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Plenary 4: Making sense of the menu of small business CGT concessions

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1 Introduction

The theme of the TTI Noosa conference in 2018 is "Mixing it right from the start to the finish - your client's journey to sizzling success". The focus of the event is on your client's growth journey, ensuring that you have the right ingredients from the start, have the ability to capitalise on the recipe and grow it once the recipe is just right. But what if you don't have the right ingredients from the start to achieve what you set out to achieve? What if you have managed phenomenal growth and now you want to exit the business without giving away the value to the taxman.

As advisers, you may be regularly called upon to review a client's business structure to ensure that it is meeting the needs of the various stakeholders. Alternatively, a client has an eye on the exit strategy and is looking for ways to mitigate the tax impost on sale. Whether looking to restructure or considering an exit, you will be called upon to evaluate and mitigate the tax cost of the transaction. There is a smorgasbord of tax concessions available to small business owners, which can provide full or partial relief from taxation on a capital gain arising from the disposal of assets related to their business.

Some provisions provide relief for all businesses, other provisions are specifically targeted to small businesses. It is unfortunate that the rules relating to "the smaller end of town" appear disproportionately complex in determining eligibility for those concessions. This complexity has been exacerbated with the introduction of further integrity measures, in relation to CGT events involving the disposal of shares in a company or interests in a trust, to ensure that the concessions are only accessed in relation to assets used in a small business or ownership interests in a small business.

Advisers need to be on top of their game to ensure you correctly determine eligibility for these tax concessions. Failure to identify eligibility for tax relief will erode the value your client has built up in their business. Conversely, incorrectly applying tax concessions when the client is ineligible, or inadequate planning for the potential application of these concessions, can be equally catastrophic for the client and potentially expose the adviser to costly PI insurance claims.

All references in this paper are to the Income Tax Assessment Act 1997 unless otherwise stated.

2 Factors to consider when restructuring

There are a number of factors that should be taken into consideration when advising a client if they are currently operating in an appropriate structure or whether it would be advantageous to change. Whilst you may start a business journey with a well thought out plan, a client's needs can and do change over the lifecycle of the business and therefore there are times when a restructure is desirable, if not essential, to address the current circumstances.

2.1 Selecting the right operating structure

There is no one-size-fits-all approach to selecting the most appropriate structure to operate a business or to hold assets to be used in the business. Whether it is preferable to operate as a sole trader, or through a partnership, trust or corporate entity, the process will inevitably require a systematic analysis of your client's needs, both now and projected into the future. Clients' needs can be dynamic and change over time, with many of the considerations appearing at odds with one another. Issues to be considered include:

a. Do you have sole ownership, ownership with others or contemplating investors in the future?
b. Taxation Benefits – tax rates, access to concessions including R&D and the small business CGT concessions
c. Taxation Costs – tax cost to owner on accessing income and capital profits, Div 7A
d. Simplicity and Flexibility
e. Does your industry have special requirements or do you operate in another jurisdiction?
f. Protecting valuable assets of the business from risk
g. Providing asset protection for the business owner
h. Will a future buyer be willing to purchase an interest in the business or the business assets?

2.2 Is a restructure appropriate?

Even the best laid plan from the outset may need to be changed in light of the current or future circumstances. Similar to the process you undertook to select the original structure, whether to restructure will also involve an analysis of a range of factors that can also be at odds with each other, including a review of the following:

a. Is the client contemplating a sale to a third party – in what time frame?
b. Is the restructure part of a succession plan to the next generation?
c. Do you wish to split trading activities or separate trading activities from other passively held assets?
d. Are you looking to incentivise key personnel for either retention and/or part of an exit strategy?
e. Does it impact on estate planning considerations?
f. Are the assets of the business and the assets of the owner/s greater protected from risk?
g. What is the tax cost of the restructure – including income tax, GST or duty on asset transfer?
h. Other commercial factors – including external financiers, professional & business registrations, landlords, industrial relations, etc.

The ultimate decision to proceed with the restructure will be when the benefits sought outweigh the costs and risk, which is often made more palatable if you are able to mitigate the tax cost of the transaction.

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3 Restructuring using other CGT rollover provisions

Business restructuring will inevitability involve a CGT event – a change in the beneficial ownership of an asset from one taxpayer to another. The change may be in the ownership of a single business asset, multiple business assets or an ownership interest in the entity operating the business or connected with the business entity.

There are a number of CGT rollover provisions, including those specifically targeting small business, which operate to either defer or disregard part of all of the capital gain or loss from a CGT event until another CGT event happens in relation to those assets. Before launching into a review of the concessions specifically targeting small business, it is useful to recap on the rollovers that are available for all entities, regardless of size. In summary, there are two types or groups of rollovers, being replacement asset and same asset rollovers.

3.1 Replacement asset rollovers

Replacement asset rollovers involve a CGT event happening in relation to an asset which you no longer own after the rollover event. Instead, you own a different or replacement asset at the conclusion of the transaction. The consequences of the choosing to apply to a replacement asset rollover provision are as follows:

a. Any capital gain or loss arising from the CGT event is disregarded at the time of the replacement
b. The gain or loss is deferred until such time as another CGT event happens to the replacement asset
c. The CGT characteristics of the original asset are transferred to the replacement asset
d. The CGT liability on the original asset remains with the taxpayer, even though they now own a different asset.

Examples of relevant replacement asset rollovers include:

Legislative reference	Details
Subdiv 122A	you, as an individual, trustee, or a partner in a partnership, dispose of assets to a wholly owned company and assume assets in the company such as shares
Subdiv 122B	a partner in a partnership, disposes of assets to a wholly owned company and assumes assets in the company such as shares
Subdiv 124-E	your shares or units are exchanged for shares or units in the same company or trust
Subdiv 124-F	your rights or options to acquire shares or units in a company or unit trust are exchanged for shares or units in the company or trust
Subdiv 124-M	your shares or units are exchanged for other shares or units
Subdiv 124N	Trust disposes of all its assets to a company and those assets are replaced by shares in the company
Div 615	your shares in one company are exchanged for shares in an interposed company

3.2 Same asset rollovers

The less applicable same asset rollover involves a CGT event happing in relation to an asset which moves from one taxpayer (transferor) to another (transferee), with the rolled over attributes attaching to the asset in the hands of the transferee. The consequences of the choosing to apply to the same asset rollover provision are as follows:

a. Any capital gain or loss arising from the CGT event is disregarded in the hands of the transferor taxpayer
b. The gain or loss on a subsequent CGT event happening to the asset is only relevant for the transferee
c. The CGT characteristics of the rolled over asset are transferred from the transferor to the transferee
d. The CGT liability is therefore effectively transferred from the transferor to the transferee, as the liability is attached to the asset subject to the rollover.

Examples of relevant same asset rollovers include:

Legislative reference	Details
Subdiv 126-A	Transfer of assets from an individual or a company or trust to a spouse or former spouse of an individual under a marriage or relationship breakdown
Subdiv 126-G	Transfer of assets between certain trusts

The above rollovers will assist in deferring the taxation cost in a number of common restructuring scenarios. Whilst each provision has its own requirements to qualify for relief, with some being more prescriptive than others, the objective is still similar – to maintain the key taxation characteristics between the transferor and the transferee and to defer the taxing point until the CGT asset is eventually disposed of.

The final category of relief for restructuring available to all entities is the demerger provisions contained in Division 125, which provide relief if a CGT event happens in relation to your interests in a company or trust because of a demerger of an entity from the group. No CGT event happens to your interest in the company or trust and there are cost base adjustments if you receive new interests under the demerger.

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4 Utilising Small Business CGT Concessions – Div 152

In addition to the range of same and replacement asset rollover provisions available to all businesses regardless of size, there are two Divisions that specifically target small businesses to provide CGT concessions. The first is Division 152 which provides for a reduction of all or part of the realised capital gain or the deferral of some or all the gain if a replacement asset is acquired, or an existing asset is improved within the prescribed time (i.e. the replacement asset period). Alternatively, there is also the Small Business Restructure Rollover (SBRR) in Subdivision 328-G which applies to defer capital gains or losses arising on the transfer of business assets from one entity to another. Importantly, SBRR applies to business with an annual turnover of $50M, whereby Div 152 targets turnover of only $2M.

Division 152 provides four CGT concessions for capital gains that arise from the disposal of a CGT asset used in the carrying on of a business by eligible taxpayers, provided certain conditions are met. These provisions do not apply if a capital loss is made, nor do they apply to depreciable assets or trading stock.

4.1 Basic Conditions

There are 4 basic conditions — set out in section 152-10 — which are required to be satisfied for a taxpayer to reduce or disregard a capital gain under this Division. Additional basic conditions apply if the relevant CGT asset is a share in a company or an interest in a trust or the CGT asset is held by an interposed entity.

1. A CGT event happens in relation to a CGT asset of yours in an income year
2. The CGT event would (apart from Div 152) have resulted in a gain
3. At least one of the following applies:
    i. you are a CGT small business entity for the income year;
    ii. you satisfy the maximum net asset value (MNAV) test;
    iii. you are a partner in a partnership that is a CGT small business entity for the income year and the CGT is an interest in an asset of the partnership; or
    iv. the conditions in s.152-10(1A) or (1B) are satisfied in relation to the CGT asset.
4. The CGT asset satisfies the active test.

