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John Tretola

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Abstract
This article reviews the significant changes that have been made to the CGT small business concessions legislation 2006-9 and focuses on whether these changes have improved access to the concessions.

Keywords
CGT, capital gains tax, small business tax concessions, ITAA 1997

'CHANGING CGT SMALL BUSINESS CONCESSIONS- FOR BETTER OR WORSE?'

'Change is not made without inconvenience, even from worse to better'

Samuel Johnson (1755)

JOHN TRETOLA*

This article reviews the significant changes that have been made to the CGT small business concessions legislation 2006-9 and focuses on whether these changes have improved access to the concessions.

INTRODUCTION[1]

One of the changes to the CGT small business concessions rules has been the increase of the net asset limit to $6 million (from $5 million). A more significant change has been the introduction of an alternative eligibility test for small business entities based on annual turnover. Other major changes include the expansion of the definition of 'active asset' to include a CGT asset that is owned by the taxpayer but used in a business operated by the taxpayer's affiliate.

The definitions of terms such as 'connected entities' and 'affiliate' have also been markedly changed. Also the eligibility requirement to access the concessions in a company or trust has changed from having to be someone who is a 'controlling individual' to someone who is a 'significant individual'.

The claims[2] that these changes have improved access and made it easier for taxpayers to work out if they are eligible for the concessions will be scrutinised to determine whether these changes have indeed broadened or in fact lessened the scope of taxpayers eligible for these concessions.

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* Lecturer, Adelaide University, Business School.

1 All references to legislation in this article are to the *Income Tax Assessment Act 1997* unless otherwise stated.

2 See Bills Digest to the Tax Laws Amendment (2009 measures No 2) Bill 2009 (Cth) 3.

THE RATIONALE FOR THE CGT SMALL BUSINESS CONCESSIONS

The CGT small business concessions were introduced in 1999 as one measure proposed by the former Ralph Review Committee in its Stage 1 reforms.[3] The measures are found in Division 152, which was inserted into the *Income Tax Assessment Act 1997* to replace the former retirement concession (contained in the former subdivision 118-F) and rollover relief (contained in the former Division 123).

Division 152 applies to CGT events happening to CGT assets on or after 11.45am EST on 21 September 1999.

One of the stated reasons for the introduction of the small business CGT concessions was to give small business operators greater access to additional funds for their retirement or to use to grow their businesses.

THE RULES AS THEY APPLIED (BEFORE 1 JULY 2006)

There were (and still are) four principal CGT concessions for small businesses, which are available to all types of taxpayers, and which are in addition to the general 50% discount.[4] These CGT small business concessions are in Division 152 of ITAA97 and comprise:

The 15-year retirement exemption (Subdivision. 152-B);

The 50% active asset reduction (Subdivision 152-C);

The $500,000 retirement exemption (Subdivision152-D); and

The rollover concession (Subdivision 152-E).

Due to the method statement in s 102-5[5] any capital losses and the CGT discount are applied before the application of any of these concessions.

If the CGT event occurred before 21 September 1999 then only the retirement concession (under the former subdivision 118-F**)** and the rollover relief (under the former division 123) were available.[6] There was also a 50% reduction for business goodwill.[7]

Subdivision 152-A set out the 3 basic pre-conditions that are common to all of these concessions and that must be satisfied.

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[3] *Ralph Report, Review of Business Taxation* 1999.

[4] As provided for in Division 115 *Income Tax Assessment Act 1997* (Cth).

[5] *Income Tax Assessment Act 1997.*

[6] Introduced with effect from 1 July 1997.

[7] Contained in the then s 160ZZR of *Income Tax Assessment Act 1936* and then rewritten into s 118-250 of *Income Tax Assessment Act 1997.*

The three basic pre-conditions that must be satisfied before eligibility for any of the CGT small business concessions can be considered were:

1. $5 million limit on the net assets of the small business and related entities;
2. Each CGT asset must be an active asset (and so pass the active asset test); and
3. If the asset is a share in a company or an interest in a trust, the entity must have at least one 'controlling individual'[8] (who was defined to an individual with shares in a company or interests in a trust that had rights to at least 50% of the income and capital) and for the individual claiming the concession to be a CGT concession stakeholder.

Maximum net asset value test

To be eligible for the CGT small business concessions the taxpayer's net value of their included assets must not have exceeded $5 million. Net value means the sum of market values of assets less the liabilities for those assets (s 152-20 (1)).

