The Tax Summit

Session 5.1: Small business CGT concessions – Accessing the proceeds from a company

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1. Introduction

A taxpayer that qualifies for the small business CGT concessions in Div 152 is a fortunate taxpayer indeed. The concessions are extraordinarily generous for those who can access them. However, where the taxpayer concerned is a company the concessions may well come with thorns.

As we know a company is a separate legal and taxpaying entity, distinct from its shareholders. A company is required to pay tax on its taxable income, and its shareholders are taxed on distributions made to them (subject to a credit for tax paid by the company). This is to be contrasted with trusts and partnerships, neither of which are separate taxpayers. Rather, in both cases, income is essentially traced through the 'entity' to its beneficiaries or partners respectively. In this way (broadly speaking) the tax attributes of trust or partnership income, including the benefit of the small business CGT concessions, 'flows through' to the members thereof.

As a result, unlike for trusts and partnerships, the benefit of the small business CGT concessions when derived by a company do not of themselves flow through to shareholders. The purpose of this paper is to explore what mechanisms there are available to get a capital gain made by a company, to which the small business CGT concessions have been applied, out to shareholders tax effectively. In particular:

- liquidating the company in order to get the small business active asset 50% reduction out tax effectively;
- using the 'two year rule' in s 152-125 to liberate a gain exempted by the 15 year exemption; and
- the requirement to make a payment of the CGT exempt amount to CGT concession stakeholders of the company to access the retirement exemption.

We will also touch on whether a gain deferred by a company using the small business CGT rollover escapes tax if distributed by a liquidator as part of winding up the company before a replacement asset has been acquired and prior to the replacement asset period ending.

2. By way of background

Division 152 of the ITAA 1997 contains CGT concessions that are available to entities that are, in broad terms, considered small businesses. These concessions enable a capital gain that arises from a CGT event to be disregarded entirely, reduced or deferred provided certain conditions are satisfied.

The four available small business CGT concessions are:

- the 15-year exemption (Subdivision 152-B);
- the small business 50 percent reduction (Subdivision 152-C);
- the retirement exemption (Subdivision 152-D); and
- the small business roll-over (Subdivision 152-E).

The basic conditions contained in Subdivision 152-A must be satisfied in order for any of these concessions to be available. The taxpayer may also need to satisfy additional requirements to qualify for a specific concession. Any additional requirements are codified within the relevant Subdivision.

The basic conditions are as follows:

- A CGT event must happen in relation to an asset the taxpayer owns.
- The event would otherwise have resulted in a capital gain.
- At least one of the following applies:
    - the taxpayer is a **small business entity** for the income year;
    - the taxpayer satisfies the **maximum net asset value test**; or
    - the taxpayer is a partner in a partnership that is a small business entity and the asset is an interest in an asset of the partnership.
- The CGT asset satisfies the **active asset** test.

If the asset is a share in a company or an interest in a trust, a number of additional conditions must be satisfied.

2.1 Applying the small business concessions in a company - Basic illustration

John and Stephen are unrelated individuals who operate a business through a company, which they own equally. The company makes a capital gain of $1 million on sale of internally generated goodwill.

The company is eligible for the small business concessions and applies them as follows:

Capital gain	**$1 million**
Small business 50% reduction (Subdiv 152-C)	($500,000)
Retirement exemption (Subdiv 152-D)	($500,000)*
Net capital gain	**Nil**

** If the company chooses to apply the retirement exemption, it must make payments to John and Stephen[1] totalling $500,000 (notwithstanding that they each have a lifetime limit of $500,000) [2]. The company can choose the amount of the payment it makes to each of John and Stephen (provided they total $500,000) – there is no requirement that the payments be equal in accordance with John and Stephen's equal shareholding. If John and/or Stephen are under 55 just before the time of payment the company must contribute the amount directly to a complying superannuation fund or RSA. Additionally, the company or trust must notify the trustee of the fund or RSA at the time of the contribution is made.*

Alternative 1

If the company declares a dividend to John and Stephen consisting of the proceeds from the sale of its goodwill remaining after payments to superannuation funds ($500,000), each will be required to include a dividend of $250,000 in their assessable income. This dividend will likely be unfranked (given that the company included none of the capital gain in its assessable income).