4.2 Modifications if the CGT asset is a Share or Unit

On Federal Budget night, 9 May 2017, the government announced an integrity measure to ensure that the small business CGT concessions are appropriately targeted. In particular, *“the Government will amend the small business CGT concessions to ensure that the concessions can only be accessed in relation to assets used in a small business or ownership interests in a small business.”*

Exposure draft legislation was released on 8 February 2018, and the *Treasury Laws Amendment (Tax Integrity and Other Measures)* 2018 was introduced into Parliament on 28 March 2018. The Bill was passed by the

Senate on 20 September 2018, with the rules now applying to all CGT events incurred on or after 8 February 2018.
The target taxpayers were identified as those accessing the concessions for assets which were unrelated to their small businesses, with access being gained through arranging their affairs so that their ownership interests in larger businesses did not count towards the tests for determining eligibility for the concessions.

The law has been modified to repeal and replace existing section 150-10(2) which previously contained two additional basic conditions required if the CGT asset being sold is a share in a company or an interest in a trust to **add 3 new conditions**.

4.2.1 Comparison of key features of the Old and New Law

New law	*Current law*
To be eligible to apply the CGT small business concessions, a taxpayer must satisfy the basic conditions set out in subsection 152-10(1) in relation to the capital gain. Additional basic conditions apply for capital gains relating to shares in a company or interests in a trust. These are: • either: – the taxpayer must be a CGT concession stakeholder in the object entity; or – broadly, entities that are CGT concession stakeholders in the object entity must have small business participation percentages totalling at least 90 per cent in the taxpayer; • **unless the taxpayer satisfies the maximum net asset value test, the taxpayer must have carried on a business just prior to the CGT event;** • **the object entity must be a CGT small business entity for the income year or satisfy the maximum net asset value test; and** • **the shares or interests in the object entity must satisfy a modified active asset test that looks through shares in companies and interests in trusts to the activities and assets of the underlying entities.**	To be eligible to apply the CGT small business concessions, a taxpayer must satisfy the basic conditions set out in subsection 152-10(1) in relation to the capital gain. Additional basic conditions apply for capital gains relating to shares in a company or interests in a trust: - the taxpayer must be a CGT concession stakeholder in the object entity or, - broadly, entities that are CGT concession stakeholders in the object entity must have small business participation percentages totalling at least 90 per cent in the taxpayer.

Note: there is no change to the existing requirement that the taxpayer must be a CGT concession stakeholder in the object entity; or that entities that are CGT concession stakeholders in the object entity must have small business participation percentages totalling at least 90 per cent in the taxpayer.

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For completeness, section 152-60 defines a CGT concession stakeholder at a time to be an individual who is either a significant individual in the company or trust, or a spouse of a significant individual with a small business participation percentage in the company or trust of greater than zero.

A *significant individual* in section 152-55 is an individual with a *small business participation percentage* in the company or trust of at least 20%. The small business participation percentage in section 152-65 is a reference to an entitlement to an entity's income, capital distributions and voting power as relevant to the applicable structure being tested, or indirectly through the sum of any intermediaries.

4.2.2 Additional conditions if the CGT asset is a Share or Unit

Three additional conditions have been added to section 152-10(2), namely:

1. the taxpayer (the share or unit holding entity) is required to either satisfy the $6M MNAV test in section 152-15 or they are carrying on a business **just before** the CGT event;

2. the object entity (that is, the entity in which its ownership interest is subject to the CGT event) would either be a CGT small business entity for the income year or satisfy the $6M MNAV test, if it is assumed that the only CGT assets or annual turnovers considered were those of:
    a. the object entity;
    b. each affiliate of the object entity; and
    c. each entity controlled by the object entity, in a way described by section 328-125, but with a reference to a 20% interest instead of 40% and disregarding any determination in force under subsection 328-125(6) *(over 40% but less than 50% ownership)*;

3. additional testing of the CGT assets held by the object entity, to ensure that the share or unit subject to the gain still satisfies the active asset test, if the assumptions in new subsection 152-10(2A) were made.

4.2.3 What is the additional modified active asset test?

The additional testing to ensure that the share in the company or interest in the trust being disposed of is still considered to be an active asset is by far the most difficult to interpret of the February 2018 changes.

There is no change to the wording of section 152-40(3) regarding when shares or units can be active:

A CGT asset is also an active asset at a given time if, at that time, you own it and:

a) it is either a share in a company that is an Australian resident at that time or an interest in a trust that is a resident trust for CGT purposes for the income year in which that time occurs; and

b) the total of:

  i) the market values of the active assets of the company or trust; and

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ii) **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**

iii) **any cash of the company or trust that is inherently connected with such a business;**

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

The new section 152-10(2) seeks to modify what assets of the company or trust are eligible to count towards the 80% or more threshold test in section 152-40(3).

To now satisfy the active asset test — for the lesser of seven and a half years (if held for 15 years or more) or at least half the period a taxpayer has held the share or interest — at least 80% of the sum of the:

1. total market value of the assets of the object entity (disregarding any shares in companies or interests in trusts); and
2. total market value of the assets of any entity (**a later entity**) in which the object entity had a small business participation percentage of greater than zero, multiplied by that percentage

must have related to assets that are:

- active assets; or
- cash or financial instruments that are inherently connected with a business carried on by the object entity or a later entity.

However, cash or financial instruments that were acquired for a purpose that included satisfying this modified active asset test will not be included as an asset counting towards the 80% threshold in either subsection 152-40(3)(b)(ii) or (iii).

Shares held by the object entity in a later entity

If the asset held by the object entity is a share or a unit in another entity (“later entity”), then what is included for the purposes of active asset testing in section 152-40(3)(b) is the market value of the assets held by a later entity multiplied by the object entity’s small business participation percentage in the later entity at the test time, rather than the share or unit itself. Thus, a look-through approach will be adopted by the object entity in relation to interests held in later entities when seeking to satisfy the active asset test.

Further, assets of the later entity will only be counted as an asset covered by section 152-40(3)(b) if the provisions of new section 152-10(2B) are satisfied. This subsection provides that assets in a later entity will only be covered if either the later entity was:

i. a CGT small business entity; or

ii. satisfies the $6M MNAV test in relation to the capital gain; and

one in which the taxpayer has a small business participation percentage of at least 20 per cent or is a CGT concession stakeholder at the relevant time.

In determining if a later entity is either a CGT small business entity or satisfies the MNAV test at a time, it is assumed that the only CGT assets or annual turnovers considered where those of:

i. the later entity;

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ii. each affiliate of the later entity; and

iii. each entity controlled by the later entity, in a way described by section 328-125, but with a reference to a 20% interest instead of 40% and disregarding any determination in force under subsection 328-125(6) *(over 40% but less than 50% ownership)*.

4.2.4 So, what is now caught?

There are a number of situations whereby taxpayers may lose access to the small business concessions on the sale of shares or units in an object entity for CGT events post 8 February 2018. The reasons for the loss of the concessions may include:-

a. The taxpayer wanting to satisfy the SBE definition, but commenced business operations after the CGT event (*pre-8 Feb 2018 business commencement only required by 30 June of the relevant year*);

b. The taxpayer holds shares or units in an object entity that does not satisfy the modified definition of SBE or the $6M MNAV test – including entities they have a 20% or more interest in *(not required pre-8 Feb 2018)*;

c. Some assets held by the object entity are no longer assets in to be included in the numerator of the 80% active asset definition *(assets in the numerator changed from 8 Feb 2018)*. For example:

    i. cash or financial instruments acquired for the purpose including passing the 80% test;

    ii. investments held in a later entity disregarded and replaced with each asset of the later entity at the object entity's ownership %

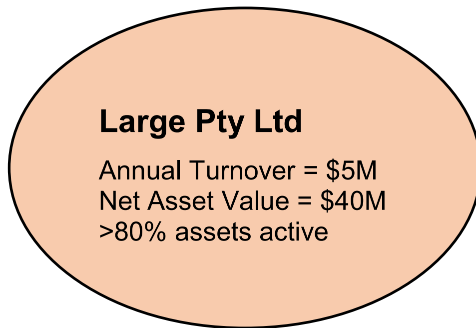
    iii. previously the object entity treated an investment in a later entity as active if 80% or more of the later entity's assets were active – thus up to 20% of the later entity's assets could be passive but still active for the object entity's 80% test. By including a portion of all the later entity's assets in the object entity's numerator, the test has effectively lost this buffer, making the active asset test harder to pass;

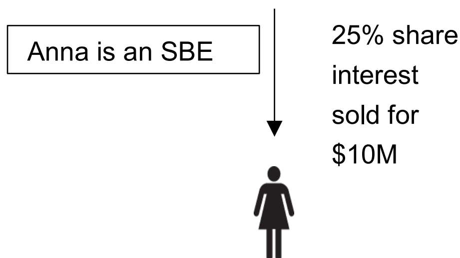
    iv. For the later entity's assets to be considered active at all in the object entity's 80% test, the taxpayer (shareholder of the object entity) must have a 20% or more interest (indirectly) in the later entity.

1. **An SBE taxpayer selling shares in a Company or Trust with 20% or more interest, irrespective of the size of the turnover or net value of assets of the business entity.**

   Example: Anna sells her 25% interest in Large Pty Ltd for $10M on the 9 February 2017, which had an annual turnover of $5M and Net Assets of $40M, with more than 80% of the company assets considered active. On the advice of her accountant, Anna purchases a milk bar, and commenced trade in her name from 1 June 2017. Can Anna claim the small business CGT concessions on the

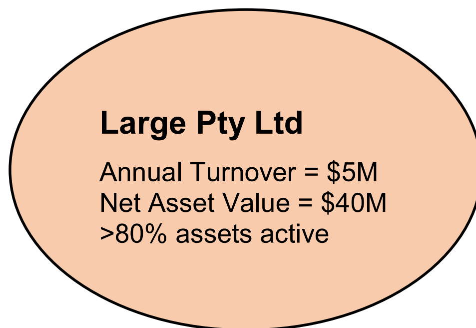
sale of her shares in Large Pty Ltd? Does the answer change if the sale took place on the 9 February 2018 and she commenced operating her milk bar on 1 June 2018?

