replacement asset is a share in a company or an interest in a trust and:

- The share or trust interest fails the active asset test (unless the failure is temporary);
- The taxpayer, or an entity connected with the taxpayer, is not a CGT concession stakeholder in the company or trust; or
- CGT concession stakeholders in the company or trust do not have a small business participation percentage in the interposed entity of at least 90%.

Where CGT event J5 occurs, the taxpayer will make a capital gain at the end of the replacement period equal to the amount of the capital gain previously disregarded under the small business roll-over.

Example

In September 2006, Luke makes a capital gain of $80,000 on an active asset and meets the maximum net asset value test. Luke disregards the whole capital gain under the small business roll-over.

In September 2008, Luke does not have any replacement or capital improved assets by the end of the two-year period. CGT event J5 happens and Luke makes a capital gain of $80,000 in September 2008.

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Where CGT event J5 occurs, the taxpayer will not qualify for the 50% general discount, 50% active asset discount or the 15-year exemption (section 152-10(4)), however they may apply the retirement exemption (Subdivision 152-D) provided the relevant conditions are met.

The resulting capital gain is not required to pass the basic conditions at subdivision 152-A, as the taxpayer would have passed this at the time the roll-over concession was applied.

For the application of the retirement exemption, and details regarding the timing of contributions, refer to Section 8.

9.2.2 CGT Event J6

CGT event J6 (section 104-198) occurs where a taxpayer chooses to obtain a roll-over, and by the end of the replacement asset period the taxpayer had satisfied all conditions, however had failed to ensure that the amount they had chosen to roll-over is equal to or greater than the following:

- The amount paid to acquire the replacement asset;
- Any incidental costs incurred in acquiring the asset, which can include giving property; and
- The amount expended on capital improvement to one or more assets that were acquired or already owned.

Where CGT event J6 occurs, the taxpayer will make a capital gain at the end of the replacement period equal to the amount of the capital gain previously disregarded under the small business roll-over less the amount incurred on the replacement asset or capital improvements.
In October 2006, Nicky makes a capital gain of $700,000 on an active asset and meets the maximum net asset value test. Nicky chooses to disregard the whole capital gain.

In November 2007, Nicky purchases new business premises for $300,000 and spends $150,000 on improving some other assets. The replacement and capital improved assets meet all of the relevant conditions.

However, the amount of expenditure on the replacement and capital improved assets is only $450,000. The capital gain that was rolled over was $700,000.

In October 2008, two years after the original CGT event, CGT event J6 happens because there has been insufficient expenditure and Nicky makes a capital gain of $250,000. The rollover of $450,000 of the original capital gain continues.

Where CGT event J6 occurs, the taxpayer will not qualify for the 50% general discount, 50% active asset discount or the 15-year exemption (section 152-10(4)), however they may apply the retirement exemption (Subdivision 152-D) provided the relevant conditions are met.

The resulting capital gain is not required to pass the basic conditions at subdivision 152-A, as the taxpayer would have passed this at the time the roll-over concession was applied.

**9.2.3 CGT Event J2**

CGT event J2 (section 104-185) occurs where a taxpayer chose to obtain a roll-over, and by the end of the replacement asset period there is a change in the status of the replacement asset or capital improved asset the taxpayer chose for the small business roll-over.

This can occur when the replacement asset or capital improved asset stops being the taxpayer’s active asset (e.g. the asset is disposed), becomes trading stock, or is used to produce exempt income.

Where the replacement asset is a share in a company or interest in a trust, J2 will occur when:

- The share or interest stops being an active asset;

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Example

In October 2006, Nicky makes a capital gain of $700,000 on an active asset and meets the maximum net asset value test. Nicky chooses to disregard the whole capital gain.

In November 2007, Nicky purchases new business premises for $300,000 and spends $150,000 on improving some other assets. The replacement and capital improved assets meet all of the relevant conditions.

However, the amount of expenditure on the replacement and capital improved assets is only $450,000. The capital gain that was rolled over was $700,000.

In October 2008, two years after the original CGT event, CGT event J6 happens because there has been insufficient expenditure and Nicky makes a capital gain of $250,000. The rollover of $450,000 of the original capital gain continues.

Where CGT event J6 occurs, the taxpayer will not qualify for the 50% general discount, 50% active asset discount or the 15-year exemption (section 152-10(4)), however they may apply the retirement exemption (Subdivision 152-D) provided the relevant conditions are met.