The assets included for the purposes of the maximum net asset value test[9] were the:

- Net value of the taxpayer's CGT assets,
- Net value of the CGT assets of any entities connected with the taxpayer;[10] and
- the Net value of the CGT assets of the taxpayer's 'small business CGT affiliate'[11] (defined to be the taxpayer's spouse or child under 18 years of age or a person who acts or who could reasonably be expected to act in accordance with the directions or wishes of the taxpayer).

The assets excluded from the maximum net asset value test were (s 152-20):

- Shares, units or other interests in an entity connected with the small business entity (which would otherwise be counted twice).
- Assets used solely for the personal use of an individual.
- A residence of the taxpayer so long as there was no entitlement to claim interest if an income producing activity is being carried out in the residence. If the home was partly used for business purposes then the whole value had to be counted.
- Superannuation balances.

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[8] Section 152-50 *Income Tax Assessment Act 1997*.
[9] Section 152-15.
[10] Section 152-30.
[11] Section 152-25.

If any other type of asset was used partly for income producing use, then its whole value was brought into account under this test.

Assets were included for the purposes of this test even if they are exempt CGT assets (eg, motor vehicles; plant and equipment; and trading stock).

Active asset test

An active asset was defined in s 152-40 as an asset owned either by the taxpayer or their affiliate or an entity connected with the taxpayer, and used in the carrying on of the taxpayer's business.

It included land and buildings used in carrying on a business and also intangible assets, such as goodwill and trade names inherently connected with the carrying on of a business.

A share or an interest in a trust would also qualify as an active asset if the market value of all the active assets of the company or trust were 80% or more of the market value of all assets of the company or trust: s 152-40 (3).

The rules prior to 2006 required the asset to have been an active asset just before the time of the CGT event.

However, an active asset could not have included (under s 152-40(4)):

> Interests in a connected entity, company or trust (unless the connected entity satisfied the 80% active asset test);
>
> A financial instrument (eg loans, debentures, options etc); or
>
> Any asset used mainly to derive interest, annuities, rent, royalties or foreign exchange gains.

An asset mainly used to derive rent also could not have been an active asset.[12]

Controlling individual requirement

If the asset being disposed of was a share in a company or an interest in a trust, to access the CGT small business concessions the taxpayer needed to be a 'controlling individual'.

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12 The ATO takes the view in TD 2006/78 that an asset used to derive rent would involve the tenant having exclusive possession of the asset or premises. If exclusive possession is not provided then it is unlikely that the asset or premises will be treated as deriving rent. For example, a taxpayer who carries on a business of providing commercial storage space is not taken to derive rent as the customer does not get exclusive possession (as owner can relocate the client to other storage areas).

The rules that applied until 30 June 2006 provided that a taxpayer needed to own at least 50% of the company or trust.

If the CGT asset was a share in a company or an interest in a trust (the object company) then to utilise the concessions, the taxpayer must have been either a CGT concession stakeholder in the object company or trust. Alternatively, the CGT concession stakeholders in the object company or trust together must have a small business participation percentage of at least 90%.

The four CGT small business concessions

15-year retirement exemption (Subdivision 152-B)

The exemption only applied to an individual (s 152-105**)** if:

- The CGT asset was owned by the individual for at least 15 years continuously just before the event; and
- The taxpayer was at least 55 years old at the CGT event time and the event must happen in relation to their retirement or they are permanently incapacitated at the time of the event.

The 15-year continuous ownership period was extended where the CGT asset was compulsorily acquired, lost or destroyed or the CGT asset was transferred under the marriage breakdown rules.[13]

The exemption also applied to the disposal of an asset by a company or trust[14] if the gain was distributed within two years of the event, s 152-125 (2) and:

- The above 2 conditions were met and the controlling individual just before the event was at least 55 years old and retiring or permanently incapacitated; and
- The entity had a controlling individual (but not necessarily the same one) during the whole 15-year period.

The 15-year rule has priority and so has to be applied first.[15] It results in a complete exemption of any capital gain (and so other capital losses are not affected).

Each CGT concession stakeholder[16] (defined to be a party who was a controlling individual in the company or trust or the spouse of someone who is) can only be paid an exempt amount under this subdivision in accordance with the following formula:[17]

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13 Section 152-115 *Income Tax Assessment Act 1997.*

14 Section 152-110.

15 Section 152-215.

16 Section 152-60.

17 Section 152-125(2).

Stakeholder's Participation Percentage x Exempt Amount

Any amount paid out of a company or trust under the 15-year retirement exemption is not assessable income to the taxpayer (but nor is the payment deductible to the company or trust). The amount paid to the taxpayer under this concession is deemed to be a dividend and so is not frankable.[18]

To be eligible for this 15-year retirement exemption, the requirement is that the taxpayer also needs to retire or be permanently incapacitated.

