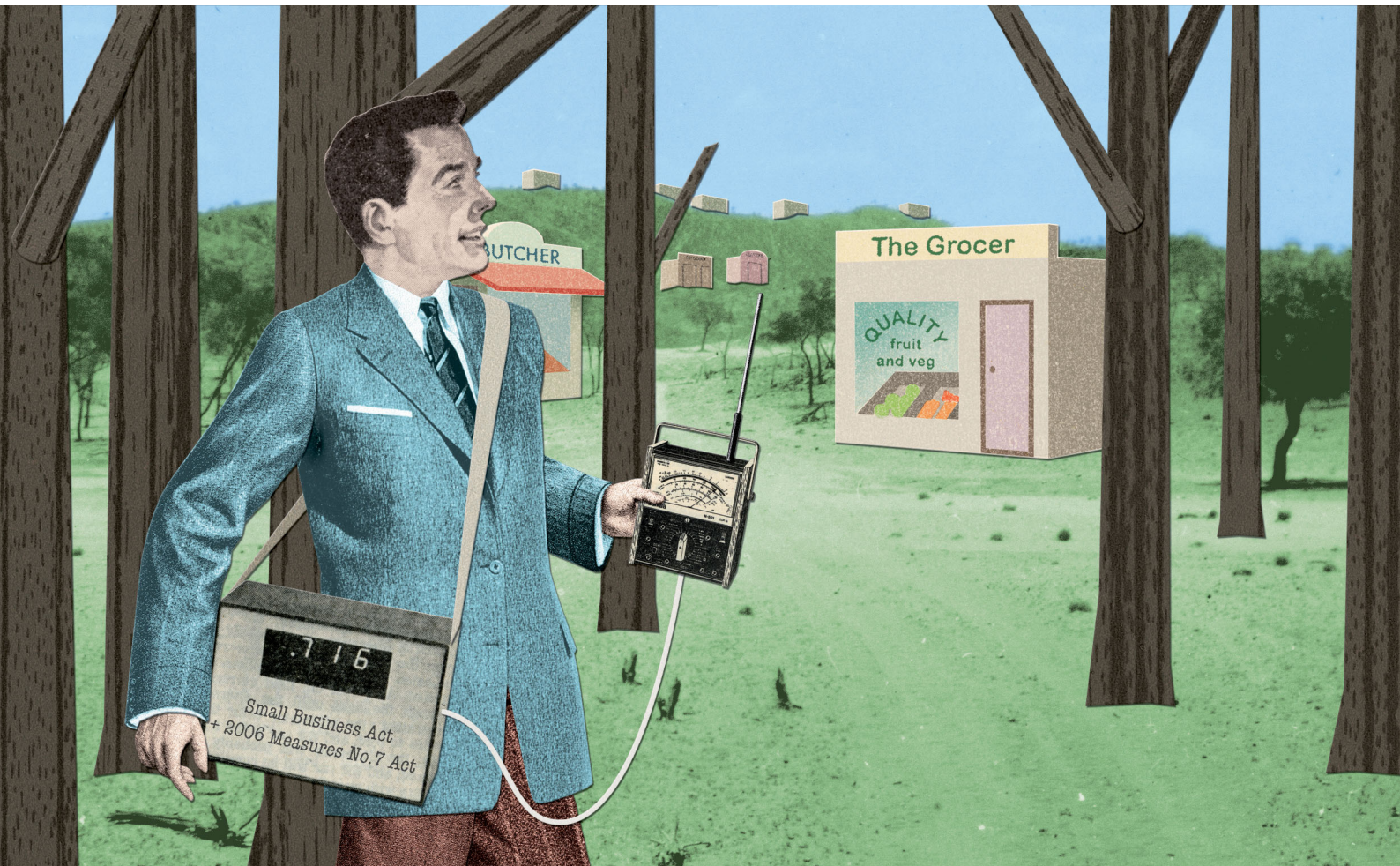


# THE NEW SMALL BUSINESS

# TAX PLAN



By Simon Tisher

# DSCAPE

**T**he small business capital gains tax concessions (small business concessions) have been an integral part of the tax planning landscape for small and medium sized taxpayers since their inception in September 1999. They are contained in Division 152 of the *Income Tax Assessment Act 1997* (Cth) (the 1997 Act). Where applicable, taxpayers may reduce their tax liability on the disposal of certain business assets, or avoid a tax liability altogether.

Two new Acts have altered the operation of the small business concessions significantly. On 12 April 2007 the *Tax Laws Amendment (2006 Measures No 7) Act 2006* (Cth) (*2006 Measures No 7 Act*) received royal assent. The amendments to the small business concessions made by this Act are effective retrospectively from 1 July 2006.