The resulting capital gain is not required to pass the basic conditions at subdivision 152-A, as the taxpayer would have passed this at the time the roll-over concession was applied.

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- A liquidator or administrator declares the shares worthless (CGT event G3);
- The taxpayer or an entity connected with the taxpayer, cease to be a concessional stakeholder in the company or trust; or
- The CGT concession stakeholders in the company or trust cease to have a small business participation percentage in the interposed entity of at least 90%.

Where CGT event J2 occurs, the taxpayer will make a capital gain at the end of the replacement period equal to the amount of the capital gain previously disregarded under the small business roll-over.

In circumstances where there was more than one replacement or capital improved asset, and the change occurs to only some of the assets, the taxpayer will make a capital gain at the end of the replacement period equal to the amount of the capital gain previously disregarded under the small business roll-over less the amount incurred on the replacement asset or capital improvements that satisfied the conditions.
Example

Peter disposes of an active asset for $1,000, making a capital gain of $2,000. He buys two replacement assets (not being depreciating assets) for $5,000 each and chooses the small business rollover.

$1,000 of the capital gain is disregarded for each replacement asset.

Peter later sells one of the replacement assets for $7,500, so Peter makes a capital gain of $2,500.

He also makes a capital gain of $1,000 as the sale of the replacement asset results in that asset no longer being an active asset. The $1,000 capital gain represents the capital gain made on the disposal of the active asset that was rolled over in respect of this replacement asset.

Peter's capital gain of $1,000 made from the crystallising of the deferred capital gain (CGT event J2) may be eligible for further rollover relief or the retirement exemption. The capital gain of $2,500 made from the disposal of the replacement asset (CGT event A1), may be eligible for any of the concessions if the relevant conditions are satisfied.

Where CGT event J2 occurs, the taxpayer will not qualify for the 50% general discount, 50% active asset discount or the 15-year exemption (section 152-10(4)), however they may apply the retirement exemption (Subdivision 152-D), or in some circumstances apply for further rollover (Subdivision 152-E) provided the relevant conditions are met..

If a replacement asset is disposed of, CGT event A1 will apply. This may qualify for any of the small business CGT concessions if the relevant conditions can be satisfied.

ATO’s Advanced Guide to capital gains tax concessions for small business 2010-11 (last modified 1 February 2012)
Recent developments

10.1 Look-through treatment for earnout arrangements

The ATO released Draft Taxation Ruling, TR 2007/D10 regarding the treatment of earnout arrangements on 17 October 2007. This Draft Ruling treats an earnout right created under an arrangement to sell a business as an asset that is separate to the business for CGT purposes. In accordance with TR 2007/D10:

- In a standard earnout arrangement, the proceeds from the sale of the asset include the lump sum amount (whether cash or property), plus the estimated market value of the earnout right. The seller holds the earnout right.

- In a reverse earnout arrangement, part of the lump sum amount received from the buyer is proceeds from the sale of the asset, and part is proceeds for the creation of the reverse earnout right. The buyer holds the reverse earnout right.

- Subsequent payments relate to the earnout right and may trigger CGT consequences for the holder, depending on the amount received and the cost base of the right (broadly reflecting its estimated market value).

Note

As each earnout is treated as a separate CGT asset under the preliminary approach adopted by the ATO in TR 2007/D10, sellers were unable to satisfy the specific conditions needed to apply the various small business CGT concessions to subsequent earnout payments – although depending upon when the earnout payment was received, the 50% CGT discount was potentially available.

Subsequently, on 12 May 2010, the Assistant Treasurer announced that ‘Look-through treatment’ will apply to earnout arrangements in order to simplify the sale of business assets as part of the 2010-11 Federal Budget announcements. This broadly, restores the generally accepted position that existed prior to the release of TR 2007/D10.
The changes are intended to ‘make it easier to buy and sell businesses….and will ensure the capital gains tax treatment of earnout arrangements is not an obstacle to the efficient functioning of the market for business assets’\(^69\).

In particular, the changes are intended to ‘benefit small business taxpayers by ensuring any small business CGT concessions that were available on the sale of the business (or business assets) are also available for capital gains made on subsequent earnout payments’\(^70\).