The ATO expect that for there to be a retirement of the taxpayer there must be a considerable reduction in hours worked.

With respect to permanent incapacity, the ATO gives the example of Jack (in the *ATO's Advanced Guide to CGT Concessions for Small Business)* who is unable to work in gainful employment again due to his deteriorating and severe health problems.

50% active asset reduction (subdivision 152-C)

This concession applied automatically if the basic conditions in s 152-205 were met.

The taxpayer has a choice of which of the 3 remaining concessions (including this one) apply and in which order (s 152-220).

Problems arise with the use of the 50% active asset reduction in a company or unit trust in that the 'concession' amount becomes 'trapped' in the company or trust and so when it is sought to be returned to the taxpayer there have been some adverse consequences.

In a company, the 'concession' amount, if it is paid out, will be an unfranked dividend. Or, if the company is liquidated, it will then form part of the capital proceeds when the shares are liquidated (and so this would affect any capital gain made on those shares at liquidation).

Distributions of the concession amounts from a unit trust can trigger CGT event E4 (when these non-assessable amounts exceed the cost base of the units held).[19]

The small business retirement exemption (subdivision 152-D)

This subdivision requires that the capital proceeds be used in connection with the retirement of the taxpayer and, as such, there is a lifetime limit of $500,000 for an individual. However, the amount applied under this exemption must be paid out as an Eligible Termination Payment (ETP).

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18 Section 152-125(3).

19 Section 104-70 (4). In the case of a unit trust, s 104-71 is not affected by the reduction amount.

There had been some doubt as to whether the legislation in its original form actually required the retirement of the taxpayer.[20]

If the individual is under 55 at the time when the choice is made,[21] the exempt amount must be rolled over as an eligible termination payment (ETP) into a super fund or approved deposit fund (s 152-305**)**.

If the taxpayer is aged 55 or older at the time when the choice is made, the taxpayer is entitled to receive the exempt amount in cash as a tax-free ETP.

For companies and trusts (s 152-325**)**:

- The conditions of an individual retiring must be met;
- The ETP must be made to a CGT concession stakeholder within 7 days of the later of making the election (at time of lodging the tax return for the year the capital gain was made) or the receipt of the consideration for the disposal of the asset;
- The controlling individual test needed to be met for the whole period of ownership.

Companies and trusts are unable to claim a tax deduction for the payment of this ETP to a controlling individual.

The small business roll-over concession (subdivision 152-E)

This rollover relief could apply where replacement active assets were acquired within two years after or up to one year before the date of the CGT event. Any amount of gain for which this rollover relief is applied is effectively deferred.

However, any amount of capital gain remaining after the application of this roll over relief provision will be taxed as a capital gain.[22]

Any concession amount that has had this rollover relief applied would again be subject to capital gains tax when the replacement asset is later sold or disposed of or the replacement asset ceases being an active asset.[23] However, further rollovers were (and still are) permitted.

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20 This has been cleared by an amendment, which does not require any actual retirement, effective from 1 July 2006.

21 Usually at the time of lodgement of the relevant year's income tax return.

22 Section 152-415 (with the net capital gain being included in assessable income under s 102-5 due to event J2 occurring.

23 Section 104-185 (CGT Event J2 happens).

If the status of a replacement asset changed (that is, it ceased to be an active asset or became trading stock and so an exempt CGT asset),[24] then CGT Event J2 was triggered and a net capital gain would accrue equal to the gain ignored under the concession. However, the rollover relief could still be applied to the capital gain to defer the payment of tax on it even further.

The J series events are not themselves eligible for the discount or other small business concessions.[25]

The changes made to the rules to apply from 1 July 2006

As a result of the Government's acceptance of most of the recommendations[26] arising from the Board of Taxation's review of the CGT small business concessions in 2005,[27] two major tranches of changes were made to the concessions. This first tranche of changes were contained in the *Tax Laws Amendment (2006 Measures No 7) Act 2007.* This first round of changes became law in April 2007 and the second round of changes became law in June 2009.

The first tranche made changes to the controlling individual requirement, the maximum net asset test, the active asset test, the 15-year exemption, the retirement exemption, and the small business rollover; how the concessions apply to partners and to deceased estates.