On 21 June 2007 the *Tax Laws Amendment (Small Business) Act 2007* (Cth) (*Small Business Act*) received royal assent. The amendments made to the small business concessions by this Act are effective from 1 July 2007. The amendments made by both Acts are contained in the 1997 Act.

The basis for the amendments made by both Acts was the announcement by the federal government in the 2006/07 federal Budget of its intention to reduce tax complexity for small business and allow more taxpayers to qualify for the small business concessions.

## Two new Acts give small businesses ways of separating the wood from the trees of capital gains tax concessions.

The *Small Business Act* introduced two major changes applicable from 1 July 2007:

- a “small business entity” as defined will be able to access the small business concessions without satisfying certain other requirements; and
- the net asset value test threshold was increased from \$5 million to \$6 million.

The amendments made by the *2006 Measures No 7 Act* were essentially a legislative response to the recommendations made by the Board of Taxation in its review of the small business concessions in November 2004.<sup>1</sup> The key amendments introduced by this Act affect:

- the maximum net asset value test;
- the active asset test;
- the controlling individual (now significant individual) test;
- the small business 15-year exemption; and
- the small business retirement exemption.

The amendments of both Acts remedy many (though not all) of the deficiencies in how the small business concessions operated, create an additional eligibility criterion and permit, in some scenarios, access to the

concessions through multi-tiered structures. For all these reasons, the implications of the changes will be significant and far reaching.

A brief context for the small business concessions will be given followed by a more detailed analysis of the key amendments of both Acts.

### Legislative context

There are four existing small business concessions:

- the small business 15-year exemption – this is a complete exemption essentially applicable where the entity continuously owned the asset the subject of the gain for at least 15 years and the requisite individual was either 55 years or over at the time of the capital gains tax (CGT) event and the event happened in connection with their retirement or was permanently incapacitated at that time;
- small business 50 per cent reduction – this reduces the entity’s capital gain by 50 per cent (unless the entity chooses for it not to apply);<sup>2</sup>

- small business retirement exemption – this allows an entity to choose to disregard a capital gain if the proceeds are used to fund the retirement of a relevant person or in the case of an entity, certain stakeholders in the entity and/or their spouses (lifetime limit of \$500,000 per person). If the recipient of the payment is under 55, the capital gain disregarded must be contributed to a complying superannuation fund within the prescribed time; and
- small business roll-over – this allows an entity to choose to defer a capital gain made on an active (business) asset if the proceeds are used to acquire another active asset within a set time.

Where the 15-year exemption is applicable, no other small business concessions will apply. If the 15-year exemption does not apply, the taxpayer may elect for some or all of the remaining concessions to apply; in many cases, multiple concessions may be applied.

Importantly, the small business concessions may be used in addition to the 50 per cent general CGT discount.<sup>3</sup> However, unlike the small business concessions, the 50 per cent general discount may be available to capital gains on both business and non-business assets.

The small business concessions may be available to individuals, companies or trusts.

Before the recent amendments, there were three basic conditions that a taxpayer had to satisfy to qualify for any of the small business concessions:

- the net value of CGT assets owned by the taxpayer and certain other entities connected or affiliated with the taxpayer just before the CGT event must not have exceeded \$5 million (net asset value test);
- the CGT asset that gave rise to the capital gain must have been an active asset (active asset test). A CGT asset was active if it was owned by the taxpayer and was used or held ready for use in a business carried on by the taxpayer or by certain entities affiliated or connected with the taxpayer.<sup>4</sup> Timing requirements had to be satisfied. Many assets were excluded from qualifying as active assets: ss152-35, 152-40; and
- if the CGT asset was a share in a company or an interest in a trust, the entity was required to have a controlling individual just before the CGT event occurred.<sup>5</sup> The taxpayer that made the capital gain was required to be a CGT concession stakeholder in the company or trust.<sup>6</sup>

The controlling individual test also had to be satisfied where a company or trust

sought to apply the 15-year exemption or retirement exemption or where any entity sought to apply the small business roll-over to a replacement asset that was a share in a company or an interest in the trust.

The basic conditions remain applicable, subject to the amendments discussed below.

### Additional eligibility criterion

From 1 July 2007 a “small business entity” will be able to access the small business concessions: s152-10(1)(c)(i). This is an additional eligibility criterion that should enable more taxpayers to access the small business concessions.<sup>7</sup> If an entity is a small business entity, it will not need to satisfy the net asset value test (although the active asset test and other conditions will still need to be satisfied).