Under this proposal:

- Additional payments made through a ‘standard’ earnout arrangement will be treated as relating to the original asset for the seller and will be added to the cost base for the buyer; and
- Payments made under a ‘reverse’ earnout arrangement will be treated effectively as a repayment of part of the capital proceeds.

The underlying principle of the look-through approach is to ignore the earnout right (in contrast to the position adopted by the ATO in TR 2007/D10) and treat all payments as related to the sale (or purchase) of the original business asset. Consistent with the normal capital proceeds rules, amounts will be recognised when they become certain (that is, money or property a taxpayer is ‘entitled to receive’).\(^71\)

### 10.1.1 Standard earnout arrangements

The Treasury Proposal paper\(^72\) released in May 2010 explains that for standard earnout arrangements, it is proposed to apply a cost recovery method in order to achieve look-through treatment.

Under the cost recovery method, the seller reduces the cost base of the asset as and when amounts they are due to receive become certain (including the initial capital proceeds and subsequent payments). After the cost base is reduced to zero, the seller realises a capital gain on all further amounts. This ensures that the seller’s capital proceeds from the sale of...
the business asset reflect the total amount received. Any capital gain is treated as realised on the business asset and is eligible for any CGT concessions that were available for that asset (see example below).

**Note**

As each earnout payment is treated as being in respect of the disposal of the original asset (in contrast to the position adopted in TR 2007/D10), where the small business CGT concessions would have been satisfied in respect of the original disposal they will continue to apply to any capital gains arising from the receipt of future earnout payments.

Similarly, the 50% CGT discount should be available in respect of any gains arising from the receipt of earnout payments if it would have been available at the time of the initial disposal.

Consequently, the possible receipt of future earnout payments will need to be considered when deciding which small business CGT concessions apply to the original disposal.

For the buyer, payments are included in the asset’s cost base as and when the buyer pays them. This ensures that the cost base reflects the actual amount paid for the asset.

The following example illustrates the proposed tax treatment for standard earnout arrangements:
Cost recovery method – overall capital gain

The structure of the earnout arrangement and the performance of the business results in an upfront payment of $800,000 and subsequent payments of $100,000 (Year 1), $150,000 (Year 2) and $100,000 (Year 3). In this example, the seller’s cost base for the business is $1 million. (Because the look-through approach ignores the earnout right there is no need to estimate its market value)

Proposed tax treatment of seller

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</tbody>
</table>

Overall the seller’s capital proceeds were $1.15 million, resulting in an overall capital gain of $150,000 realised as two separate gains of $50,000 and $100,000 (the capital gains in Year 2 and Year 3 are brought to account in the respective income year for Year 2 and Year 3). The seller will have access to any CGT concessions for the subsequent capital gains that they could access for the original capital gain.

Proposed tax treatment for buyer

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount paid</th>
<th>Cost base</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$800,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>1</td>
<td>$100,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>2</td>
<td>$150,000</td>
<td>$1.05 million</td>
</tr>
<tr>
<td>3</td>
<td>$100,000</td>
<td>$1.15 million</td>
</tr>
</tbody>
</table>

Applying the cost recovery method, the buyer’s cost base for the business is $1.15 million.

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73 Example 2 on page 4 of the Treasury Proposals Paper, Capital gains tax treatment of earnout arrangements, May 2010
10.1.2 Reverse earnout arrangements

The Treasury Proposals paper also explains that for reverse earnout arrangements, subsequent payments from the seller to the buyer would effectively be treated as a partial refund. It is proposed that this will be implemented by making amendments to the existing ‘repaid’ rules (for sellers) and the ‘recoupment’ rules (for buyers).

The repaid rules in section 116-50 could be amended to allow earnout payments made by the seller to reduce their capital proceeds. This would allow the seller to amend their capital gains calculations to reduce their capital proceeds from the disposal of the original asset as and when they become obligated to pay an amount to the buyer under the reverse earnout arrangement.

The recoupment rules in subsection 110-45(3) could be expanded to require the buyer to decrease their cost base when they recoup part of the purchase price – that is, when the buyer is entitled to payments under the earnout arrangement.

10.1.3 Integrity and transitional measures

The measures are proposed to apply from the date of Royal Assent of the relevant legislation (which has not yet been developed), with transitional provisions to apply.

It is proposed that taxpayers will have the choice to apply the ‘look-through’ treatment for earnout arrangements entered into between 12 May 2010 and the date of Royal Assent of the amending legislation.