Alternative 2

Alternatively, John and Stephen could wind up the company and arrange for it to distribute the proceeds from the sale of its goodwill remaining after payments to superannuation funds ($500,000) as a liquidator's distribution. In that case, John and Stephen will each receive $250,000, which will be assessed as follows:

Assessable amount of liquidator's distribution	**Nil***
Capital proceeds for CGT event C2	$250,000
Capital gain	$250,000**
50% CGT discount	($125,000)
Small business 50% reduction	($62,500)
Retirement exemption	($62,500)***
Net capital gain	Nil

** The component of a liquidator's distribution represented by the small business 50% reduction is not assessable as a dividend in accordance with the method statement in s.47(1A)(b) ITAA 1936 (refer below for more information).*

*** This assumes, for ease of illustration, that the shares have a nil cost base.*

[1] John and Stephen are both CGT concession stakeholders in the company because they each hold shares which entitle them to at least 20% of dividends, capital distributions and voting.
[2] Unless capital proceeds are less than $500,000, in which case payments to John and Stephen must total that amount.

**** If John and/or Stephen are under 55 just before they make the choice to use the retirement exemption they must contribute $62,500 to a complying superannuation fund or a retirement savings account.*

3. Preserving the small business 50% reduction when used by a company

As the 'low-hanging fruit' in the suite of small business CGT concessions, and therefore the most commonly used, it is perhaps ironic that the 50 percent small business reduction in Div 152-C, unlike its cousins the 15-year and retirement exemptions, does not have a built in mechanism for extracting the benefits of the exemption from a company.

We will explore two of the mechanisms available for a company that has applied the small business CGT reduction to reduce a capital gain to distribute the underlying proceeds, one likely more attractive than the other.

3.1 Pay a dividend

Dividends paid to shareholders by a company out of profits are assessable income to shareholders (s 44 ITAA 1936).

An important question when it comes to distributing profits to shareholders by way of dividend is whether, and to what extent that dividend can be franked. Accessing company funds via franked dividend can be reasonably tax effective, especially where dividends can be declared in accordance with the shareholder(s)' tax profile e.g. in years where the shareholder can claim deductions for superannuation contributions, or where their marginal rate of tax is less than the relevant corporate tax rate. This is especially the case given that excess franking credits are refundable.

However, that part of the dividend represented by the 50% small business CGT reduction may give rise to an unfranked dividend. In other words, the benefit of the small business reduction in a company is potentially 'washed out' or lost when the amount is distributed to shareholders via the 'normal' dividend route.

3.2 Liquidate the company

The income tax consequences of a company distributing an amount to shareholders upon liquidation, are two-fold:

- distributions to shareholders of a company by a liquidator in the course of winding up the company are **deemed dividends** and therefore included in the assessable income of shareholders; and
- **CGT event C2** happens when shares in the company are cancelled upon deregistration .

3.2.1 Deemed dividends

Distributions to shareholders by a liquidator in the course of winding up a company are deemed dividends to the extent they represent income derived by the company (other than income which has been properly applied to replace a loss of paid-up share capital) (s 47 ITAA 136). Income derived for these purposes includes:

- income according to common law principles, even if it is exempt for income tax purposes;
- other amounts included in the company's assessable income for the year (other than net capital gains, which are dealt with below) i.e. non-CGT statutory income; and

- any net capital gain of the company (which by definition does not include capital gains that have been disregarded), **determined without regard to indexation, and disregarding any capital losses**.

A deemed liquidator's dividend is a frankable distribution (s 202-40 ITAA 1997).

Income includes *net capital gains* of the company 'determined *without regard to indexation* and *disregarding any capital losses*'

Generally speaking, the tax treatment of a liquidator's distribution is more favourable than that of a 'normal' dividend. That is because distributions of non-assessable capital profits by way of liquidator's distribution are not included in assessable income, whereas the entire amount of a 'normal' dividend is included in assessable income regardless of whether it consists of non-assessable capital profits. In particular, as the small business 50 percent reduction does not form part of a net capital gain (and is not otherwise included in the section 47 calculation) it can be distributed to shareholders by a liquidator in the course of winding up the company without it being included in their assessable income. However, there is a catch (see below under heading 3.2.2)!