An entity will be a small business entity if it:

- carries on a business in the year the gain is made; and
- satisfies the \$2 million aggregated turnover test: s328-110.

The \$2 million aggregated turnover test will be satisfied if an entity carried on a

some scenarios, access to the small business concessions where the relevant asset is owned by the taxpayer but used in a business by the taxpayer’s affiliate or another entity connected with the taxpayer.

A business that is not a small business entity (as defined) may still access the small business concessions if the net asset value and active asset tests are satisfied.<sup>9</sup>

The *Small Business Act* also contains rewritten definitions of “connected with” and “affiliate” (previously small business CGT affiliate) in the small business entity provisions: ss328-125, 328-130. It is not the purpose of this article to discuss the new definitions other than to note that care should be taken since they differ in some respects from their predecessors.

### Amendments to the net asset value test

Important changes to the net asset value test have been made by both the *Small Business Act* and the *2006 Measures No 7 Act*. Foremost is that the net asset value test has been increased to \$6 million (from \$5 million) for CGT events occurring on or after 1 July 2007: s152-15.

**THE SMALL BUSINESS CONCESSIONS MAY BE AVAILABLE TO INDIVIDUALS, COMPANIES OR TRUSTS.**

business for the previous income year and its aggregated turnover for that year was less than \$2 million or if an entity’s aggregated turnover for the year the gain was made is likely to be less than \$2 million. A calculation of aggregated turnover for a current income year may be made either as at the first day or at the end of the relevant income year or, if a business started during the year, the commencement date of the business: s328-110.

The term “aggregated turnover” is essentially an entity’s annual turnover, being ordinary income derived in the ordinary course of carrying on a business for the income year: ss328-115, 328-120. Certain amounts, including GST and capital gains are excluded. The annual turnover of certain entities affiliated or connected with the entity are included in the \$2 million aggregated turnover test.

Note that the law requires the small business entity to both own the relevant asset and carry on a business.<sup>8</sup> This differs from the net asset value test which permits, in

Certain assets have always been excluded from the net asset value calculation. With effect from 1 July 2006, the net value of CGT assets is to be reduced by any provisions for annual leave, long service leave, unearned income and tax liabilities made by the entity: s152-20(1). Further, negative asset values will be taken into account in calculating the net value of CGT assets. For example, an individual with CGT assets of \$1 million and liabilities of \$1.5 million relating to those assets would have a negative net asset value of \$500,000. If a company connected with (as defined in s328-125 of the 1997 Act) the individual has a net value of CGT assets of \$2 million, the individual’s net value of CGT assets will be \$1.5 million.

Other amendments affect how a dwelling owned by an individual taxpayer is treated for the purposes of the net asset value test. Further, with effect from 1 July 2006, the net asset value test is to be applied to each partner’s individual interest in the assets of the partnership (and not the assets of the partnership as a whole).<sup>10</sup>

## Active asset test

The active asset test contains certain timing rules that must be satisfied. Before the recent amendments, the active asset test required the asset to be active *just before* the earlier of the CGT event or, if the cessation of the business occurred within the 12 months before the CGT event occurring, the cessation of the business.<sup>11</sup> This requirement resulted in the small business concessions unintentionally being denied in some cases such as where an asset ceased being active in a continuing business before the sale of the asset.

With effect from 1 July 2006, new timing rules no longer require the asset to be active just before either the CGT event or the cessation of the business. Instead, the asset must be active for at least half the period of ownership (at least 7½ years if the asset was owned for more than 15 years), commencing when the asset was acquired and ending at the earlier of the CGT event and the cessation of the business.<sup>12</sup>

Shares or units in resident Australian companies or trusts can be active assets. The requirements that must be met for this

to occur are contained in ss152-40(3), (3A), (3B) and (4) of the 1997 Act and are beyond the scope of this article. It should be noted that the *2006 Measures No 7 Act* introduced changes that will enable shares and units to satisfy the active asset test more easily.

## Significant individual 20 per cent test

The *2006 Measures No 7 Act* introduced significant (and largely positive) changes to the small business concessions where shares or units are sold in a company or trust that carries on a business.

From 1 July 2006, an individual selling shares or units in a company or trust that carries on a business will be required to satisfy the CGT concession stakeholder test instead of the controlling individual test to access the small business concessions: s152-10(2)(a). The CGT concession stakeholder test will be satisfied where the individual is a significant individual or a spouse of a significant individual in the object entity provided the spouse has an entitlement to at least some of the voting power, dividends

or capital distributions that the company or trust may make: s152-60.