In addition, buyers under a standard earnout arrangement will have the choice to apply "look-through" treatment for arrangements entered into on or after 17 October 2007 (being the date on which TR 2007/D10 was issued). For arrangements entered into before 17 October 2007, they will have the choice to apply the effective look-through treatment prescribed in withdrawn Taxation Ruling TR 93/15.

The proposal includes specific integrity measures to ensure that the earnout arrangement is genuine and to minimise exploitation of the look-through treatment to avoid or artificially delay tax liabilities. Genuine earnout arrangements in this context are considered to be arrangements which run for less than 5 years, where payments are genuinely contingent and related to the performance of the asset where there is sufficient uncertainty, and the transaction is at arm’s length.
Note

As taxpayers have the choice to apply the proposals prior to their receiving Royal Assent, this provides an opportunity to consider whether there is a potential for capital gains to be deferred under the proposed measures, provided the arrangement accords with the relevant integrity measures.

In addition, where prior year returns have been lodged in accordance with the ATO’s views in TR 2007/10, there may be opportunities to amend prior year assessments where a more favourable outcome may be achieved by applying the ‘look-through’ approach.

10.2 Ensuring taxpayers can have a non zero direct small business participation percentage

Legislation\(^\text{74}\) has been passed by the Parliament which is aimed at ensuring taxpayers can have a non-zero direct small business participation percentage. This may occur in situations where shares in a company are held jointly by taxpayers and a discretionary trust has not made a distribution in an income year where the trust had a tax loss or no net income for that year.

10.2.1 Companies – joint shareholders

As discussed previously in order to access the small business CGT concessions in relation to a share in a company, it is necessary for that company to have one or more significant individuals. The significant individual test is thought to represent a readily verifiable proxy for active participation in a small business. However, where shares are jointly held, those joint holders may be unable to qualify as a significant individual.

To qualify as a significant individual, the individual’s direct and indirect small business participation percentage in the company must be at least 20% (sections 152-55 and 152-65).

Under subsection 152-70(1), an entity’s direct small business participation percentage in a company is the smallest of the entity’s percentage of:

\(^{74}\) Tax Laws Amendments (2011 Measures No 9) Bill 2011. This Bill passed the remaining stages in the Senate on 1 March 2012. The Bill received Royal Assent as Act No 12 of 2012 on 21 March 2012.
- The voting power in the company the entity is entitled to exercise;
- Any dividend payment that the entity is entitled to receive; and
- Any capital distribution that the entity is entitled to receive.

Where shares are jointly held, it is arguable that each joint holder in their own right has a zero percentage of voting power as no joint holder individually controls the voting power bestowed on the jointly held shares. This gives each joint holder a direct small business participation percentage of zero in relation to those jointly held shares and consequently may exclude them from qualifying for the small business CGT concessions.

These amendments propose to ‘switch off’ the voting power calculation in subsection 152-70(1) to accommodate joint shareholders for the purpose of qualifying for the small business CGT concessions.

This has the effect that joint shareholders calculate their small business participation percentage based on the lesser of their percentage entitlement to any dividend or capital distribution of the company.

10.2.2 Discretionary trusts – no distributions and no net income and tax losses

These amendments seek to repeal section 152-120 and amend section 152-70 to deal with situations where discretionary trusts (i.e. trusts where entities do not have entitlements to all of the income and capital of the trust) do not make a distribution of income or capital during the year and the trust has a tax loss or no taxable income for that year.

Section 152-120 currently treats a discretionary trust as if it had a significant individual (i.e. an assumed significant individual) during an income year in which the trustee did not make a distribution of income or capital if the trust had a tax loss or no taxable income for that year.

However, section 152-120 only applies for the purposes of meeting the condition required in particular circumstances in the small business 15-year exemption that a trust must have a significant individual for at least 15 years — see paragraphs 152-105(c) and 152-110(1)(c).

However, a number of shortcomings have been identified with the operation of section 152-120 including:

- It does not work for indirectly held entities as it does not give the assumed significant individual a direct small business participation percentage where the first entity in the chain is a discretionary trust, which is needed to calculate their small business participation percentage in the final entity in the chain (the indirectly held entity).
• It does not work in relation to paragraphs 152-110(1)(d) and 152-125(1)(b) for directly-held entities where a discretionary trust did not make a distribution in the income year that the relevant CGT event happens (the CGT event year). This is because those paragraphs require the trust to have respectively a significant individual or a CGT concession stakeholder just prior to the CGT event who must also satisfy other conditions (such as an age condition). By deeming there to be a significant individual but not identifying that individual, these conditions cannot be satisfied.