Moreover, the net capital gain of a company for the purposes of determining income derived by the company under s 47 may well be quite different to the company's net capital gain determined in accordance with the 'ordinary' net capital gain method statement in s 102-10. In particular:

- cost bases cannot be indexed; and
- capital losses cannot be subtracted from capital gains.

Include in s 47 net CG calculation	Do not include in s 47 net CG calculation
Post-CGT gains* ** reduced by the small business CGT reduction if applicable*	Pre-CGT gains
	Component of post-CGT gains represented by the small business CGT reduction ('disregarded capital gain')
	Capital losses
	Indexed cost base

Illustration					
Asset	**Cost base**	**Capital proceeds**	**Capital gain/loss**	**Div 152 reduction**	**Capital gain/loss (after reductions)**
A	$20,000	$30,000	$10,000	($5,000)	$5,000
B	$75,000	$65,000	($10,000)	-	($10,000)

Illustration					
C	$12,000	$15,000	$3,000	Not available (active asset test not satisfied)	$3,000
		Accounting	**$3,000**	**Net capital gain/loss (‘ordinary rules’)**	**($2,000)**
				Net capital gains (s 47)	**$8,000**

Ensuring that the small business 50 percent reduction retains its tax-free character - The *Archer Bros* principle

The Commissioner takes the view that (based on the High Court judgement in *Archer Bros Pty Ltd (In Vol Liq) v. FCT* (1952-53) 90 CLR 140), if a liquidator sources a particular fund of profit or income in making a distribution (or part of a distribution), that source ordinarily determines the character of the distributed amount for the purposes of s 47. This is commonly known as the ‘Archer Bros principle’.

The Commissioner considers that the Archer Brothers principle applies if:

- the company accounts have been kept so that a liquidator can clearly identify a specific profit or fund in making a distribution; and
- it is clear from either the accounts or statement of distribution that the liquidator has appropriated the specific profit or fund in making the distribution.

(TD 95/10)

Planning point: During the life of the company (or by way of reconstruction from historical records), company accounts should be kept in such a way that a liquidator can clearly identify a specific profit or fund in making a distribution. While there is no prescriptive requirement to keep separate accounts it might be prudent to set up some or all of the following reserves in the accounts:

- capital gains reserve;
- capital losses reserve;
- reserve for that part of a capital gain subject to the small business CGT reduction;
- pre-CGT capital gains.

Note that, as outlined by the Commissioner in TD 2000/5, if a liquidator makes a distribution in accordance with the Archer Brothers principle, s 47 cannot operate to deem any more than the amount actually distributed to be a dividend. This might be an issue where capital losses have resulted in the company having distributable funds less than the net capital gain calculated for the purposes of s 47. This is demonstrated in the following illustration.[3]

[3] Taken from *Liquidations - Income Tax Issues* (2002) 5(2) Journal of Australian Taxation 149

Illustration

Detail	DR $	CR $
Balance Sheet		
Cash on Hand	50,000.00	
Issued Capital		20,000.00
Pre-CGT Reserve		10,000.00
Post CGT Reserve		130,000.00
Post CGT Reserve - Capital Losses		(125,000.00)
Retained Earnings		15,000.00
Section 47(1) calculation		
Retained Earnings		15,000.00
Post-CGT Reserves		130,000.00
Total		**145,000.00**

Based upon the distributable funds in the balance sheet ($50,000), and assuming the Archer Bros Principle, the Liquidator may choose to source his distribution from:

Issued Capital	20,000.00
Pre- CGT Reserve	10,000.00
Retained earnings	20,000.00
Total distribution	**50,000.00**

Despite the s 47 calculation being $145,000, the Archer Bros principle results in only $20,000 of the distribution being sourced from income derived by the company. It follows that only $20,000 will be assessed to shareholders as liquidator's distributions.

3.2.2 CGT event C2 upon cancellation of shares

CGT event C2 happens to the shares in a company when the company ceases to exist in accordance with the *Corporations Act* 2001 upon winding up (TD 2000/7). According to the Commissioner, the full amount of a final distribution made by a liquidator on the winding-up of a company constitutes capital proceeds from the ending of the shareholder's shares in the company for the purposes of capital gains or capital losses made on the happening of CGT event C2 (TD 2001/27). Of course, where the shares are pre-CGT[4] any capital gain or loss arising from CGT event C2 will be disregarded.