The significant individual 20 per cent test replaces the more onerous controlling individual 50 per cent test. An individual will be a significant individual if he or she has a "small business participation percentage" in the company or trust of at least 20 per cent: s152-55. This is the percentage of voting power, dividend payments and capital distributions the entity is entitled to exercise or receive, directly or indirectly: ss152-65, 152-70.<sup>13</sup>

The calculation of an entity's small business participation percentage includes an entity's direct and indirect small business participation percentage for interests held through interposed entities. The legislation sets out how this is done: ss152-65, 152-70, 152-75. An entity's indirect small business participation percentage in an object company or trust is calculated by multiplying the entity's direct small business participation percentage in an interposed entity by the sum of the interposed entity's direct (and indirect) small business participation percentage in the object company or trust.<sup>14</sup>

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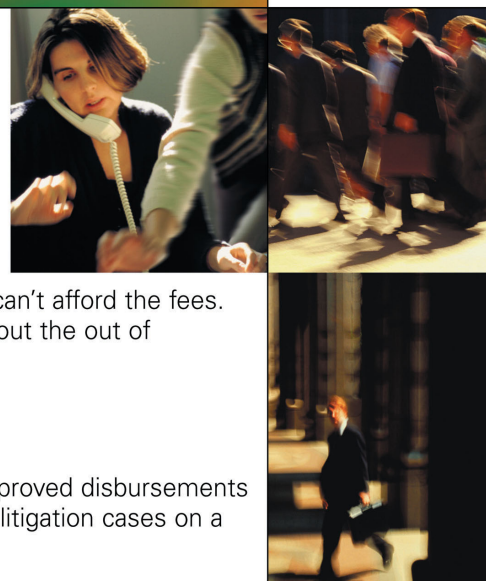
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## PREVIOUSLY, THE INABILITY OF MULTI-TIERED STRUCTURES TO ACCESS THE SMALL BUSINESS CONCESSIONS WAS A MAJOR RESTRICTION IN SMALL BUSINESS STRUCTURING.

In some situations, the law now permits an interposed entity access to the small business concessions where it sells shares or units in the object company or trust. In addition to the object entity satisfying the CGT concession stakeholder test described above, CGT concession stakeholders in the object entity must have a small business participation percentage of at least 90 per cent in the interposed entity (90 per cent test): s152-10(2)(b). For example, John owns 90 per cent of the shares in company A. Company A owns 50 per cent of the shares in company B. Company A sells its shares in company B. The CGT concession stakeholder test is satisfied as John has a small business percentage of at least 20 per cent (90% x 50% = 45%). Further, the 90 per cent test is satisfied as John owns 90 per cent of the shares in the interposed entity, company A.

The implications of these changes are significant. The requirement of a 20 per cent rather than 50 per cent stake will enable a greater number of stakeholders (up to eight) to access the small business concessions on disposing of their shares or units.<sup>15</sup> Before the changes, it had been considered unfair by many to restrict access to the small business concessions to two individual stakeholders (50 per cent each) where those stakeholders sought to sell their shares or units. The benefits of the required 20 per cent stake for the significant individual test will flow through to the retirement exemption and the 15-year exemption. In the case of the

retirement exemption, up to eight stakeholders in a company or trust will now each be able to benefit from the \$500,000 lifetime limit, as opposed to two.<sup>16</sup> This could result in the entity disregarding a capital gain of up to \$4 million.

The changes discussed above permit, in limited circumstances, access to the small business concessions through multi-tiered structures. They do this in that they permit, in some scenarios:

- an individual to access the small business concessions by having a minimum 20 per cent stake in a company or trust that conducts a business either directly or indirectly through another entity; and
- an interposed entity to access the small business concessions on the disposal of its shares or units in an entity that conducts a small business.

Previously, the inability of multi-tiered structures to access the small business concessions was a major restriction in small business structuring.

### Amendments to the 15-year exemption

Where an individual sells a share in a company or an interest in a trust and seeks to apply the 15-year exemption or the 15-year exemption is sought by a company or trust, it is now a requirement (as of 1 July 2006) that the company or trust have a significant individual for a total of at least 15 years. The 15 years for which the company or trust must

have a significant individual need not be continuous and may comprise several periods totalling 15 years: s152-105(c), 152-110(1)(c). This replaces the rule that the company or trust must have a controlling individual for the whole period of ownership.

### Amendments to the small business retirement exemption

The law relating to the retirement exemption was amended by the *2006 Measures No 7 Act* and subsequently by the *Superannuation Legislation Amendment (Simplification) Act 2007*.