(i) Change to controlling individual requirement

Under the old law, in order to access the CGT concessions if the CGT event involved a company or trust, a taxpayer had to be a controlling individual in the company or trust. This required the individual to hold a 50% or greater interest (or stake) in the company or trust.

This law changed so that an individual is only required to hold a 20% or greater small business participation percentage[28] in the company or trust to access the concessions and such a person is now referred to as a 'significant individual'.[29]

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24 Section 118-25.

25 Except the newly introduced (from 2006) events J5 and J6 which are both eligible for the retirement exemption.

26 The then Treasurer accepted 25 of the 26 recommendations.

27 Board of Taxation, *A Post-Implementation Review of the Quality and Effectiveness of the Small Business Capital gains Tax Concessions in Division 152 of the Income Tax Assessment Act 1997*, Report to the Treasurer, (2005).

28 This term is now defined in s 152-65.

29 Section 152-55.

(ii) Change to maximum net asset value test

The maximum net asset value test was increased from $5 million to $6 million. The law also takes into account negative asset values of a connected entity in calculating the net value of an entity's CGT assets.[30]

The new asset test rules take into account, for the first time, the related liabilities of an entity including provisions for annual and long-service leave, unearned income and tax liabilities. The new rules now only apply in relation to partnerships in terms of the individual interests in the partnership that each partner has. Therefore, in a partnership, if the partner does not control the partnership,[31] it is only the net value of the individual partner's interest that is taken into account.[32]

If a partner holds a 30% interest in a partnership with a net asset value of $10 million, they would not have been eligible to access the concessions under the old rules (since the full value of the partnership was taken into account) but they may be eligible under these new rules (if their other net assets counted together with their partnership interest do not exceed $6 million).

Another change made to the net asset test is the way in which a taxpayer's dwelling is counted for the purposes of the test. Under the old rules where any part of a dwelling was used for income producing use its full value would have to be counted for the purpose of this test. Under the new rules it is only the proportion of the dwelling used for income producing that is included for the purposes of the test.[33]

This new concession of only including a portion of the home (based on business use) still does not apply to other assets that are likely to have large private use components, such as holiday homes and cars.

(iii) Change with respect to the definition of active assets

The active asset test was changed in 2006. To be an active asset the asset only needs to be an active asset for half the period of ownership or, if the asset was owned for more than 15 years, then it only needs to be an active asset for at least 7.5 years of the last 15 years of ownership.[34]

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30 Section 152-20 and thereby reversing the previous view of the ATO in ATO ID 2004/207.

31 That is having a 50% or more control percentage.

32 Change introduced in 2006 and now reflected in s 328-125(1) and (6).

33 Section 152-20(2A).

34 Section 152-35.

Under the former rules for an asset to be an active asset it had to be an active asset just before the time of the CGT event. Under these new rules, an asset does not need to be an active asset just before the time of the CGT event as long as it has been an active asset for the lesser of at least half the period of ownership or 7.5 years, in which case it will retain its active asset status indefinitely.[35]

In addition, cash and financial instruments inherently connected with the business are now counted (whereas they previously were not) for the purposes of the 80% look-through test used to determine whether shares in a company or interests in a trust qualified as active assets.

(iv) Alternative test added where there is a disposal of shares or trust interests

An alternative test was added for an entity that disposed of its shares in a company or interests in a trust. That entity could instead satisfy the requirements to access the concessions if the CGT concession stakeholders had a small business participation percentage in the entity disposing of the shares or interests of at least 90%.

This change is part of a number of changes designed to allow significant individuals to hold indirect interests in an entity.

(v) Relaxation of some of the requirements with regard to the various CGT small business concessions

a 15-year exemption

Under the previous rule the controlling individual had to be a controlling individual for the entire period of ownership.

This rule has been relaxed so that the significant individual only needs to be a significant individual for any period or periods totalling at least 15 years during the period of ownership.

It would also now appear to be the case, with the introduction of this 'significant interest' requirement that only one (of up to four or five shareholders or unit-holders) would need to be aged over 55 and retire to access this concession.[36] This change greatly loosens the required link to retirement that has been needed to access this particular concession.

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35 Ibid.

36 John Middleton, 'New CGT Small Business Concession Rules. Part 2 - Planning and Structuring' 43(3) *Taxation in Australia* 172.

b Retirement exemption

Since 1 July 2006, there is no requirement for any actual retirement of the taxpayer at the time of the payment. Capital proceeds now do not need to be actually received and so this exemption now also applies to gifts of property with the market value substitution rule applying to deem the amount of capital proceeds. Equally it is now possible to claim this exemption on intra-family or vendor-financed transactions.

c Small business roll-over

This concession has now been relaxed so that a taxpayer can choose to rollover all or part of any capital gain (whereas under the former rule they could only roll-over all of the capital gain). In addition replacement assets can now either be newly acquired assets (which they could only be previously) or improvements to existing assets.