The issues associated with the operation of section 152-120 effectively stem from the way in which section 152-70 was drafted. Section 152-70 provides that an entity’s small business participation percentage at the relevant time in a discretionary trust is equal to the smaller of the percentage of income or capital distribution the entity was beneficially entitled to during the income year in which that time occurs.

A problem arises when the trustee of the trust does not make a distribution in an income year, which results in the trust not having a significant individual, apart from the section 152-120 assumed significant individual, or any CGT concession stakeholders for that income year. This is particularly problematic if the income year is the CGT event year because access to the small business CGT concessions in particular circumstances requires an entity to have a significant individual or a CGT concession stakeholder (for example, see subsection 152-10(2) and paragraph 152-305(2)(b)).

The proposed amendments allow, for the purpose of accessing the small business CGT concessions, an entity to work out their direct small business participation percentage in a discretionary trust at the relevant time if during the income year that includes that time (the relevant year), the trustee of the trust:

• Does not make a distribution of income; and

• Does not make a distribution of capital.

However, an entity is able to work out a direct small business participation percentage greater than zero only if the trust did not have net income or had a tax loss for the relevant year (new subsections 152-70(4) and (6)).

If the trustee of the trust made a distribution in the CGT event year, the entity’s direct small business participation percentage at the relevant time is worked out via item 3 in the table in subsection 152-70(1) using the percentage of the distributions the entity was beneficially entitled to in the CGT event year. If the trustee of the trust did not make a distribution in the CGT event year, the entity’s direct small business participation percentage at the relevant...
time is worked out using the percentage of the distributions the entity was beneficially entitled to in the last income year before the CGT event year in which the trustee made a distribution (new subsection 120-70(5)).

The operation of these provisions is illustrated in the following example:

**Example 8.1**

XYZ trust is a trust where entities do not have entitlements to all of the income and capital of the trust. XYZ trust operates a business and owns land that it has used in the course of carrying on its business for the last 20 years. Evan, Mario, Denise and Katrina are all objects of XYZ trust and have been so for the last 20 years. After suffering a bad trading year, XYZ trust decides to sell the land.

XYZ trust’s aggregated turnover for the income year in which it sells the land (the CGT event year) is less than $2 million. XYZ trust wants to exempt the capital gain under the small business 15-year exemption and pay out the exempt amount to Evan, Mario, Denise and Katrina.

In order for XYZ trust to meet the conditions of the small business 15-year exemption, Evan, Mario, Denise and Katrina have to work out a small business participation percentage in XYZ trust.

The trustee of XYZ trust did not make a distribution in the CGT event year and the trust had a tax loss for that year. The trustee made a distribution of income in the year prior to the CGT event year with Evan being beneficially entitled to 40% of the income and Mario, Denis and Katrina each being beneficially entitled to 20% of the income. The trustee did not make a distribution of capital in that year.

In all the other income years except the income year 14 years before the CGT event year, the trustee of XYZ trust made a distribution and XYZ trust had a significant individual. In the income year 14 years before the CGT event year, the trustee did not make a distribution and the trust had a tax loss for that year.

The amendments allow a direct small business participation percentage to be calculated for Evan, Mario, Denise and Katrina for the CGT event year and for the income year 14 years before the CGT event year. As there is no distribution in the CGT event year, the focus shifts...
to the last income year before the CGT event year in which there was a distribution — that is, the income year prior to the CGT event year.

Therefore, in the CGT event year and in the income year 14 years before the CGT event year the direct small business participation percentages are as follows: 40% for Evan; and 20% for each of Mario, Denise and Katrina.

In the circumstances of this example, the amendments allow XYZ trust to have a significant individual in the two tax-loss years. As Mario was 60 years of age just before the land was sold, XYZ trust would be able use the small business 15-year exemption to exempt the capital gain on the sale of the land so long as the other relevant conditions of the small business 15-year exemption are met.