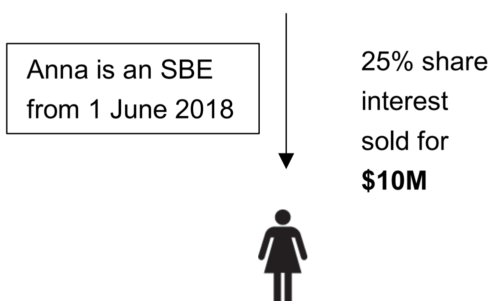




CGT event – 9 February 2017
SBCGT concessions are available

a. Anna is a CGT concession stakeholder of Large, with a 20% or greater interest in the Company;
b. Anna is a CGT Small Business Entity as at 30 June 2017;
c. Anna is not required to pass the $6M MNAV test;
d. Anna is not connected to Large (owning less than 40% interest) and therefore is not required to aggregate turnover or net asset values);
e. Anna's shares in Large are considered active – 80% or more of Large's assets are active;





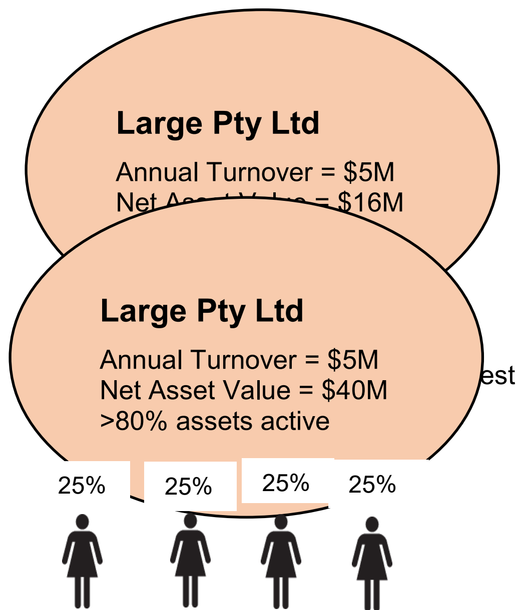
CGT event – 9 February 2018
SBCGT concessions are NOT available

a. Anna is a CGT concession stakeholder of Large, with a 20% or greater interest in the Company;
b. Anna is not a CGT Small Business Entity just before the CGT event, therefore must pass the MNAV test;
c. **Anna's net asset value is $10M and therefore cannot access the small business CGT concessions;**
d. In addition, the new rules also require Large to satisfy either the modified CGTSBE or MNAV test (aggregate entities with 20% or more ownership). **Large cannot satisfy either the CGTSBE definition ($>$2M turnover) or the $6M MNAV test.**

2. **Three or more taxpayers owning at least a 20% but not more than a 40% interest in a company or trust conducting a business but only required to include their own share value in the MNAV test.**

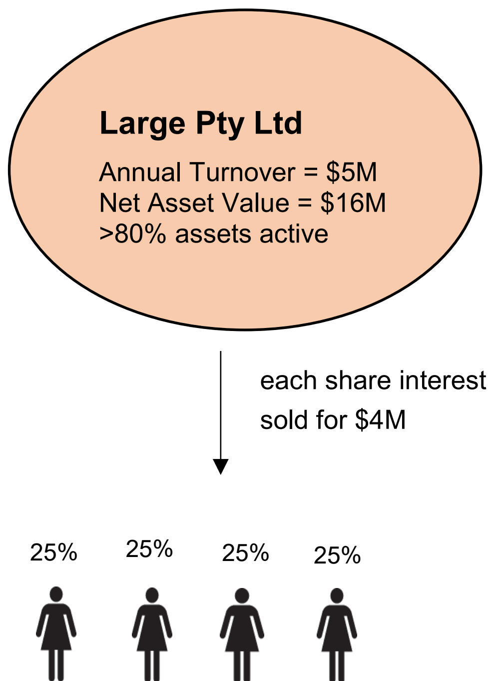
Example: Four unrelated taxpayers sell their 25% interest in Large Pty Ltd for $4M each on the 9 February 2017, which had an annual turnover of $5M and Net Assets of $16M. No shareholders

conducted a business and no shareholder had in excess of $2M in other CGT assets. Can each shareholder claim the small business CGT concessions on share sale gain? What if the sale takes place on the 9 February 2018?



CGT event – 9 February 2017
SBCGT concessions are available

a. Each shareholder is a CGT concession stakeholder of Large, with a 20% or more interest in the Company and are required to satisfy either the CGT SBE definition or the $6M MNAV test;
b. As each shareholder is not connected to Large (owning less than 40% interest), therefore are not required to aggregate turnover or net asset values with Large – each shareholder only includes $4M in their MNAV test – MNAV test pass;
c. the shareholder's shares in Large are considered active – 80% or more of Large's assets are active;

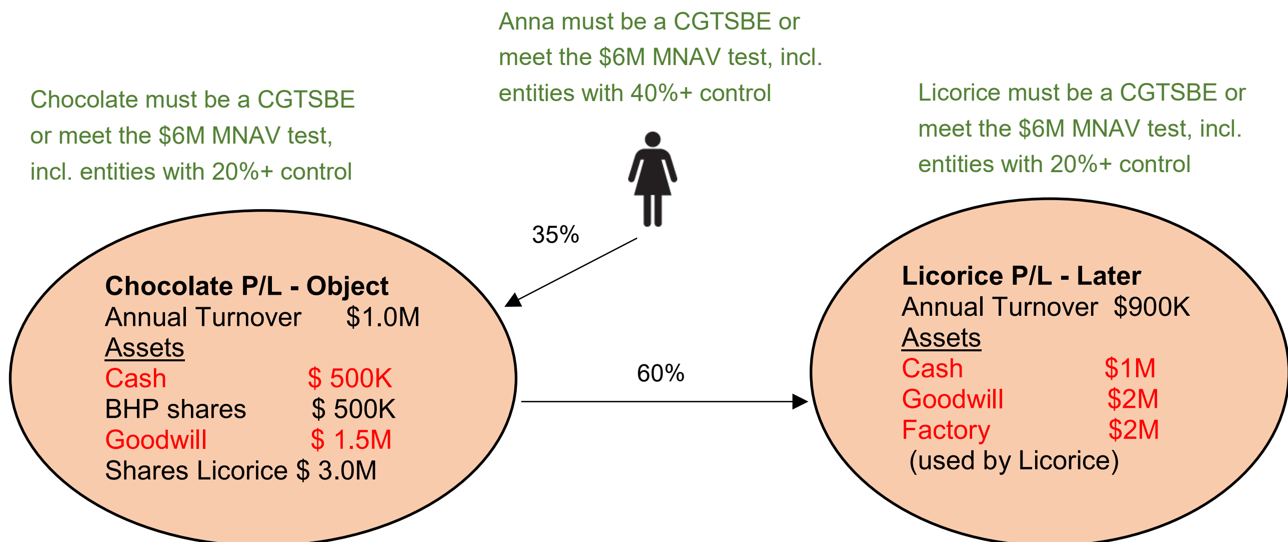


CGT event – 9 February 2018
SBCGT concessions are NOT available

a. Each shareholder is a CGT concession stakeholder of Large, with a 20% or more interest in the Company and are required to satisfy either the CGTSBE definition or the $6M MNAV test;
b. As each shareholder is not connected to Large (owning less than 40% interest), therefore are not required to aggregate turnover or net asset values with Large – each shareholder only includes $4M in their MNAV test – MNAV test pass;
c. the shareholder's shares in Large are considered active – assume 80% or more of Large's assets are active (may be modified if Large holds shares in other entities);
d. Large is required to satisfy either the modified CGTSBE or MNAV test (aggregate entities with 20% or more ownership). Large Pty Ltd cannot satisfy either the CGTSBE definition ($>$2M turnover) or the $6M MNAV test.

4.2.5 Detailed Example – Sale of shares in Object Entity, with Later Entity investments

Can Anna access the Small Business Concessions on the sale of her only CGT assets, being shares in Chocolate Pty Ltd for $2.75M? (assume the shares have a cost base of $250K)



Anna must satisfy the all the basic conditions in section 152-10(1) & (2) to access the small business concessions.

Section 152-10(1)

a) CGT event A1 has happened on sale of the shares in Chocolate - YES

b) Anna has made a capital gain on the sale of the shares – YES

c) At least one of the following applies:-

   i) Is Anna a small business entity? - NO

   ii) Does Anna satisfy the $6M MNAV test – not connected to Chocolate - <40% interest - YES (shares in Chocolate = $1.925M)

d) do the shares in Chocolate satisfy the active asset test s. 152-35? - YES

Section 152-10(2)

a) the shares in Chocolate would still satisfy the active asset test in s.152-35 if the assumptions in s.152-10(2A) were made?