However, it is important to note that s 118-20, which reduces a capital gain where the amount is otherwise assessable, ensures that no part of the final liquidator's distribution is taxed both as a dividend and as a capital gain (TD 2001/27).[5]

[4] Note that, while CGT event K6 (which can result in capital gains if certain CGT events happen to pre-CGT shares in a 'private' company where the market value of the post-CGT property of the company is at least 75% of its net value) can theoretically happen when a pre-CGT company is liquidated, it is unlikely to give rise to a capital gain because there will be no post-CGT property in the company when the shares are finally cancelled (the final liquidator's distribution having happened some time before that) (TR 2004/18 paragraph 48).

[5] Where the shareholder has sufficient cost base in their shares to result in a capital loss arising from CGT event C2 happening upon cancellation of their shares s 118-20 does not work to increase that loss. In that way double tax will arguably result.

Also important is, as the entire liquidator's distribution forms the capital proceeds for CGT event C2, the amount represented by the small business 50% reduction contributes to the gain made under that CGT event when the shareholder's shares are cancelled, notwithstanding that it does not count towards the assessable amount of the liquidator's distribution. However, 're-application' of the small business 50% CGT reduction to this gain at shareholder level effectively preserves the benefit of the concession. (Also note the potential availability of the CGT discount at shareholder level.)

<table>
<tr><th colspan="2">Illustration</th></tr>
<tr><td colspan="2">Bill is the sole shareholder in ABC Pty Ltd, which was incorporated in 2003. He has a cost base in his shares of $1,000.

Bill has decided to arrange for the company to sell its assets (all of which are on capital account) at a time when their market value is $2 million, followed by liquidation of the company. The cost base of those assets at that time was $1 million. The company therefore makes a capital gain of $1 million, which was reduced by the small business CGT reduction.

Assume purchase of the assets was funded with borrowings, which are repaid out of the proceeds of sale. That is, ABC Pty Ltd has cash on hand representing paid up capital of $1,000 in addition to the proceeds of $2 million less repayment of $1 million.</td></tr>
<tr><td>Capital proceeds</td><td>$2,000,000</td></tr>
<tr><td>Less cost base</td><td>($1,000,000)</td></tr>
<tr><td>Capital gain</td><td>$1,000,000</td></tr>
<tr><td>Less small business 50% reduction</td><td>($500,000)</td></tr>
<tr><td>Ultimate gain</td><td>$500,000</td></tr>
<tr><td colspan="2">Bill receives a liquidator's distribution of $851,000 (being $1,000,000 less tax paid on $500,000 of $150,000 in addition to the paid up capital).</td></tr>
<tr><td>Paid up share capital</td><td>$1,000</td></tr>
<tr><td>Capital gain (after tax)</td><td>$850,000</td></tr>
<tr><td>Distributable funds</td><td>$851,000</td></tr>
</table>

Illustration	
Less return of share capital	($1,000)
Less that part of the company's capital gain subject to the small business CGT reduction	($500,000)
Assessable s 47 distribution	**$350,000**[6]
CGT event C2 will happen to Bill's shares when they are cancelled.	
Capital proceeds	$851,000
Less cost base	($1,000)
Capital gain	$850,000
Less s 118-20 reduction	($350,000)
Less general 50% discount	($250,000)
Less 50 percent reduction	($125,000)
Ultimate gain	**$125,000**

The following illustration demonstrates the same concepts from an accounting point of view.

Illustration
Regional Tax Advisory Network Pty Ltd (RTAN) has three equal shareholders. Together the shareholders' have an indexed cost base in their shares of $190,000. In the 2023 income year RTAN sells a post-CGT asset for $500,000. It purchased the asset prior to 21 September 1999 for $100,000. Its indexed cost base in the asset is $190,000. It follows that RTAN makes an accounting profit of $400,000 but a capital gain (before concessions) of $310,000. However, as RTAN is eligible for the small business CGT concessions it can reduce that gain by 50 percent to $155,000. It pays income tax on that gain of $38,750 (assume a corporate tax rate of 25 percent). Subsequent to the asset sale the after tax proceeds are distributed as a final liquidator's distribution.

