Schedule 2

Increased access to the small business capital gains tax concessions

Background

3.1 'The small business capital gains tax (CGT) concessions 'were introduced to provide small business operators with access to additional funds for retirement or to grow their businesses'. The concessions include a 15-year exemption; retirement exemption; active assets 50 per cent reduction and small business roll-over.[1]

3.2 The *Tax Laws Amendment (Small Business) Act 2007* introduced a single definition of a small business entity to 'simplify and standardise the various small business concessions'. Generally, a small business has to carry on a business and have a yearly aggregated turnover of less than $2 million. For entities that do not meet these criteria, the Act 'retained the existing alternative eligibility criteria for accessing the small business CGT concessions…but increased the maximum net asset value threshold from $5 million to $6 million'.[2]

3.3 However, the changes affected how the small business entity test and the $6 million net asset value test treated businesses in a situation where one entity owned a CGT asset and did not carry on a business but another entity connected to it used the asset (this is called a 'passive asset structure'). Under the current law, the owner of the asset can access the concessions via the net asset value test in some circumstances but not via the small business entity test because it does not carry on a business.[3]

Purpose

3.4 The proposed amendments of this schedule increase access to the small business CGT concessions for owners of a CGT asset that is used in a business by an affiliate or a connected entity and 'for partners owning a CGT asset used in the partnership business'. It also makes minor amendments 'to clarify and refine elements of the small business CGT concessions'. The changes are outlined in more detail below.

Entities holding passive assets

3.5 The amendments proposed in this schedule enable the owner of the asset to access the small business CGT concessions via the small business entity test under

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1 Explanatory Memorandum, p. 37.

2 Explanatory Memorandum, p. 37.

3 Explanatory Memorandum, p. 38.

certain circumstances.[4] These include that the entity connected to the asset owner and using the asset is a small business entity and its turnover is under $2 million.[5]

Partners in a partnership

3.6 Currently, a partner can access the small business CGT concessions via the small business entity test 'only if the partnership is a small business entity and the relevant CGT asset is "an asset of the partnership"'. If an individual partner owns an asset directly and makes it available for general use in the partnership, the owner is not able to access concessions via the small business entity test.[6] The proposed amendments will provide access to the concessions via the small business entity test.[7]

3.7 Amendments also provide that 'a partner in a partnership could not in their capacity as a partner be a small business entity'. This applies for the small business concessions generally, not just for small business CGT concessions. The legislation will apply retrospectively 'as it aligns the legislation with administrative practice'.[8]

Spouses and children as affiliates

3.8 For the purposes of determining whether the individual owning a CGT asset is eligible for the small business CGT concessions, the current legislation provides an active asset test. A CGT asset is considered active if it is owned by one entity but used in another 'directly carried on by their spouse or child (under 18 years of age)', or if it was used in an affiliate that was operated by an entity owned by the spouse/child. However, 'it may be difficult in practice to establish' the relationship between the two entities.[9]

3.9 Therefore, the proposed amendment treats a spouse or a child as an affiliate, increasing 'access to the concessions…in a wider range of situations'.[10] However, 'for the purposes of the maximum net asset value test, the new rule also reduces access to the concessions by potentially bringing in more affiliates and more entities'.[11]

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4 Explanatory Memorandum, p. 38.

5 Explanatory Memorandum, p. 42.

6 Explanatory Memorandum, p. 38. The partner may be able to access concessions via the maximum net asset value test.

7 Explanatory Memorandum, p. 38.

8 Explanatory Memorandum, p. 69.

9 Explanatory Memorandum, p. 47. The asset is treated as passive if the taxpayer's spouse owns an entity that uses the asset in its business.

10 Explanatory Memorandum, p. 48.

11 Explanatory Memorandum, p. 48.

3.10 The changes apply 'in relation to any capital gain from any CGT asset owned by the individual, an affiliate…or an entity connected with the individual'.[12] However, 'the rule does not apply for the purposes of determining eligibility for the other small business concessions such as the concessional rules for fringe benefits tax and pay as you go instalments'.[13]

Retirement exemption and proceeds received in instalments

3.11 The proposed amendments insert a rule applying the 'retirement exemption to capital proceeds received in instalments by individuals' and removes 'the duplicate provision for receipt of capital proceeds in instalments by companies and trusts'. This is to correct the 'unintended effect' of Schedule 2 to the *Superannuation Legislation Amendment (Simplification) Act 2007*, that removed the rule 'relating to the receipt of capital proceeds in instalments for individuals and introduced a second rule for capital proceeds received in instalments by companies and trusts'.[14]