   Therefore, the shares held by Anna in Chocolate will be an active asset under section 152-40(3)(b) if the market value of the active assets in Chocolate, including financial instruments and cash inherently connected with the business, are 80% or more of the market value of assets of Chocolate ("80% test")

   The market value of the assets of Chocolate that count towards this 80% test include:

   i) Chocolate's (inherently connected) cash – provided it was not acquired for a purpose including satisfying the 80% test - $500K

   ii) Chocolate's goodwill – an active asset inherently connected with Chocolate's business - $1.5M

   iii) Licorice shares – these shares are considered shares held by Chocolate in a later entity and therefore the value of the Licorice share is disregard for the 80% test and replaced with the market value of the active assets held by Licorice multiplied by Chocolate's small business participation percentage of 60%, Cash $600K, Goodwill $1.2M & Factory $1.2M

   Licorice's assets will only be considered active in the 80% test if the following are satisfied:

a. Anna must have a small business participation percentage (SBPP) in Licorice of at least 20% or she is a CGT concession stakeholder of Licorice – YES, Anna has a SBPP of 2%1 in Licorice (35% of 60%); and

b. Licorice is either a CGT small business entity for the income year, including affiliates and connected entities with at least 20% control – YES, Licorice's annual turnover is less than $2M; or

c. Licorice would satisfy the MNAV test at the test time, including affiliates and connected entities with at least 20% control – YES, Licorice's MNAV is $5M

iv) BHP shares – these shares are considered shares held by Chocolate in a later entity. The investment in BHP does not satisfy a number of provisions for the asset to be covered by the 80% test including that Anna has a SBPP of less than 20% in BHP, and that BHP fails to meet the applicable CGT small business entity definition or satisfy the modified MNAV test.

Therefore, the sum of the market value of all of Chocolate's assets that are active, a financial instrument or cash for the purposes of section 152-40(3)(b) are ($500K+ $1.5M +$600K + $1.2M + $1.2M) = $5,000,000 out of the total market value of the assets in Chocolate of $5,500,000 (90%) – YES, shares in Chocolate are active assets!!

And finally, the other tests to be satisfied in section 152-10(2) are as follows:

b) As Anna met the MNAV test, she is not required to have carried on the business just prior to the CGT event - PASSED

c) The object entity, being Chocolate, is either a modified CGT small business entity or satisfies the modified MNAV test – Chocolate is a CGT small business entity with an aggregated turnover of $1.9M but does not satisfy the MNAV test with a combined net value of CGT assets of itself and its controlled entity Licorice (at least a 20% interest) of $10.5M - PASSED

d) Anna was required, just before the CGT event, to be a CGT concession stakeholder of Chocolate (the object entity) or CGT concession stakeholders in Chocolate together must hold at least 90% of the interests in the taxpayer – Anna is a CGT concession stakeholder of Chocolate (holds at least a 20% interest in Chocolate) - PASSED

Accordingly, Anna can access the small business CGT concessions on the sale of her shares in Chocolate Pty Ltd.

4.3 Tips & Traps in satisfying the Basic Conditions

To assess if you are a small business entity or if you satisfy the MNAV test or active asset test requires an in depth understanding not only of the taxpayer making the gain, but also who controls that taxpayer, either from an ownership or decision making perspective. Failure to identify the relevant connections can lead to a failure to aggregate turnover, asset values or ownership percentages that can lead an erroneous conclusion that the taxpayer has met the basic conditions and can apply the concessions to which the taxpayer may not be entitled.

4.3.1 Identifying Connected Entities

The concept of a small business entity was introduced in 2007 into Division 328, which outlines the meaning of a small business entity, what entities are taken to be *connected with* that entity and the meaning of an *affiliate*. Eligibility for being a considered a small business entity is focused on aggregating turnover of the business entity, its affiliates and connected entities, currently under $10M per annum. As it relates to the small business CGT concessions, section 152-10(1AAA) introduced a new term, a *CGT small business entity*, which is defined as both a small business entity and an entity that would be a small business entity if each reference in section 328-110 of the 1997 Act to $10M were a reference to $2M.

Section 328-15 (1) of the 1997 Act provides that:

(1) An entity is connected with another entity if:
   a) either entity controls the other entity in a way described in this section; or
   b) both entities are controlled in a way described in this section by the same third entity.

The concept of control, in situations other than a discretionary trust, can be summarised as an entity will control another entity if the first entity, its affiliates, or the first entity together with its affiliates have the right to at least 40% of income and a capital distributions from the other entity, or, if the other entity is a company, control at least 40% of the voting power.

Which entity controls a discretionary trust requires an examination of whether the trustee acts, or could reasonably be expected to act, in accordance an entity's directions or wishes. This a factual based analysis of who is making the decisions regarding the trust. In the case of *Gutteridge v FCT [2013] AATA 947*, it was found on the facts that whilst the trustee company of a trust sourcing child care centres was 100% owned by the daughter, it was in fact the father who made all the business decisions and therefore it was the father who controlled the trust. This meant that the trust could access the small business CGT concessions as the trust was taken not to be connected to another company which operated the child care centres – that company was 100% owned by the daughter - so both entities were not controlled by the same third entity.

An alternative control test for discretionary trusts is to look at the past four income years of trust income and capital distributions, deeming a beneficiary in receipt of at least 40% of the distributions to control the trust.

4.3.2 So, what is an Affiliate?

To correctly identify connected entities and potentially what assets can be considered active, you need a clear understanding of the concept of an affiliate, given the meaning in section 328-130.

(1) An individual or a company is an affiliate of yours if the individual or company acts, or could reasonably be expected to act, in accordance with your directions or wishes, or in concert with you, in relation to the affairs of the business of the individual or company.

Whilst this section appears logical and easy to apply to the concept of control, it can be very challenging to apply in a factual situation. Firstly, an affiliate can only be an individual or a company that is conducting a business. A person is not your affiliate merely because of the nature of a business relationship that the two parties share. Therefore, you are identifying an entity that causes an individual or company conducting a business to act in accordance with your directions or wishes or in concert with them.

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The ATO has published a view on their website that whether a person acts, or could reasonably be expected to act, in accordance with your directions or wishes, or in concert with you, is a question of fact dependent on all the circumstances of the particular case. Relevant factors include:

- the existence of a close family relationship between the parties
- the lack of any formal agreement or formal relationship between the parties dictating how the parties are to act in relation to each other
- the likelihood that the way the parties act, or could reasonably be expected to act, in relation to each other would be based on the relationship between the parties rather than on formal agreements or legal or fiduciary obligations
- the actions of the parties.

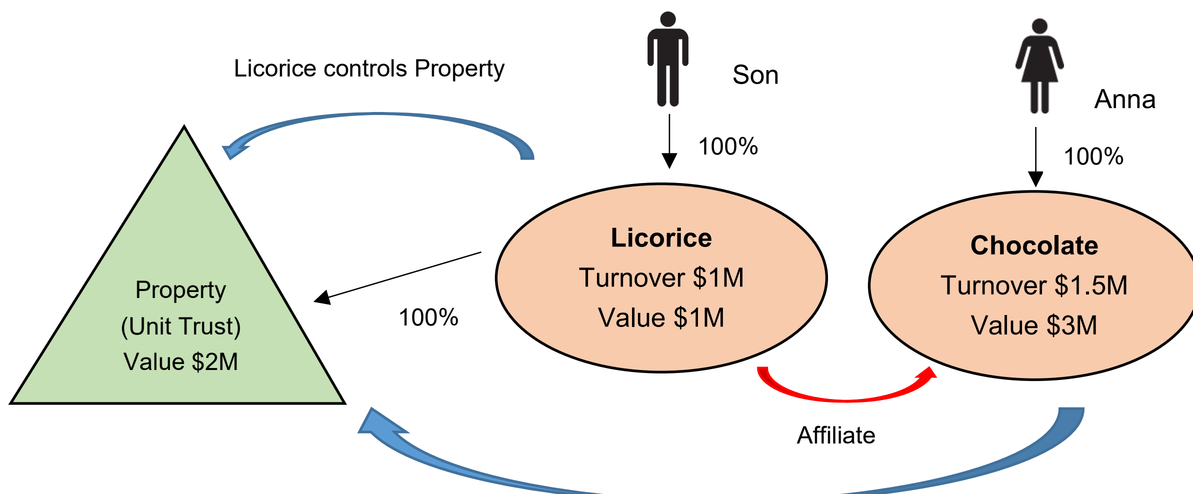
Generally, another business would not be acting in concert with you if they:

- have different employees
- have different business premises
- have separate bank accounts
- do not consult you on business matters
- conduct their business affairs independently in all regards.

But how does this definition apply when often you are testing for entities that are connected to the business entity that has made the gain, when the connection is established in most cases by you, your affiliates, or you together with your affiliates having the right to at least 40% of the voting, income and capital distributions in the other entity? The way to make sense of the principle is that both the "controlling" entity and the affiliate are both conducting business and thus these provisions ensure that you can't avoid connections merely because you have divested your business activities into entities with little or no common ownership.

<u>Let me explain by way of an example</u>

Anna operates the Chocolate manufacturing company and owns 100% of the shares, valued at $3M and an annual turnover of $1.5M. Anna's son owns 100% of the shares in a Licorice manufacturing company valued at $1M and an annual turnover of $1M. Both the Chocolate and the Licorice companies operate from a factory which is 100% owned by the Licorice Company valued at $2M. Chocolate is the dominant decision maker and controls both the strategic and day-to-day activities of its own and Licorice's business operations. Both Anna and her son own no other CGT assets. If Chocolate's business is sold, can Chocolate access the small business CGT concessions?



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Chocolate controls Property with its affiliate Licorice

From the facts, the following can be established:

1. Anna is connected to Chocolate as she owns interests in Chocolate that the carry the right to at least 40% of the distribution of income from the company (and voting power) s.328-125(2).

2. Anna's son is connected with Licorice as he owns interests in Licorice that carry the right to at least 40% of the distribution of income and capital from the company (and voting power). s.328-125(2)

3. Licorice is connected with Property as Licorice owns interests in Property that carry the right to at least 40% of the distribution of income and capital from the unit trust.

4. Licorice is an affiliate of Chocolate, as Licorice acts in accordance with the directions or wishes of Chocolate or in concert with Chocolate in relation to Licorice's business.

5. Chocolate will control Property if Chocolate, its affiliate Licorice or Chocolate together with Licorice own interests in Property that carry the right to at least 40% of the distribution of income and capital from the unit trust. Chocolate, through its affiliate Licorice, is also connected with Property.