CGT Event J5[37] now occurs if the replacement asset is not acquired within the 2-year period after the CGT event occurred.

Event J6 now occurs if replacement assets are acquired but the cost base of those assets is less than the amount of the rolled over gain.[38]

(vi) Replacement of term small business CGT affiliate

The term 'small business participation percentage' was introduced to replace the term 'small business CGT affiliate' and allows an individual to access the concessions by holding interests in a trading entity through a chain of entities.[39]

The term small business participation percentage is defined to mean the sum of an entity's direct and indirect small business participation percentages in other entities and, in the case of fixed and non-fixed trusts, means the smaller of any income and capital distributions received.

37 Section 104-197.

38 Section 104-198.

39 Section 152-65.

The changes made to the rules from 1 July 2007

(a) Introduction of small business entity test

The *Tax Laws Amendment (Small Business) Act 2007* introduced a single definition of small business entity to 'simplify and standardise the various small business concessions'.[40]

A small business entity is now one that meets the turnover test, which was introduced as an alternative to the net asset value test.[41] If a taxpayer is a small business entity then they are now eligible to access the CGT small business concessions.[42]

A business will pass the turnover test if its aggregated turnover is less than $2 million.

Partners in a partnership can utilise this new turnover test as long as the partnership carries on a business and the partnership's aggregated turnover (not each partner's share of it) is less than $2 million.[43]

The turnover test for small business entities[44] also changed in 2007 so that instead of taking an average of 3 of the previous 4 years of turnover, there are now 3 different ways in which to satisfy the turnover test. If:

1. The taxpayer's aggregated turnover for the previous year was less than $2 million; or
2. The taxpayer's aggregated turnover for the current income year as worked out at the start of the income year is expected to be less than $2 million; or
3. The taxpayer's aggregated turnover for the current income year as worked out at the end of the income year is actually less than $2 million.

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[40] The Treasurer and the Minister for Small Business and Tourism jointly announced on 13 November 2006 that this new turnover test was necessary to standardise the eligibility criteria for the various small business tax concessions, such as the (old) simplified tax system and the CGT small business concessions.

[41] This new provision was drafted on the basis that taxpayers currently accessing the concessions would not be disadvantaged through the application of the new provisions and so this new provision is to be seen as additional to the existing rules .The new provision was designed to overcome the disadvantage of the $6 million test, which would mean taxpayers with assets of significant value, such as a farm, but minimal income would miss out.

[42] Section 152-10.

[43] Section 328-115.

[44] Section 328-110.

(b) New CGT grouping rules

The previously known grouping rules were changed to become aggregation rules.

These new rules differ from the former grouping rules by defining the term 'affiliate' differently, changing the reference to the ownership of shares in a company to holding equity interests and also changing the definition of 'control of a discretionary trust'.

The term 'affiliate' has changed to no longer automatically include the spouse or a child less than 18 years of the taxpayer.[45]

An affiliate now means an individual or company that acts, or is reasonably expected to act, together with them in accordance with the taxpayer's directions in relation to the taxpayer's business affairs.[46]

Under these new rules, just because persons may have a business relationship does not necessarily mean they are affiliates. For example partners in a partnership, trustees of the same trust and directors of the same company are not necessarily affiliates unless they are actually acting in relation to the affairs of the partnership, trust or company.

Section 328-125 provides that an entity is connected with another entity if the first entity controls at least 40% of the ownership interests in the other entity.[47]

If an entity owns between 40% but less than 50% of the ownership interests in the other entity they will not control the other entity if another third entity has 50% or more control of that other entity.[48]

These new rules create a so-called 'sweet spot' for structuring and planning purposes between 20.01 and 39.99%so that the full assets of the company would not count for the purposes of the net asset test, although the market value of the shares will still be relevant.[49]

(c) New control rules

The new rules redefine the control of a company to refer to the ownership of equity interests rather than shares in a company.

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45 Change to former rule set out in former s 152-20(3) and s 152-25(1).

46 Section 328-130.

47 Section 328-125(2) and (4).

48 Section 328-125(6).

49 Above n 36.

Under the new rules, an entity will control a company if the entity or its affiliates or all of them together, beneficially own 40% or more of the equity interests in the company.