An entity will be taken to have a direct small business participation percentage at the relevant time in a discretionary trust of zero where:

- The trust had net income for the relevant year and did not have a tax loss for that year (new paragraph 152-70(6)(a), or
- The trustee did not make a distribution of income or capital before the end of the CGT year (new paragraph 152-70(6)(b)) This would apply where the trustee of the trust had never made a distribution in the income years (including the CGT event year) that the entity was an object of the trust and the trust had no net income or had a tax loss in each of those income years.

The amendments also enable an entity to calculate a small business participation percentage in another entity in which it has an indirect interest.

10.2.3 Retrospective start date

The amendments will generally apply in relation to CGT events happening in the 2006-07 income year and later income years to align with the date of effect of the amendments that introduced the ‘significant individual’ test.
The operation of section 170 of the ITAA 1936 is modified so that taxpayers are able to seek an amended assessment to take advantage of these amendments where their original assessment was made before the commencement of these amendments but their period for seeking an amendment to their tax return has expired. Broadly, taxpayers are able to seek an amended assessment in these circumstances within two years of that commencement.

**Note**

Given the retrospective nature of these amendments, taxpayers have an opportunity to revisit the availability of the 15 year retirement exemption in respect of CGT events that occurred in the 2006-07 income year and later income years.

**10.3 Nomination of controllers of a discretionary trust – new section 152-78**

As part of a package of miscellaneous amendments enacted by *Tax Laws Amendments (2011 Measures No 2) Act 2011*, which received Royal Assent on 27 June 2011, changes were made to the rules associated with the nomination of controllers of a discretionary trust. These changes have been made through the repeal of section 152-42 and the insertion of new section 152-78.

Former section 152-42 allowed a trustee of a discretionary trust to nominate up to four beneficiaries of the trust as controllers of the trust for an income year in which the trustee did not make a distribution of income or capital and the trust had a tax loss or no taxable income for that year. The result of nominating a beneficiary to be a controller of a discretionary trust under section 152-42 was that the beneficiary and discretionary trust were connected entities for the income year but only for the purpose of applying the definition of ‘active asset’ in subparagraph 152-40(1)(a)(iii) or paragraph 152-40(1)(b).

Where a beneficiary was a controller of a discretionary trust only because of the nomination in former section 152-42, this did not make the beneficiary a controller of the trust for the purposes of calculating the maximum net asset value of the entity that owns the asset. In particular, section 152-42 did not apply to paragraph 152-10(1A)(a), which is part of the provisions that extend access to the small business CGT concessions via the small business entity test to passively-held assets.
This meant that an entity that did not carry on a business (other than as a partner in partnership) and that was not connected with a discretionary trust could not access the small business CGT concessions via the small business entity test for a capital gain made on a CGT asset it owned that was used in the business of the discretionary trust.

In order to remedy this gap in the legislation, section 152-42 was repealed with effect from 27 June 2011. In its place new section 152-78 was introduced which also allows a trustee of a discretionary trust to nominate (in writing) up to four beneficiaries of the trust as controllers of the trust for an income year in which the trustee did not make a distribution of income or capital and the trust had a tax loss or no net income for that year.

However, where the trustee has made a nomination under section 152-78, its extended scope allows an entity that does not carry on a business (other than as a partner in partnership) whose asset is used in the trust’s business to access the small business CGT concessions via the small business entity test through the operation of subsection 152-10(1A).

The extended scope of a nomination also means that it applies for determining whether one entity is connected with another entity for calculating the maximum net asset value of the entity that owned the asset or the aggregated turnover of the discretionary trust that used the asset in its business.

For access to the small business CGT concessions generally, the amendments apply to CGT events that occur on or after 27 June 2011 (the date of Royal Assent). However, for access to the small business CGT concessions via the small business entity test only, the amendments apply in relation to CGT events that happened after the start of the 2007-08 income year.

The combination of the two application rules results in:

- The amendments applying, for access to the concessions via the small business entity test, in relation to CGT events that happen in the 2007-08 income year and later income years (which aligns with the date of effect of the amendments that extended access to the concessions via the small business entity test to passively held assets); and
Taxpayers who accessed the concessions where a trustee made a nomination under section 152-42 prior to Royal Assent not being disadvantaged by the increased scope of the new nomination, which includes determining whether one entity is connected with another entity for calculating the maximum net asset value of the entity that owned the relevant asset.