So, what does this mean for Chocolate's ability to access the small business CGT concessions?

6. Is Chocolate a Small Business Entity?
    a. Is Chocolate's aggregated turnover under $2M? (s.328-115) – No $2.5M
        i. Chocolate's turnover - **$1.5M**
        ii. Entities connected to you – Property - **$Nil**
        iii. Affiliate's turnover – Licorice - **$1M**
    b. Does Chocolate pass the MNAV test under $6M? (s.152-15) – Yes $5M
        i. Chocolate's CGT assets - **$3M**
        ii. CGT assets of entities connected to you - Anna – $Nil
        iii. CGT assets of your affiliates or entities connected with your affiliates (excl. ii)
            - Licorice **- $Nil**
            - Property **- $2M** (refer c)
    c. Section 152-20(3) provides that in working out the net value of the CGT assets of your affiliate (Licorice) or entities connected to your affiliate (Property), only include those assets of Licorice or Property that are used, or held ready for use, in Chocolate's business. As Chocolate uses the factory owned by Property and no other assets owned by Licorice, only the value of the factory is included **- $2M**

7. If Licorice was a discretionary trust, the affiliate provision would not be needed, as it may be determined that Chocolate has direct control of Licorice on the basis that the trustee would act in accordance with Chocolate's directions or wishes – hence a direct connection under section 328-125(3). Property would then be connected with Chocolate through the indirect control provisions in section 328-125(7).

8. Would the outcome be different if Licorice was a Unit Trust?

In summary, the affiliate provision ensures that a business entity making a capital gain cannot access the small business CGT concessions by fragmenting their business operations into a number of entities that do not have the requisite common ownership to be connected, however each of the business activities are directed by a common person or entity. The connection, via an affiliate status, will always mean that the two operating businesses are still counted for the purpose of determining the aggregated turnover. However, for MNAV testing, you only need to count those CGT assets that are used, or held ready for use, in the business of the entity making the gain. In contrast, if the connection was by the requisite 40% or more ownership control, all of the CGT assets of the connected entity are counted. Further, you can disregard the assets of a business being conducted by a connected entity that is only connected with you because of your affiliate.

It is vital in interpreting the provisions that you clearly understand which entity is the taxpayer making the capital gain and then how they may be connected with other entities, either by themselves or by being linked with other entities if both the taxpayer and other entity is controlled by the same third entity. Nothing can be assumed in applying the *connected with* and the *affiliate* provisions, as the assessments undertaken are predominately factually based.

4.3.3 Maximum Net Value Asset Test (MNAV) Considerations

Section 152-15 of the 1997 Act sets out how a taxpayer satisfies the MNAV test, and provides that the sum of the net value of the CGT assets of the following entities must not exceed $6 million:

i. the entity that has the CGT event ("the taxpayer");
ii. entities connected with the taxpayer
iii. entities which are affiliates of the taxpayer
iv. entities connected with the affiliates of the taxpayer (with some exceptions)

reduced by liabilities that are related to the assets; and provisions for annual and long service leave, unearned income and tax liabilities (s.152-20).

When determining if you satisfy the $6M MNAV test, careful consideration should be given to the following:

a. Have you included all your CGT assets as defined in Section 108-5(1) of the 1997 Act, including any kind of property – depreciating assets, trading stock, bank accounts and cash, debtors and loans?
b. Have you disregarded interests in an entity that is connected with you or is your affiliate but included the related liabilities?
c. If you are an individual, have you excluded assets being used solely for their personal use and enjoyment, superannuation, life insurance policies and their main residence, unless it was used at some time to produce assessable income, in which case include a reasonable proportion of the market value having regard to the extent the interest was or would have been deductible?
d. Have you correctly identified all entities connected with you, including 100% of the value of their assets less the related liabilities – irrespective of your ownership percentage?
e. Have you excluded assets of an affiliate other than those used or held ready for use in your business or an entity that is connected with you (excluding business entities connected only because of your affiliate)?

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f. Have you correctly calculated the market value of the CGT assets **just before** the CGT event?
g. Have you only reduced the value of the CGT asset by a liability that is related with the asset or a named provision in Section 152-20 (1)(b). There remains some uncertainty regarding the interpretation of a liability that is “related to the asset”. Whilst the relationship nexus is quite clear if the liability arose to fund the acquisition of the asset, there other instances where the link is not so strong. For example, if a loan facility has been redrawn for payments to owner’s equity, is that still related to the current assets of the business? What if the asset was transferred out of the entity under a family law directive but the liability remained. Always check the nexus between the asset and the liability if you wish to reduce the value of the asset.
h. The Commissioner outlined his views in TR 2015/4 on how an unpaid present entitlement (UPE) of a beneficiary connected with a trust is treated for the purposes of working out whether the trust satisfies the maximum net asset value test in section 152-15. Where a connected beneficiary has a UPE to receive an amount of income or capital from a trust, the value of that UPE will be included once, and once only, in determining whether or not that trust satisfies the maximum net asset value test in section 152-15. The way in which the value of that UPE is so included will vary depending on the character of the beneficiary's entitlement and the way that funds representing the UPE are held.

   The ruling provides a table, summarising where the value of the UPE will be factored into calculating the net asset value of the trust (or main trust, where relevant) for each scenario that is outlined in the ruling.

		Part A: Sub-trust	Part B: No sub-trust	Part C: Absolutely entitled
Main trust	Assets	x	✓	x
	Liabilities	x	✓	x
Sub-trust	Assets	✓	N/A	(if any) x
	Liabilities	x	N/A	(if any) x
Connected beneficiary	Assets	x	✓	✓
	Liabilities	x	x	x

i. The timing of the liability can also be important. In the case of *FCT v Byrne Hotels Qld Pty Ltd* [2011] FCAFC 127, the Full Federal Court found that that expenditure on legal and accounting fees and real estate commission in relation to the sale of the asset could be included in the MNAV test assessment which is undertaken just before the CGT event, as it was found that the obligations were either existing legal or equitable obligations; or an obligation that was not “truly contingent” in the sense of being “uncertain as both a theoretical and a practical matter”.

4.3.4 An update on Market Value

There is no helpful statutory definition in the Act for what is the market value of an asset, save for the fact that section 260-405 requires the value to be reduced by any relevant GST input tax credits. We therefore need to refer to either case law or the regulator for additional guidance. The ATO has released a comprehensive

summary document which outlines their view of acceptable processes to undertake a market valuation for tax purposes – **QC 21245**. This guide contains details and links to other ATO products depending on the nature of the transaction or asset being valued. Importantly, the ATO guide indicates that you should assess market value on the basis of the "highest and best use" of the asset as recognised in the market.

In relation to guidance from case law, most would be familiar with Justice Griffith's statement on the ordinary meaning of market value in *Spencer v Commonwealth* (1907) 5 CLR 418 being *"the test of the value of land is to de determined, not by inquiring what price a man desiring to sell could actually have obtained for it on a given day, in fact, on the day a willing buyer, but by inquiring: What would a man desiring to buy the land have had to pay for it on that day to the vendor willing to sell it for a fair price but not desirous to sell?"*

This test was also adopted in *Abrahams v FC to T (1944) 70 CLR 23* where Williams J stated the market value was *"The process which a willing but not anxious vendor could reasonably expect to obtain and a hypothetical willing but not anxious purchaser could reasonably expect to pay … if the vendor and purchaser had got together and agreed on a price in friendly negotiation".*

Where both parties are knowledgeable, dealing at arms-length and not anxious to transact, the actual market should align with this hypothetical market, which should also align with the price agreed to be paid.

However, there may be instances where the price agreed to be paid may not align with the actual or hypothetical market as the price may include differences due to special circumstances unique to the purchaser (or vendor) or the pricing could be aggregated with other disposals. If the measurement for the MNAV test is the sum of the market value of the CGT asset just before the CGT event, is the figure for MNAV purposes always equal to the transacted price or not?

Syttadel Holdings

Syttadel Holdings Pty Ltd v FC of T [2011] AATA 589 involved the sale of a marina in 2006 for a contracted price of $8.9M. In late 2008, the vendors applied for an ATO ruling seeking a determination that, despite a sale price of $8.9M, the market value of the marina was actually in the range of $4M to $4.5M and therefore the taxpayer satisfied the MNAV test. The ATO disagreed and the matter was heard at the AAT in 2011. Although Hack DP was unpersuaded with the opinion of Syttadel's valuer that the market value of $4.5M was acceptable, he did conclude that the market value of the marina was at least $5.3M which was the opinion of the valuer commissioned by the ATO.

Whilst the value of $5.3M still exceeded the then MNAV limit of $5M, it nevertheless established there could be circumstances that market value and sale price must not necessarily always be the same, albeit one that the ATO considers not a general outcome and one that is decided on the facts – see the ATO's Decision Impact Statement following the *Syttadel* decision.

Miley

Miley v C of T AAT [2016] 73 concerned the sale of all 300 shares in AJM Environmental Services Pty Ltd under a sale agreement for $17.7M, or $5.9M for each of the three equal shareholders, including Andrew Miley's 100 shares. It was a condition of the agreement that the buyer would purchase all the shares held by the shareholders and was not obliged to buy the shares held by one of the shareholders to the exclusion of the other shares held by the shareholders.

The ATO assessed the market value of Miley's 100 shares just before the CGT event as $5.9M which, when added to Miley's other CGT assets of $120,000, exceeded his MNAV limit of $6M. Miley objected and successful appealed to the AAT in the first instance. The Commissioner's principal argument was that the most reliable evidence of the market value of the shares was the price that the unrelated buyer had in fact paid.