[6] This assumes that, in accordance with the Archer Bros principle (discussed above), the liquidator has sourced $500,000 of the distribution from that part of capital gains subject to the small business CGT reduction. If this were not done (say because the company accounts were kept in such a way that the liquidator could not clearly identify a specific profit or fund) the assessable s 47 distribution would be $500,000 and Bill's ultimate capital gain would be $87,500 (being $850,000 less $500,000, subsequently reduced by the CGT discount and the small business CGT reduction).

Illustration (cont.)

How much of the distribution is deemed to be a dividend in pursuance of s.47(1) ITAA36?

Detail	DR $	CR $
Transactions/Journals		
1. Share subscription		
Cash on Hand	100,000.00	
Issued Capital		100,000.00
2. CGT Asset Acquisition		
Goodwill	100,000.00	
Cash on Hand		100,000.00
3. Asset Sale		
Cash on Hand	500,000.00	
Goodwill		100,000.00
Profit on Sale of NCA		400,000.00
4. Tax Payment		
Provision for Taxation	38,750.00	
Cash on Hand		38,750.00
Balance Sheet		
Cash on Hand	461,250.00	
Issued Capital		100,000.00
Retained Earnings		361,250.00

Tax Reconciliation	Total $
Profit/(Loss) per Trial Balance	400,000.00
Less: Accounting Profit on Sale of NCA	(400,000.00)
Add: Taxable Profit on Sale of NCA	155,000.00
Taxable Income	155,000.00
Tax on Taxable Income - 25%	**38,750.00**

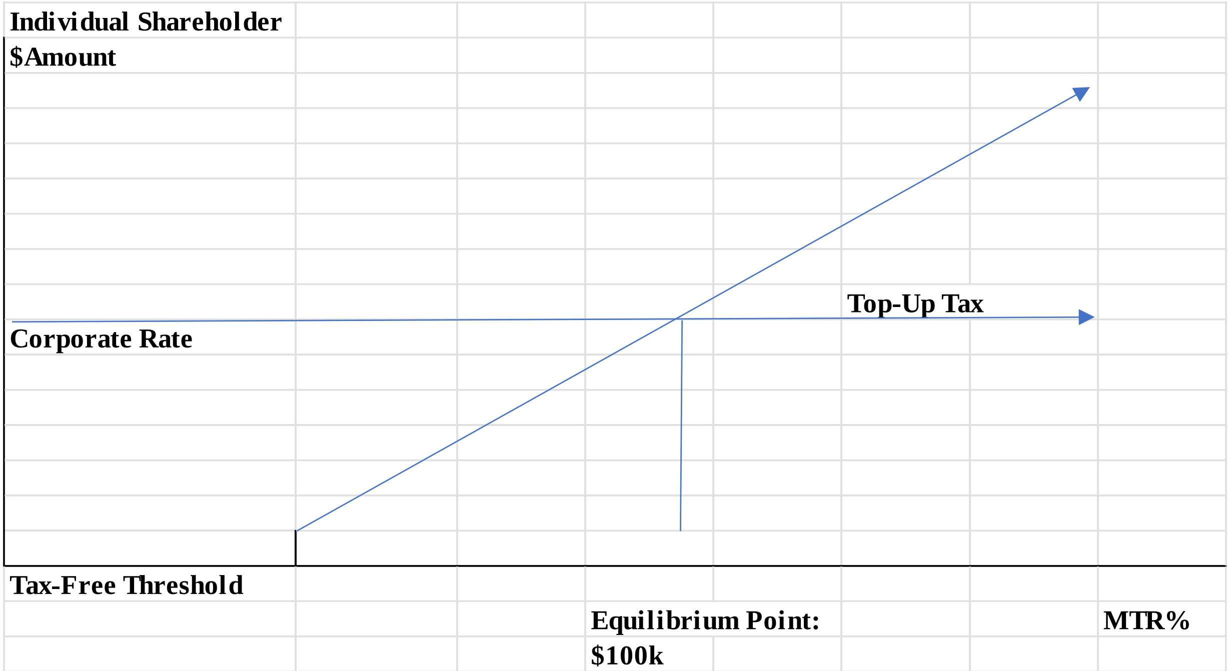
What are the CGT consequences for all shareholders?