The retrospective component of the amendments will be beneficial to discretionary trust beneficiaries who, following the trustee of the trust making a nomination, will have the opportunity to access the small business CGT concessions via the small business entity test (i.e. through the operation of subsection 152-10(1A)).

The small business CGT concessions require taxpayers to make choices. For example, the small business retirement exemption and small business roll-over are available only if the taxpayer chooses to obtain them. Subsection 103-25(1) limits the date for making a choice to the day an entity lodges its income tax return for the income year in which the relevant CGT event happened or a later date allowed by the Commissioner.

However, taxpayers who become eligible to make a choice under Division 152 due to these amendments will have an extended period, under a transitional rule, to make such a choice in relation to CGT events happening before the day on which this Bill receives Royal Assent.

The time limit for an entity to make the choice it is eligible to make as a result of these amendments is the latest of:

- The day the entity lodges its income tax return for the income year in which the relevant CGT event happened;
- 12 months after date of Royal Assent (i.e. By 27 June 2012); and
- A later day allowed by the Commissioner.
**Note**

The extended scope of new section 152-78 means that once a trustee has made a nomination:

- an entity that does not carry on a business (other than as a partner in partnership) whose asset is used in the trust’s business will be able to access the small business CGT concessions via the small business entity test through the operation of subsection 152-10(1A); and

- The nomination will apply for determining whether one entity is connected with another entity for calculating the maximum net asset value of the entity that owned the asset or the aggregated turnover of the discretionary trust that used the asset in its business.

Again, the retrospective nature of these amendments, will allow taxpayers an opportunity to revisit access to the small business CGT concessions via the small business entity test (through subsection 152-10(1A)) in respect of CGT events that happened in the 2007-08 income year and later income years.
Accessing capital proceeds

A taxpayer’s structure, and the concessions they choose, may have a material impact on the total tax payable on a capital gain and the subsequent payment of (or access to) the capital proceeds.

Taxpayer’s should consider the effects their existing structure will have on their ability to access the capital proceeds of a gain. Some concessions are more effective where assets are held through certain entity types, and as such a taxpayer’s structure should always be considered when applying the small business CGT concessions to ensure the proceeds can be accessed effectively.

11.1 Individuals & trusts (other than unit trusts)

For individuals and trusts (other than fixed trusts such as unit trusts), accessing the capital proceeds of a capital gain that qualified for the small business concessions will generally not trigger any additional taxing events.

Provided the small business CGT concessions have been applied correctly, as individuals have access to the 50% general discount, individuals and discretionary trusts (with individuals as beneficiaries) will often receive the most tax efficient outcome in relation to small business capital gains.

11.2 Companies

Where a company makes a capital gain that qualified for the small business concessions, care must be taken to ensure that taxpayers are able to access the capital proceeds without incurring further income tax. Due to the application of CGT event C2 (cancellation of shares) and G1 (capital payment for shares), a taxpayer may be better off choosing not to apply the 50% active asset discount if other discounts are available.

Where a company has made a capital gain that qualifies for the CGT 15-year exemption, the exempt amount may be distributed (‘flow through’) to an individual who is a CGT concession stakeholder without further tax implications, provided the amount is paid within two years (section 152-125).
Where a company has made a capital gain that qualifies for the retirement exemption, the payment made in relation to the exemption is not treated as a dividend, and the deemed dividend rules in Division 7A ITAA 1936 are not applied (section 152-310 and subsections 152-325(9) – (11)).

Where a company has made a capital gain that qualifies for the 50% active asset reduction, and this amount is distributed whilst the company is a going concern, if an entity had sufficient franking credits, this amount may be paid as a franked dividend however ‘top-up’ tax may apply in the hands of the shareholder. If the 50% active asset reduction amount is distributed upon liquidation of the company, the amount would not be taken to be a dividend (TD 2001/4), however the liquidation of the company would give rise to CGT event C2 (if the company was dissolved within 18 months of the payment) or CGT event G1 (where the company was dissolved after 18 months of the payment).

Where the shares in the company are pre-CGT, any capital gain resulting from CGT event C2 or G1 would be disregarded.

Where the shares in the company are post-CGT, the shareholder may have access to the 50% general discount (if held for more than 12 months) and may also apply the small business CGT concessions provided the shares are active assets and the other basic conditions contained in Division 152-A are met.