Miley referred to the High Court decision in *Pioneer Concrete (Vic) Pty Ltd* (2002) CLR 651, submitting that the market value is to be determined by reference to a hypothetical sale between willing but not anxious parties and this was not necessarily equal to the amount paid by the actual buyer. Although different to the expert valuations, the AAT accepted that the market value was $4,914,700, after applying a 16.7% discount for lack of control.

Frost DP, concluded *"that the consideration that Mr Miley received for his shares, which formed part of the consideration paid by the Buyer for all the shares in the Company, is more than a hypothetical willing but not anxious purchaser would have paid if it had purchased Mr Miley's shares alone — and that is the basis on which the market value of Mr Miley's shares should be determined. Therefore, while the actual consideration received by Mr Miley should not be ignored as an indicator of the market value of his shares just before the time of the CGT event (*Inez Investments*: [26] of these reasons), it is not determinative of that market value".*

The AAT concluded that the correct enquiry when determining the market value of the 100 share parcel was not to look at the "special circumstances" of this sale, which contemplated that the parcel was sold along with the balance of the shares on issue, but rather to determine the value of the shares alone and not part of the whole share package.

The AAT decision was subsequently overturned in the Federal Court in favor of the Commissioner – *C of T v Miley* [2017] FCA 1396 – with the substantive issue argued before the Court was whether a minority interest discount for lack of control should apply for the purposes of determining market value for the MNAV test.

The Federal Court found that the AAT misdirected itself in relation to *Pioneer Concrete* which caused it to ignore a relevant consideration, being the fact that just before the sale there was a 'not anxious' buyer in the market willing to paying $17.7M for all the shares in the Company and that Miley and his fellow shareholders were willing to sell at that price. Therefore, there were no special circumstances, as contemplated in *Pioneer Concrete*, but rather that was the reality of the market and no discount should be applied.

Miley established the following principles for determining market value:

- Confirmed the accepted definition of market value from *Abraham's case*, being … *a willing but not anxious vendor could reasonably expect to obtain and a hypothetical willing but not anxious purchaser could reasonably expect to pay*.
- If there is no ready market or no present, willing but not anxious buyer for the shares, then you will need to hypothesise that there is such a buyer and they got together with the seller and agreed on a price.
- If the current transaction was effectively akin to a recent sale at arm's length, there is nothing to suggest that both parties were not knowledgeable, willing but not anxious buyers and sellers and therefore the price agreed by arms-length negotiation should relevantly be the market value.
- If there is, or is likely to be, a particular buyer who is willing to pay more for the shares than other buyers for a particular reason, that buyer should not be excluded in considering the relevant market value, rather it may just be the realities of the market.

- It is not appropriate to apply a minority interest discount to a parcel of shares where the terms of the sale require all of the issued shares of the company to be sold contemporanously and the buyer is not required to buy the shares of one shareholder to the exclusion of others.

Hookey

In *Hookey v FC of T* [2018] AATA 1509, Rayment DP recently confirmed these principles whereby, "*the taxpayer has failed to establish that the contract price was not the market price of the learning centers. In order to do such a thing, it would have needed to lead evidence that the price paid by ABC was wholly erroneous, and affected by error. The prima facie effect of the negotiated price was to show that the market price was the amount agreed to be paid by ABC and the taxpayer has not in my opinion displaced that prima facie position, I am not satisfied that ABC paid other than the market value for the properties".*

4.3.5 Active Asset Considerations

To satisfy the fourth basic condition, you must ensure that the CGT asset, which is subject to the gain, satisfies the active asset test. Section 152-40 indicates that a CGT asset is an active asset if it is used in a business (or if intangible, inherently connected with a business) carried on by the taxpayer; an affiliate of the taxpayer or an entity connected with the taxpayer. The asset must be active for the time prescribed in section 152-35 – being 50% of the ownership period if held for 15 years or less, or at least 7½ years if held for more than 15 years.

When determining if an asset satisfies the active asset test, careful consideration should be given to the following:

a. Has the asset been used or held ready for use for the prescribed time – starting when the asset is acquired and ending at the time of the CGT event?

b. If the business ceases within 12 months before the CGT event, the time period for active asset testing ends on the date the business ceased. Cessation means either the sale of the business or when the business is terminated (not continuing by anyone) – see **TD 2006/64**.

c. Although a child or spouse is not automatically considered to be an affiliate merely because of the relationship, section 152-47 provides when an asset is held by an asset owner for use by another entity carrying on a business, which is not otherwise considered an affiliate of, or connected with the asset owner, the following are taken to be affiliates of an individual:
    i. a spouse of the individual; and
    ii. a child who is under 18 years of age.

  These individuals are then taken to be affiliates of the taxpayer for the purposes of the MNAV test and the small business entity test, turnover calculations and connection testing. The deeming provision applies

whether it is the spouse/child who is directly carrying on the business which uses the owner's CGT asset or carried on indirectly by the spouse/child through an affiliate of or entity connected with the spouse/child.

d. Exclude CGT assets that are excluded assets in section 152-40(4), including interests in entities connected with you (avoids double-counting), financial instruments, trust UPEs (TD 2006/78), or assets whose **main use** in the course of carrying on a business is to derive interest, an annuity, rent, royalties or foreign exchange gains, unless it is an intangible asset of substantial improved value because of development or its main use for deriving rent is temporary. As 'main use' and 'temporary' are not defined, they take their ordinary meaning.

   It does raise the question though, what is 'main use' – is it based on a pro-rata percentage of time or floor space and what is temporary - is this based on an annual period, the period of ownership or some other reference point? The Tribunal in *Tingari Village North Pty Ltd v C of T* [2010] AATA 233 found that the sale of a mobile home park was excluded as an active asset as the income derived from the mobile homes was leasing income. TD 2006/78 also outlines the ATO views on when providing accommodation amounts to the derivation of rent and is thus excluded from the definition of an active asset.

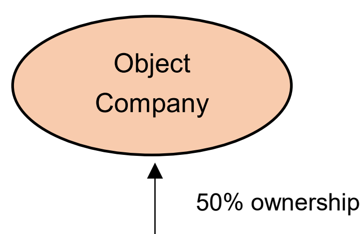
e. Adherence to the additional conditions set out in section 152-10(2) if the CGT asset being sold is a share in a company or an interest in a trust and you are testing if the interest is an active asset under section 152-40(3).

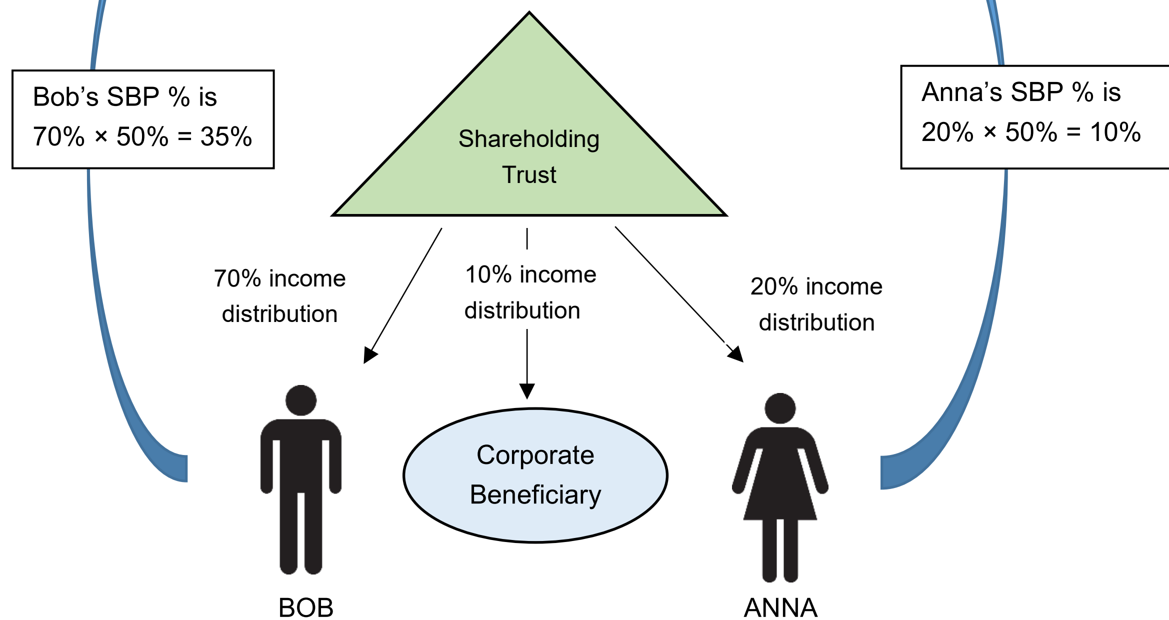
4.3.6 Disposing of a Company Share or Trust Unit

Additional care must always be taken if the taxpayer disposing of a share or unit subject to Division 152 is a discretionary trust. A trust can never be a CGT concessional stakeholder as it is not an individual. Therefore, it must satisfy the second limb of section 152-10(2), being that CGT concessional stakeholders in the object company or trust together have a small business participation percentage in the trust of at least 90%.

Practically, it is a requirement in the year of disposal that there are individual beneficiaries of the trust making the capital gain in receipt of combined minimum of 90% of both the income and capital of the trust and that those individual beneficiaries are also CGT concession stakeholders in the object company or trust.

Example





The shareholder trust will satisfy the requirements of section 152-10(2) on the sale of the shares in the object company as Bob is a CGT concession stakeholder of the object company with a small business participation percentage (SBP%) of 35% and Anna, his wife, is also a CGT concession stakeholder in the company with a SBP% of 10% (greater than zero). Finally, the CGT concession stakeholders together have a SBP% in the taxpayer making the capital gain of 90%.