Retirement exemption—CGT events J5 and J6

3.12 The proposed amendments fulfil the intended effect of the *Tax Laws Amendment (2006 Measures No. 7) Act 2007* in relation to the retirement exemption. The original intention was that the taxpayer could choose to roll over his or her business before acquiring a replacement asset or making an improvement to an existing asset.[15]

3.13 However, at the moment the exemption is not available because the capital gains from J5 and J6 events cannot satisfy some of the basic conditions outlined in the legislation, including an active asset test and the requirement for a CGT event to take place in an income year. The CGT event J5 happens if the replacement or improvement of an asset does not take place within a two-year replacement asset period; J6 happens if the cost of a new asset is less than the amount of the capital gain originally deferred. The amendments ensure that if the gain arises from CGT events J5 and J6, the small business retirement is exempted from satisfying the basic conditions.[16]

3.14 Similarly, while the intention of the Act was to allow indirect ownership to qualify an individual as a CGT concession stakeholder, the payment requirement was not updated to allow indirect payments. The proposed amendments remove that discrepancy.[17]

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12 Explanatory Memorandum, p. 51.

13 Explanatory Memorandum, p. 52.

14 Explanatory Memorandum, p. 65.

15 Explanatory Memorandum, p. 66.

16 Explanatory Memorandum, p. 66.

17 Explanatory Memorandum, p. 67.

3.15 In addition, the proposed legislation excludes small business exemption payments from the 'deemed dividend provisions'—excessive payments by a company to shareholders, directors and associates or tax-free distributions of profits to shareholders or their associates in the form of payments, loans or forgiven debts. The current legislation is 'counter to the policy objective of the exemption, which is to allow small business operators to sell their small business assets and provide for their retirement as their business and its assets may be their sole retirement asset'. The amendments reduce uncertainty and complexity and 'remove any potential conflict between the amendments that treat indirect retirement exemption payments between interposed entities as if they were neither a dividend nor a frankable distribution'.[18]

Other amendments

3.16 The amendments also address situations where an owner of a CGT asset is a partner in more than one partnership and makes their CGT asset available for use in the business of these partnerships. Current legislation does not require partnerships to be connected with the asset owner to access the CGT concessions, making it easier for each partnership to qualify for the small business CGT concessions through either the small business entity test or the maximum net asset value test. The amendments correct this situation by treating each partnership as being connected with the asset owner. As a result, each partnership's annual turnover is required to include the turnover of the other partnership(s).[19]

3.17 The amendments provide access to the small business CGT concessions to an asset owner 'where the CGT event occurs in a year that the business is being wound up' as opposed to the year when the business ceased operating. This is 'only if the asset had been used, held ready for use, or was inherently connected with the business in the income year it ceased to operate'.[20]

3.18 Another amendment provides that the calculation of the net asset value takes into account the 'liabilities relating to disregarded interests in entities connected with the taxpayer or the taxpayer's affiliates'.[21]

3.19 The schedule amends the active asset test to 'ensure that all the uses of an asset [except personal use by the taxpayer or an affiliate] are considered in determining whether it is an active asset for the purpose of the small business CGT concessions'. In order for a taxpayer to qualify for GCT concessions, the CGT asset has to be active. Assets whose main use is to derive rent are not considered as active assets. The focus shifts from the use of an asset in the business to the main use of the asset by the taxpayer. The amendments adopt an attribution approach, treating 'the use

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18 Explanatory Memorandum, p. 68.

19 Explanatory Memorandum, p. 54.

20 Explanatory Memorandum, p. 56.

21 Explanatory Memorandum, p. 60.

of the asset by the affiliate or the entity connected with the taxpayer as though it were the use of the taxpayer'.[22]

3.20 In relation to joint tenants and testamentary trusts, the proposed amendments ensure that the surviving tenant(s) have access to the small business CGT concessions for capital gains relating to assets acquired on the death of a joint tenant and that there is an 'automatic transfer of the asset to the surviving tenant [when he or she] does not continue with the business'.[23]

Financial impact

3.21 The measure is expected to have a minimal to small cost to revenue. The compliance cost impact is expected to be low.[24]

3.22 The Explanatory Memorandum stated that the amendments have been 'actively sought by industry' and will generally be beneficial by increasing access to the small business CGT concessions. However, it also noted that some taxpayers may be disadvantaged by the introduction of the new affiliate rule treating an individual's spouse or child as an affiliate in particular circumstances.[25]

3.23 The amendments apply to CGT events from the 2007–08 income year onwards.[26]

22 Explanatory Memorandum, pp. 60–61.

23 Explanatory Memorandum, p. 64.

24 Explanatory Memorandum, p. 4.

25 Explanatory Memorandum, pp. 69–70.

26 Explanatory Memorandum, pp. 3–4.