11.3 Unit trusts

Where a unit trust makes a capital gain that qualifies for the small business concessions, care must be taken to ensure that taxpayers may access the capital proceeds without incurring further income tax. Due to the application of CGT event E4 and C2, a taxpayer may be better off choosing not to apply the 50% active asset concessions if other concessions are available.

Where a unit trust has made a capital gain that qualifies for the CGT 15-year exemption, the exempt amount may be distributed (‘flow through’) to an individual who is a concession stakeholder without further tax implications, provided the amount is paid within two years (section 152-125).

Where a unit trust has made a capital gain that qualifies for the retirement exemption, the payment made in relation to the exemption is also not treated as a taxable distribution, and there are no adverse additional tax consequences.
However, as discussed previously, where a unit trust has made a capital gain that qualifies for discount or reduction (e.g. 50% active asset reduction, 50% general discount), either CGT event E4 or C2 will apply.

CGT event E4 will apply where a trustee of a unit trust makes a payment to unit holder, and some or all of that payment is not included in the taxpayer’s assessable income (section 104-70(1)). The non-assessable amount will reduce the cost base of the unit. If the non-assessable amount is greater than the cost base of the unit, the excess will result in a capital gain (section 104-70(4)). CGT event E4 cannot give rise to a capital loss (section 104-70(5)).

CGT event C2 will apply on the subsequent wind up of the unit trust. CGT event C2 applies where a unit in a unit trust has been redeemed or cancelled, released, discharged or satisfied (section 104-25). If CGT event C2 were to apply, and the unit was post-CGT, a capital gain would arise where the capital proceeds from the surrender (or similar ending) were more than the unit’s cost base (section 104-25(3)). For the purposes of CGT even C2, the discount or reduction amount (as a result of the application of the small business CGT concessions) would form part of the capital proceeds on the cancellation of the units to the extent that they had not previously been distributed by the company.

Both CGT event C2 and E4 may qualify for the 50% general discount and the small business CGT concessions provided the units have been held for more than 12 months, are active assets, and the other basic conditions contained in Division 152-A are met.
### 11.4 Summary of considerations

<table>
<thead>
<tr>
<th>Entity Type</th>
<th>15-year exemption</th>
<th>50% active asset reduction</th>
<th>Retirement exemption</th>
<th>Roll-over exemption</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>General / Individual</td>
<td>If this concession applies, no further concessions may be accessed</td>
<td>Consider whether you choose this concession or not.</td>
<td>Consider use of roll-over concession before retirement exemption for potential deferral benefit.</td>
<td>Consider potential CGT events J5, J6 and J2 should appropriate replacement asset not be found.</td>
<td>Consider whether 50% CGT discount applies. Consider ownership structure – ensure identify all controlled entities and affiliates</td>
</tr>
<tr>
<td></td>
<td>Requirement for payment to be ‘in connection with retirement’</td>
<td></td>
<td>No specific requirement for retirement.</td>
<td>Consider retirement cap ($500K) and contribution dates</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Consider CGT cap amount ($1.205m 2011/12)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Company</strong></td>
<td>Can act as tax effective manner to distribute pre-CGT profits. Can be distributed to CGT concession stakeholders for up to two years without any adverse tax result Distribution of reduction amount is likely to be treated as an assessable (unfranked) dividend for post-CGT companies. Amounts paid in relation to the retirement exemption are not deductible</td>
<td>Consider potential CGT events J5, J6 and J2 should appropriate replacement asset not be found. 50% CGT general discount does not apply</td>
<td>Consider if shares/units pre or post CGT</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Discretionary trust</strong></td>
<td>Can be distributed to CGT concession stakeholders for up to two years without any adverse tax result Legislation provides for ‘flow through’ treatment. CGT event E4 does not apply Amounts paid in relation to the retirement exemption are not deductible</td>
<td>Consider potential CGT events J5, J6 and J2 should appropriate replacement asset not be found.</td>
<td>Consider whether 50% CGT general discount applies</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Unit trust</strong></td>
<td>Can be distributed to CGT concession stakeholders for up to two years without any adverse tax result Distribution of reduction amount is likely to trigger CGT event E4 or have C2 implications Amounts paid in relation to retirement exemption are not deductible</td>
<td>Consider potential CGT events J5, J6 and J2 should appropriate replacement asset not be found.</td>
<td>Consider whether 50% CGT general discount applies</td>
<td></td>
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</tbody>
</table>