Remember for a discretionary trust, the small business participation percentage is the lower of the income and the capital distributions made by the company in the income year in which the capital gain is made. There may be circumstances when you stream say the non-taxable portion of the capital gain to one beneficiary Bob to affect the streaming provisions but this will reduce Anna's small business participation percentage in this calculation to nil% thus disqualifying her as a CGT concession stakeholder and denying the trust access to the small business CGT concessions. You must remain vigil in the year of the gain when drafting trust nominations for both income and capital distributions to ensure this section is satisfied and the concessions can be applied.

5 The CGT Concessions – an overview

The relevant concessions available to defer or disregard a gain include:

1. The small business 15-year exemption – Subdivision 152-B

2. The small business 50% active asset reduction – Subdivision 152-C

3. The small business retirement exemption – Subdivision 152-D

4. The small business rollover – Subdivision 152-E

and in addition to the Division 152 provisions:

5. The 50% general discount for individuals and trusts – Division 115; and

6. The small business restructure rollover – Subdivision 328-G.

5.1 General CGT discount

Division 115 provides for a 50% discount for capital gains made by individual or trusts and a 33⅓% discount for capital gains made by superannuation funds, without regard to cost base indexation. The general discount is not available for companies acting in their capacity, as opposed to acting as a trustee of a trust. Non-residents are not entitled to the CGT discount.

To qualify for the discount, the asset must have been held by the taxpayer for a minimum period of twelve months which, which the ATO have indicated in TD 2002/10 does not effectively include the day of acquisition – that is the date following the anniversary date of the acquisition of the asset. Other special rules regarding the timing of the acquisition of assets for Div 115 purposes are contained in the table in section 115-30 and as a result of the asset being acquired under certain replacement asset rollovers – sections 115-32 and 115-34.

The percentage discount applied to foreign or temporary residents in modified by section 115-105 which effectives denies a discount to a period while you were a foreign or temporary resident after 8 May 2012.

Capital losses are always offset against capital gains prior to applying the general CGT discount. If the capital gain is made by a trust, it will flow through to the ultimate beneficiaries of the trust. Subdivision 115-C sets out the rules about trusts with net capital gains, so that the gain received by the beneficiary is multiplied by **2** (if the general discount has been applied by the trust) or multiplied by **4** (if both the general discount and the 50% small business reduction have been applied by the trust) prior to the application of the method statement in section 102-5 by the beneficiary. This allows the beneficiary to then offset their capital losses and reapply the discount or concessions if they are eligible.

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5.2 Small Business 50% Reduction

Subdivision 152-C contains a further small business 50% reduction to a capital gain, after an eligible general CGT discount has been applied.

This 50% reduction is available to all capital gains that satisfy the basic conditions in Subdivision 152-A, although you may choose not apply this reduction to a particular capital gain. For example, you may wish to not apply the 50% reduction to maximise the amount that is disregarded by the retirement exemption that allows part of all of the disregarded gain to be contributed to a complying superannuation fund.

The 15-year exemption has priority and therefore the 50% reduction does not apply as the gain has already been entirely disregarded.

Unlike the general CGT discount, the 50% reduction can be applied to all structures, including companies. However, returning the tax sheltered gain to shareholders is problematic. A distribution of the amount attributable to the 50% reduction would be deemed to be a dividend (potentially unfranked), unless the company is in liquidation when the reserve could be returned as capital to the shareholders. Similar difficulties will be experienced by a unit trust when distributing this non-assessed gain, with the distribution being caught under section 104-70 – CGT event E4 – which reduces the cost base of the units and can result in a taxable capital gain for the unitholder.

From a planning perspective, the use of a discretionary trust or a partnership of discretionary trusts can alleviate top-up tax being payable on the distribution of the 50% reduction amount.

5.3 Small Business 15-year Exemption

Subdivision 152-B allows a taxpayer to completely disregard a capital gain on the realisation of active assets held by the taxpayer for at least 15 years. If this Subdivision applies, there is no need for any further concessions to apply and your capital losses are not affected. For an eligible taxpayer, this concession is the nirvana of tax planning, with no limits placed on the size of the gain being disregarded unless you are looking to contribute to superannuation. Therefore, extreme care is required by advisers to understand the history of when the asset was acquired and how long the asset has been used in an eligible business. Failure to hold the asset for the required period, both a total of 15 years and used in an eligible business for a minimum of 7.5 years will deny the taxpayer access the 15-year exemption.

Individuals

If you are an individual, you can disregard any capital gain arising from a CGT event if you satisfy the basic conditions in Subdivision 152-A and you have continuously owned the CGT asset for the 15-year period ending before the CGT event.

If the relevant CGT asset is a share in a company or an interest in a trust, the company or trust must have had a significant individual for a total of at least 15 years during which it owned the asset. You will recall a significant individual under section 152-55 is an individual with a small business participation percentage of at least 20%. The period does not have to be continuous and it does not need to be the same individual, and there are modified rules for involuntary disposal of assets in section 152-115.

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Finally, it is a requirement that you are either 55 or over at the time of the CGT event and the event happens in connection with your retirement; or you are permanently incapacitated at the time of the CGT event. The ATO has indicated that "in connection with your retirement" does not mean a permanent or everlasting retirement from the workforce, but rather they would expect at least of significant reduction of hours or a significant change in the nature of the activities undertaken to be regarded as retirement.

Companies and Trusts

A company or trust can also disregard a capital gain from a CGT event if the entity satisfies the basic conditions in Subdivision 152-A, continuously owns the CGT asset for a 15-year period, had a significant individual for a total of at least 15 years (not necessarily continuous or the same individual) and, just before the CGT event had a significant individual who was either 55 or over and the event happened in connection with their retirement or they were permanently incapacitated at that time. Modification rules also apply for the 15-year testing period involving involuntary disposal cases, including assets lost or destroyed, marriage breakdown or a small business restructure under Subdivision 328-G, but this does not extend to replacement asset and same asset rollovers which, if utilised would result in a reset of the period the asset was held.

The ordinary or statutory income the company or trust derives from the CGT event is neither non-assessable nor exempt income: section 152-110(2). Special rules apply to payments by the company or trust to CGT concession stakeholders within 2 years of the CGT event (or later from earn-out rights) that represent the exempt amount (NANE income in section 152-110(2)), or an amount that would have been exempt but for the fact that the gain was in relation to a pre-CGT asset or a deemed pre-CGT asset under Subdivision 149-B. These payments, whether by way of dividend or a distribution, are disregarded in calculating the taxable income of the CGT concession stakeholder or any interposed entities to a maximum limit equal to the CGT concession stakeholder's participation percentage in the company or trust multiplied by the exempt amount.

Qualifying individuals wishing to make an additional contribution to superannuation can elect to contribute an amount of **proceeds** from the CGT event that qualifies for the 15-year exemption under the CGT cap amount (a lifetime limit currently $1.48M for 2018-19) and is in addition to the individual's other contribution cap limits.

5.4 Small Business Retirement Exemption

Subdivision 152-D contain a further exemption to disregard a capital gain from a CGT event happening to a CGT asset of yours up to a lifetime limit of $500,000 per individual. You may choose not to apply the small business 50% reduction if you wish to maximise the amount to which this Subdivision applies. Whilst the name may suggest that this exemption is in connection with retirement, unlike the 15-year exemption, there is no requirement in the Subdivision for anyone to retire to access the concession. It does however provide a mechanism to contribute an amount to superannuation outside of an individual's annual non-concessional contribution cap limit which can be beneficial.

The amount that the individual, company or trust chooses to disregard is referred to as the *CGT exempt amount*. The CGT exempt amount is so much of the gain that ensures that the relevant individual/s do not exceed their CGT retirement exemption limit of $500,000 (section 152-320). The CGT exempt amount must be stated in writing and, if there is more than one CGT concession stakeholder, the company or trust must specify the percentage of each CGT asset's CGT exempt amount that is attributed to each of those stakeholders.

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Individuals

An individual can choose to disregard all or part of a capital gain if they satisfy the basic conditions in Subdivision 152-A and, if you are under 55 just before making the choice, contribute an amount equal to the asset's CGT exempt amount to a complying superannuation or an RSA and that contribution is made within the prescribed time – generally the later of when you make your choice under section 103-25 (lodge your relevant income tax return) or when you receive the proceeds – which can be by instalments. An individual over 55 years can still contribute to superannuation up to the CGT exempt amount, which will be measured against their lifetime CGT cap amount, rather than their annual non-concessional contribution cap limits.

Companies and Trusts

A company or trust can also choose to disregard some or all of a gain if they satisfy the basic conditions in Subdivision 152-A, the entity satisfies the significant individual test in section 152-50 and the company or trust makes a payment to the CGT concession stakeholder under section 152-325.

The company or trust must make a payment to one or more CGT concession stakeholders, equal to the lesser of the relevant CGT exempt amount and either the amount disregarded under CGT event J2, J5 or J6; or capital proceeds received, within the later of 7 days of the making the choice or receiving the proceeds.

Payments made by the company or trust to either the CGT concession stakeholder or through interposed entities are not treated as dividends nor frankable distributions up to the relevant individual's percentage of the CGT exempt amount.

Should any gain remain after the application of the 50% reduction and the small business retirement concessions, you may choose to apply the small business rollover. If, after application of the small business rollover provision a gain arises from CGT events J2, J5 or J6, you may choose to apply the small business retirement exemption to that gain, without retesting for the basic conditions for CGT events J5 & J6. However, if you intend to contribute some or all of the gain from the J Event gains to superannuation, care should be taken to ensure the superannuation fund can still accept the contribution e.g. are you under 75 or do you still satisfy the work test requirements if aged between 65 and 75 (40 hours of gainful employment in a 30 day period) – *Reg 7.04 of Superannuation Industry (Supervision) Regulations 1994.*

5.5 Small Business Rollover

Subdivision 152-E applies in addition to the 50% general discount, the 50% reduction and the retirement exemption outlined above.