Among other things, the amendments removed any reference to "eligible termination payment" from the retirement exemption provisions. This confirms the intention that it is not necessary for the relevant person to actually retire to access the retirement exemption. Note, however, that a payment made by a company or trust to a person who is an employee of that entity will not qualify for the retirement exemption if it is considered a deemed dividend pursuant to s109 of the *Income Tax Assessment Act 1936*: s152-325(9).<sup>17</sup>

The amendments to the retirement exemption should be viewed as part of the wider simplified superannuation package of reforms introduced recently by the government.

There are other amendments to the retirement exemption that warrant a brief mention. As of 1 July 2006, the retirement exemption applies to gifts of property in some circumstances.<sup>18</sup> The amendments also clarify that the retirement exemption can be available to capital gains that were previously deferred because of the small business roll-over.

### Conclusion

The amendments remedy many (though not all) of the deficiencies in the law containing the small business concessions. The addi-



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tional eligibility criterion will improve access to the concessions to taxpayers who are asset rich but cash flow poor. The removal of the restrictive controlling individual test and the introduction of the significant individual test, with its lower minimum threshold of 20 per cent, will greatly improve access to the small business concessions to taxpayers selling shares or units. Further, the ability of stakeholders to access the small business concessions where their interests in an object entity are held via an interposed entity is a long-awaited legislative overhaul. So too is the limited ability of interposed entities to sell shares or units in the object entity and access the small business concessions.

Ultimately, the magnitude of the changes has created a different small business tax landscape. That landscape may again be the subject of change in the future. Before the 2007 federal election, the Howard government announced that it would introduce amendments to further improve access to the small business concessions for small business entities and partnerships. Whether such improvements are enacted by the new Labor government remains to be seen. ●

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1. The Board of Taxation made 39 recommendations intended to clarify certain aspects of the small business concessions and achieve greater consistency and certainty of their operation. All but one of the recommendations was the subject of a legislative response.
2. The benefits of a company or fixed trust applying the small business reduction are lost or reduced if the tax sheltered amount is paid as an unfranked dividend to shareholders or paid to unitholders.
3. See Division 115 of the 1997 Act. Note that the 50 per cent general discount will not be available to companies (unless they act solely as trustee of a trust).
4. If the asset is an intangible, it was sufficient if it was inherently connected with a business carried on by the taxpayer or by certain entities affiliated or connected with the taxpayer.
5. An individual was required to have a stake of at least 50 per cent in the entity to be a controlling individual.
6. A CGT concession stakeholder was defined as a controlling individual, or their spouse, provided the spouse owned any shares or had a beneficial entitlement to any of the trust income or capital or in the case of a discretionary trust, was beneficially entitled to a distribution of any of the trust income or capital in the year the gain was made.
7. Note that the *Small Business Act* amendments introduced new uniform eligibility criteria that apply across a range of small business tax concessions (not just the CGT small business concessions).
8. This requirement may be the subject of future legislative amendment. Just before the 2007 federal election, the Howard government announced that it would introduce amendments that would allow in some scenarios, a small business entity taxpayer

- who owns a CGT asset that is used in a business by an affiliate or a connected entity of the taxpayer access to the small business concessions. The position of the Labor government on this issue has not been stated. No legislation had been introduced at the time of writing.
9. A further basic condition must be satisfied if the CGT asset is a share or unit regardless of whether the entity is a small business entity: s152-10(2) of the 1997 Act.
  10. This is achieved by repealing former s152-15(2) of the 1997 Act.
  11. The Commissioner had a discretion to extend the time.
  12. Provided the cessation of the business is within 12 months of the CGT event occurring or such longer period that the Commissioner allows: s152-35 of the 1997 Act.
  13. If the percentages differ, the smallest is taken to be the entity's direct small business participation percentage.
  14. If there is more than one interposed entity, the holding entity will be required to calculate its small business participation percentage in respect of each interposed entity.
  15. This is calculated by taking four significant individuals with a 20 per cent stake each plus each of their spouses as concession stakeholders (provided they each own some shares in the entity).
  16. See Subdivision 152-D of the 1997 Act for other rules applicable to the retirement exemption.
  17. Where a payment is made by a company or trust to an employee of that entity, the payment is deemed to be in consequence of the termination of the employment to ensure that the payment is subject to s109 of the *Income Tax Assessment Act 1936*.
  18. If no capital proceeds are received, the market value substitution rules will apply to determine the amount of deemed capital proceeds. See Subdivision 152-D of the 1997 Act for other rules applicable to the retirement exemption.



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