The new control test for a discretionary trust removes the automatic control of a discretionary trust from a trustee. An entity will now control a discretionary trust if the trustee acts, or could be reasonably expected to act, in accordance with the directions of the entity, its affiliates or all of them together.[50] The ATO has taken the view in TD 2006/67 that the appointer of a discretionary trust will always control the trust.[51]

Therefore, an appointer of a discretionary trust will always be connected with the discretionary trust because the appointer has the power to remove and appoint the trustee and therefore, according to the ATO, has the effective power to determine the manner in which the trustee exercises their power to make distributions.

A beneficiary will only be considered to control a discretionary trust if the beneficiary has received at least 40% of the total income or capital distributions of the trust in at least one of the preceding four years before the event. Importantly it is not the year of the event that is relevant for this issue of control.

The new rules do extend the operation of the control test to years where the trust has no taxable income from which to make distributions so as to allow the trustee to nominate up to four beneficiaries to be controllers of the trust in that year.[52]

The changes made to the rules in 2009[53]

In the 2008 Budget which became law in June 2009, there were further changes to the way in which the $2 million aggregated turnover test is applied.

(a) Passively held assets

These changes[54] extend the eligibility for the concessions (subject to the other requirements that must be met by all taxpayers to use these concessions) to

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50 Section 328-125(3).

51 Previously the ATO took the same view in ATO ID 2004/698.

52 Under s 152-42.

53 Treasury has estimated that these changes, as set out in the Tax Laws Amendment (2009 Measures No 2) Bill 2009 would have an 'unquantifiable (but minimal to small) cost to the revenue over the forward estimates' at 13 of the Digest to the Bill. Above n 2.

54 Contained in s 152-10(1A).

taxpayers who are not carrying on a business but who own a CGT asset used in the business of an affiliate or entity connected with the asset owner. This new provision requires the business that is using the asset to have an aggregated turnover of less than $2 million.

The new rules also allow partners to access the concessions[55] by using the turnover test where they own a CGT asset (that is not an asset of the partnership) and that asset is used in the partnership business. In this context, the turnover test is required to be satisfied by the partnership (not the individual partner) and the partner must be a partner in the partnership in the year that the CGT event happens.

Some minor drafting changes have also been made to s 150-20 so that the 'net value of the CGT assets' must have deducted any liabilities related to any shares, units or other interests held by an affiliate or entity connected with the first entity.

An example was given in the Explanatory Memorandum that accompanied this amending legislation to show just how this new rule would broaden eligibility to these CGT small business concessions.

Example

Jim is a farmer and owns land through a discretionary trust. Jim is proposing to sell the farm land to a developer for $10 million.

The farming business is carried on by a company in which Jim and his wife are the sole shareholders and directors. The company's annual turnover is $60,000 and it is not registered for GST.

It is expected that Jim will make an $8 million capital gain when he sells the farm land. He would be unable to satisfy the $6 million net asset test and therefore under the current rules he would need to be a small business entity to use the CGT small business concessions.

With this new rule, as the land is being used in a business by an entity connected with Jim, and as this business has an annual turnover of less than $2 million, Jim would be eligible to use the concessions.

(b) Change to the definition of 'affiliate'

The amendment[56] to the 2007 rules (introduced in 2009) allows for assets held by a taxpayer, as long as the asset meets the other conditions for active assets, to still

55 Contained in s 152-10(1B).

56 Contained in s 152-47.

qualify as a taxpayer's active asset even if used by a spouse or child under 18 in a business carried on by them even where the spouse or child is not an affiliate.

This new rule not only extends the application of the active asset test but also means the asset is counted for the purposes of the $6 million net asset limit.[57]

(c) Main use of asset to derive rent

In trying to determine whether an asset is an active asset all uses of the asset are considered. This amendment[58] changed the previous approach which was to only consider what the use of the asset was by the affiliate or connected entity.

(d) Businesses that are winding up

An amendment[59] was made to enable a taxpayer to still utilise the concessions where a business was previously carried on by an affiliate, an entity connected with the taxpayer or a partnership in which the taxpayer was a partner, where that business is being wound up and the asset is no longer used in the business.

(e) Change with respect to deceased estates[60]

If the taxpayer dies and the replacement active asset passes to the taxpayer's legal personal representative, then the legal personal representative is treated as if they were the taxpayer and so the legal personal representative is eligible for the same CGT small business concessions that the taxpayer would have been entitled to.