The small business rollover allows you to defer making the gain from the CGT event if you acquire a replacement active asset/s within a period commencing one year before and ending two years after the disposal of the existing active assets (i.e. the *replacement asset period*) – section 104-90. The gain on the original asset is deferred until one of the following CGT events apply:

CGT event J2 – section 104-185 – happens when the replacement asset stops being your active asset, becomes trading stock or you start to use the asset solely to produce exempt or NANE income. If the replacement asset is a share in a company or an interest in a trust, CGT event J2 happens when you (or an entity connected with you) stop being a CGT concession stakeholder in the company or trust or CGT concession

stakeholders in the company or trust stop having a small business participation percentage in you of at least 90%. The gain you make is generally the amount disregarded under Subdivision 152-E and the timing of the CGT event is the date of change.

CGT event J5 – section 104-197 – happens when you fail to acquire a replacement active asset or incur fourth element expenditure after a rollover under Subdivision 152-E within the prescribed replacement asset period, that satisfies all the relevant conditions. The gain you make is the amount that was disregarded under Subdivision 152-E and the timing of the CGT event is at the end of the replacement asset period.

CGT event J6 – section 104-198 – happens when you do acquire a replacement active asset or incur fourth element expenditure after a rollover under Subdivision 152-E within the prescribed replacement asset period, that satisfies all the relevant conditions, but the expenditure on the assets is less than the amount disregarded under Subdivision 152-E. The gain you make is the difference between the amount incurred and the amount that was disregarded under Subdivision 152-E, with the timing of the CGT event being at the end of the replacement asset period.

5.6 Order in which the Small Business CGT concessions apply

The method statement in section 102-5 sets out the order in which the CGT concessions apply in relation to the concessions, capital losses and the CGT discount.

1	15-Year Exemption	If the 15-year exemption applies, the capital gain is entirely disregarded and no further concessions can be applied (not necessary). This concession is applied before capital losses and the CGT discount.
2	Capital Losses	The capital gain is then reduced by any capital losses from the current year and those carried forward from prior years.
3	CGT General Discount	Apply the general discount under Div 115, if applicable (usually 50% - section 102-205).
4	50% Reduction	A gain or discount gain can be reduced by the 50% reduction under Subdiv 152-C. This is optional and may be forgone to maximise the use of the small business retirement exemption, or avoid the circumstance of an unfranked dividend or CGT event E4 happening.
5	Retirement Exemption/Rollover	The retirement exemption and/or the rollover may be applied as an alternate or in combination to reduce the capital gain, the former as a full or partial disregard and the later as a deferral until another CGT event happens.
6	Net Capital Gain	Any remaining gain after steps 1 to 5 will be included in the taxpayer's assessable income in the year the gain was made.

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6 Small Business Restructure – a comparison

Effective from 1 July 2016, an additional rollover relief option was introduced as an alternative pursuant to Subdivision 328-G for the transfer of assets occurring as a result of a change in the legal structure owning assets of a business, without changing the ultimate economic ownership of the assets.

The legislation states that the object of the Subdivision is to facilitate flexibility for owners of small business entities to restructure businesses and the way their business assets are held, while disregarding tax gains and losses that would otherwise arise. However, it should be noted that there are other tax considerations that should be considered that Subdivision 328-G does not fully address including Part IVA, GST, FBT, Division 7A and other State duties.

6.1 Qualifying for the small business restructure rollover

In order to qualify for the relief, the following criteria contained in section 328-430 must be satisfied:

a) the transaction is, or is a part of, a genuine restructure of an ongoing business;
b) each party to the transaction is either a small business entity, has an affiliate that is a small business entity, connected to a small business entity, or a partner in a partnership that is a small business entity
c) the transaction does not have the effect of materially changing the relevant share an individual has in the ultimate economic ownership of the asset;
d) the assets transferred must be an eligible asset that satisfies the active asset test;
e) both the transferor and transferee must meet the residency tests in section 328-445; and
f) the choice must be made to apply the rollover.

6.2 What is a Genuine Restructure?

By far the most challenging aspect to the rollover provision in Subdivision 328-G is satisfying the requirement that the transaction is part of a "genuine restructure" of an ongoing business. This requirement is unique to this Subdivision and quite distinct from the other concessions outlined in Division 152 or the other replacement or same asset rollovers.

The ATO's Law Companion Ruling LCR 2016/3 provides guidance as to:

What features the ATO considers should exist to indicate if this is satisfied, including:

- It's a bona fide commercial arrangement undertaken in a real and honest sense to:
  - Facilitate growth, innovation and diversification;
  - Adapt to changed conditions; or
  - Reduce administrative burdens, compliance costs and/or cash flow impediments.

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- It is authentically restructuring the way in which the business is conducted as opposed to a 'divestment' or preliminary step to facilitate the economic realisation of assets.
- The economic ownership of the business and its restructured assets is maintained.
- The small business owners continue to operate the business through a different legal structure – for example, there is:
  - continued use of the transferred assets as active assets of the business;
  - continuity of employment of key personnel; and
  - continuity of production, supplies, sales or services.
- It results in a structure likely to have been adopted had the small business owners obtained appropriate professional advice when setting up the business.

Factors which may indicate that a transaction is NOT a genuine restructure, including:

- The restructure is a preliminary step to facilitate the economic realisation of assets or takes place in the course of a winding down to transfer wealth between generations.
- The restructure effects an extraction of wealth from the assets of the business (including the accumulated profits) for personal investment or consumption or otherwise designed for use outside of the business.
- Artificial losses are created or there is a bring-forward of their recognition.
- The restructure effects a permanent non-recognition of gain or the creation of artificial timing advantages.
- There are other tax outcomes that do not reflect economic reality.

Section 328-435 contains a **safe harbour rule** which provides an alternative way to meet the "genuine restructure" of an ongoing business requirement. Under this rule, a transaction will be taken to be a genuine restructure if there is no change in the ultimate economic ownership of any of the significant transferred assets of the business, those assets continue to be active and are not significantly used for private purposes for a period of 3 years.

6.3 Comparison with the Division 152 and other Asset Rollovers

Each rollover provision is subject to a number of eligibility criteria that will dictate whether the provision is suitable for the transaction that you are contemplating. Some provisions are more prescriptive than others whether it be in what types of entities it applies to or what the provision is used for.

Below is a table to highlight some of the key differences between the provisions.

Matter dealt with	Subdivision 122-A	Division 152	SBRR
Eligible Entities	Applies to individual or trustees transferring to a company. Partnerships transferring to companies are covered by Subdiv 122-B.	Applies to individuals, trustees, partnerships & companies	Applies to individuals, trustees, partnerships & companies.
Small Business Entity?	Does not have to be an SBE	Must be an CGTSBE, a partner in an CGTSBE partnership, hold passively assets used in an CGTSBE or meet the MNAV test	Only SBEs can use the SBRR
CGT events	Applies to a limited number of CGT events	Applies to all CGT events except CGT event K7	No restriction on CGT events to which the provisions apply
Eligible Assets			
• Active assets	✗	✓	✓
• Share or Unit	✗	✓	✗
• Trading Stock	✗	✗	✓
• Depreciable Asset	✓	✗	✓
Turnover threshold	✗	$2 million	$10 million
Value at which assets are transferred	Requires assets to be transferred at market value – consideration is shares	No requirement for consideration to be provided on transfer or sale	No requirement for consideration to be provided on transfer
Residency requirement?	✓ Unless the asset and Co shares are taxable Australian property	✗	✓ Both the transferor and transferee
Are family trust elections required for discretionary trusts?	✗	✗	✓
Step up in cost base	✗	✓	✗
Is a change in ultimate economic owner permitted?	✗	✓	✗
Asset disposal restriction?	✗	✗	✓ No safe harbour for genuine restructure if disposal within 3 years
Facilitates superannuation contributions?	✗	✓ Access to CGT cap amount	✗
Useful as a step	✓	✓	✗

Matter dealt with	Subdivision 122-A	Division 152	SBRR
to sale or succession planning?	if desired outcome is the asset be held by a Company		unlikely to satisfy genuine restructure requirement

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7 Conclusion

Whether you are advising clients on setting up structures for a business, restructuring the current arrangements in response to changing business needs or contemplating an exit, whatever your strategy entails it will fraught with taxation perils.

It will always be a risky tax business to formulate and adopt a strategic plan for owning or disposing of business assets. The risks become more apparent if the strategy is to enact a succession plan when there is no cash from the transaction to pay any unintended tax consequences.

The structures we use and the manner in which undertake commercial transactions can and do dictate the taxation outcomes.

When applying the small business CGT concessions to a transaction, it is critical that you, the adviser, have an in depth understanding of the taxpayer making the gain and those entities which are connected with that taxpayer, whether it be through the aggregation of ownership interests or control of the entity's decision making process.

This analysis inevitably takes time and costs the client money to be undertaken properly. The law in relation to the small business CGT concessions can be extremely advantageous but complex, with short cuts leading to errors, and errors leading to increased tax exposure for all concerned.

Finally, the laws can and do change. You may have thought your client's retirement or succession planning is rock solid and then the law changes – read small business concessions or superannuation. You may now be holding shares or units which were once eligible for concessions that now fail the tests, especially if the group is multi-layered. It's time to revisit all client's structures to ensure your exit plans are still effective. If not, consider a new structure – is it using a business unit trust or a partnership of discretionary trusts – and utilise the small business rollover provisions to mitigate the restructure costs.

Plan smart and plan ahead.