(f) Liabilities related to shares, units or interests

For the first time[61] liabilities related to shares, units or interests can also be included to reduce the net asset value of these items.

(g) Removal of deemed dividend provision regarding retirement exemption amounts

Section 152-325(9) was amended to ensure that payments made to CGT concession stakeholders would no longer be subject to s 109 and Division 7A rules.[62]

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57 This change is to be reflected in the new proposed s 152-47.

58 Contained in s 152-40(4) (a) and (b).

59 Contained in s 152-49.

60 Section 152-80 was inserted as a result of changes made in 2009, backdated to 1 July 2006, so access to the CGT small business concessions is extended to assets acquired by an individual on the death of a joint tenant and the assets devolve to the trustee of a trust as a result of a will of an individual where the deceased would have been able to access the concessions.

61 Section 152-20(2) (a) amended to include the inclusion of liabilities in relation to shares, units or interests.

62 *Income Tax Assessment Act 1936* (Cth).

STILL UNRESOLVED PROBLEMS?

A recent article[63] has highlighted some unresolved issues (even after the 2009 changes) with the CGT small business relief rules with respect to the issue of partnerships and connected entities.

This issue has arisen due to the recent case - *White v FCT*[64] where it was held that a partnership was not 'another entity' for the purposes of the right to distribution control rule as existed before the recent 2007 amendments.

In the *White* case the taxpayer was in the 2002/03-tax year the owner of a pharmacy business, which she sold in that year, and just before the sale, her assets included an interest in two partnerships (one of 75% and one of 50%).

Under the former rules (as they applied before the 2007 amendments) an entity was connected with a taxpayer (and so the assets of the entity were included for the purposes of the net asset rule to determine eligibility for the CGT small business concessions) if the taxpayer owned at least 50% of the entity. However, Sundberg J in his judgment, said that a partnership could not be an 'entity' for the purposes of these CGT small business concession rules and the definition of entity in s 960-100 did not apply.

Sundberg J based his somewhat surprising conclusion on the basis that the 'control' provisions found in the former s 152-30 are 'in a different position' to the net asset value test found in s 152-20 and that while for some purposes the *Income Tax Assessment Act 1997* treats partnerships as entities, he was not prepared to hold to 'the generality of the submission that the scheme (Division 152) expressly treats partnerships as entities'.

Although there is some concern about the correctness of the decision by Sundberg J[65] the implications of his decision and reasoning have been overcome by the 2007 amendments to the connected entities rules as those rules specifically treat a partnership as an entity that may be connected with an another entity.

Section 328-125 provides that an entity is connected with another entity if:

(a) Either entity controls the other entity or;

(b) Both entities are controlled by a third entity.

Control is defined to exist where an entity and its affiliates own, or have the right to acquire, the beneficial ownership of interests in the other entity that carry the right to

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63 Tax Counsel Pty Ltd (August 2009) 44/2 *Taxation in Australia* 44/4, October 2009 at 198-200.

64 [2009] FCA 880.

65 Tax Counsel Pty Ltd, (2009) 44(4) *Taxation in Australia* 198.

a percentage of at least 40% of any distribution of income. If the other entity is a partnership, then control exists if the entity and its affiliates have an entitlement to share in at least 40% of the net income of the partnership or 40% of any distribution of capital.

Despite the seemingly improved drafting, this new definition still leaves some uncertainty as it is hard to understand how a general law partnership can control another entity within the meaning of these rules. It is also unclear whether a tax law partnership is intended to be treated as a connected entity. A tax law partnership is defined to exist in a situation where two or more persons are in receipt of income jointly.

The difficulty arises from the fact that the connected entity provisions are contained within the small business entity provision (in Division 328) and it is impossible to imagine how a tax law partnership could be a small business entity taxpayer (since a tax law partnership is not carrying on a business).[66]

Until further clarification is obtained it would seem that any net asset calculation should not include the assets of a tax law partnership.[67]

One other unresolved problem is an issue identified with CGT events J5 and J6 and the availability of the CGT small business concession of the $500,000 lifetime retirement exemption. Changes made to the CGT rules in 2007 that applied to 2007 and later tax years made it clear that the retirement exemption was intended to be available for CGT events J5 and J6.

The change in 2007[68] was required because the former wording of s 152-305(1) (a) and (2) (a) could not have been satisfied by CGT events J5 or J6 as there was a requirement that the CGT event happen in relation to an active asset. Since the business would have been sold, there would have been no possibility of this requirement being satisfied at this later time.

Amendments in 2009[69] have modified the operation of s 152-305 (by inserting subsection (4)) which no longer requires this same 'active asset' condition to be satisfied in connection with CGT events J5 or J6.

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66 Ibid. As is stated in the conclusion to this article, it is not yet known what the Commissioner's views will be on this issue.

67 Ibid. The author strongly suggests that any taxpayer close to the net asset limit where there is a tax law partnership involved obtain a private ruling from the Commissioner.

68 Under the *Tax Laws Amendment (2006 Measures No 7) Act 2007* (Cth).

69 *The Tax Laws Amendment (2009 Measures No 2) Act 2009* (Cth).

This new measure has been backdated to apply from the 2007 tax year. This amendment has been justified on the basis that it had always been intended that the retirement exemption be available for gains made from CGT events J5 and J6.

Some further problems have been created by the wording used in the legislation to introduce these new changes[70] such as the problem in identifying how much has been chosen as part of the retirement exemption 'for the asset' or the problem of how to treat for the purposes of calculating the retirement limit any amount that is not exempt that applies to a CGT event J5 or J6.

There is also a problem with determining when cash or financial instruments are inherently connected with a business and so meet the definition of active asset in s 152-40(3A) at the 'later time' - and so whether proceeds received up to two years after the sale of those assets would still be counted for the purposes of the 80 % 'look through' test. It is hoped there will be further clarification on these issues.

FURTHER PROPOSALS FOR CHANGE

Roisin Arkwright[71] quoted a thesis prepared by Chris Evans in 2003[72] that recommended that the small business concessions be simplified by eliminating the 15-year exemption and the 50% active asset reduction and instead making the retirement and rollover concessions available to all business taxpayers. These changes make more sense in light of the proposal (also put forward by these commentators) to replace the 15-year exemption with a 10-year exemption.

CONCLUSION

The CGT small business concessions have always been generous and the recent changes to the rules from 2006 to 2009 have, in the words of one commentator, made them 'stunningly generous'.[73]

The recent changes have broadened the scope of taxpayers eligible for concessions and there is a general perception that 'no taxpayer is worse off after the changes.'[74] But, as this article has tried to point out, it is not necessarily true for all taxpayers.[75]

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[70] As more fully explained above n 66, 200.

[71] Roisin Arkwright, 'Henry- An Opportunity to Reform the Individual CGT Regime' (2009) 44(2) *Taxation in Australia* 81.

[72] CC Evans, *The 0perating Costs of Taxing the Capital Gains of Individuals: A Comparative Study of Australia and the UK, with Particular Reference to the Compliance Costs of Certain Tax Design Features* (PhD Thesis, UNSW, 2003).

[73] Above n 66.

[74] Ibid 177.

The recent amendments have increased access to the small business CGT concessions for passively held CGT assets and for partners owning a CGT asset used in the partnership business. It is also evident that the increase in the net asset limit to $6 million and extending the eligibility to the concessions in deceased estates are measures that have extended the eligibility to the concessions.

Another change that has dramatically increased the availability of the concessions is the change from having to be a controlling individual with a 50% or more interest in a company or trust to only having to be a significant individual holding at least a 20% interest in the company or trust.

The use of the (alternative) turnover test is also likely to substantially increase the numbers of taxpayers eligible for the concessions and could mean that it would be possible for a capital gain of up to $16 million to be reduced to zero if eight CGT concession stakeholders were all eligible for the discount and active asset reduction and able to access the retirement exemption.

An even higher potential capital gain could be reduced to nil in an asset rich business with a small annual turnover (less than $2 million) if the 15-year exemption were applied. Furthermore, the change to the active asset test requirement so that the asset does not need to be an active asset at the time of sale, broadens the scope of taxpayers eligible to utilise the concessions.

These scenarios, which represent the most significant of the recent changes, together with the numerous minor amendments to the rules, undoubtedly mean that more taxpayers are likely to be able to access the concessions than under the previous rules.

A decrease in the number of taxpayers eligible for the concessions may come about under the new definition of 'affiliate'. While it does mean that an asset used in a business directly carried on by the spouse or child can still be an active asset of a taxpayer, this broader definition of an affiliate also potentially brings in more affiliates and more entities and thus is likely to mean that fewer taxpayers are able to satisfy the $6 million net assets test. More improvements are required to ensure the rules of eligibility are easier to satisfy rather than in achieving the opposite result.

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[75] A view also shared by Robert Allerdice, 'The Latest Changes to the Small Business CGT Concessions' (2009) 43(10) *Taxation in Australia* 592.