Liquidator Distribution	**ITAA 1936**	**ITAA 1997**		
Proceeds Available for Distribution			461,250.00	
Issued Capital			(100,000.00)	
Sheltered Capital Gain	47(1A)		(200,000.00)	
Dividend Amount	47(1A)		**161,250.00**	
Ability to Frank - 75/25			116,250.00	
Shareholder - Dividend				
- FF Dividend	44(1)		116,250.00	
- U/F Dividend	44(1)		45,000.00	
Total			**161,250.00**	
Shareholder - CGT Event C2			**Co.**	**Individual**
Total Proceeds			461,250.00	461,250.00
Share - Cost Base			(190,000.00)	(100,000.00)
Net Nominal Current Year Capital Gain			271,250.00	361,250.00
Less: Dividend		118-20	(161,250.00)	(161,250.00)
Capital Gain			**110,000.00**	**200,000.00**
Less: General Discount		Subdiv. 115-A	N/A	(100,000.00)
Taxable Capital Gain			**110,000.00**	**100,000.00**

3.2.3 Where does all this leave us?

The ability of a liquidator to choose the source from which distributed funds are made must be finely balanced when taking account of the ultimate shareholder's tax position. The advantage of limiting shareholder tax incidence in respect of dividend distributions may wash out CGT preferences in respect of non-assessable amounts in favour of the company. In addition, franking credits may be wasted where the company's franking account balance exceeds the distributed dividend amount.

Shareholders adversely affected by a liquidator's choice to prioritise the return of non-assessable amounts ahead of assessable dividends will be those with marginal tax rates below that of the corporate rate, namely those shareholders with taxable income below approximately $100,000. Conversely, it could be those same shareholders that have access to CGT preferences on the ending of their shares.



3.2.4 Liquidator Distributions In Specie

What about a liquidator's distribution in specie?

An in specie liquidator's distribution, similar to a cash distribution, may constitute a deemed dividend under s.47 for the purposes of s 44 of the ITAA 36 and accordingly will be included in the assessable income of the shareholder. Similar to the cash dividend component of a liquidator's distribution, an in specie distribution is frankable as it is not excluded by s 202-45, which specifies what are unfrankable distributions.

However, the making of an in specie liquidators' distribution will trigger CGT event A1, capital proceeds will equate to the market value of the asset at the time of the distribution in pursuance of the market value substitution rule in s. 116-30, and the liquidator will be required to provide for any company tax resulting from an assessable capital gain.

So, what is the potential problem here – timing and availability of franking credits. In accordance with s 205-15, a franking credit is available only at the time company tax is paid, until this time, there may be insufficient credits in the company's franking account to frank the in specie distribution at the time it is made. Franking credits relating to the in specie distribution may therefore be lost as they will likely arise after the liquidator has exhausted all funds available for distribution as dividends. The corollary is that the franking credits will be wasted as there will be no dividends to which they can be attached.

4. Liberating the 15 year exemption amount from a company

The 15-year exemption provides for a full exemption of a capital gain where a company taxpayer has owned the CGT asset for at least 15 years and a significant individual of the company is 55 years old and retiring, or permanently incapacitated. A company may disregard a capital gain in its entirety by applying the 15-year exemption (s 152-105, s 152-110). There is no limit on the amount of the gain that can be disregarded under this concession.

In addition to satisfying the basic conditions, a company seeking to access the 15 year exemption must:

- have owned the CGT asset continuously for at least 15 years (s 152-105(b)), s 152-10(1)(b));
- have had a significant individual for at least 15 years during which the company owned the CGT asset (s 152-110). The significant individual does not have to be the same person at all times during the 15 years (s 152-110(1)(c));
- an individual who was a significant individual in the company just before the CGT event must be:
  - over 55 at the time of the CGT event and the event happens in connection with the individual's retirement; or
  - permanently incapacitated at the time of the CGT event (s 152-110(1)(d)).

If a capital gain made by a company is disregarded under the 15-year exemption, any payment (in relation to the exempt amount) that the company makes to a CGT concession stakeholder is disregarded in determining the taxable income of the company, the individual and/or any interposed entities, provided the payment is made within two years of the CGT event (s 152-125). Additionally, if a company makes such a payment, the payment is not taken to be either of a dividend or a frankable distribution (s 152-125(3)). Importantly, the amount of the payment which can be disregarded is limited to the stakeholder's percentage interest in the company.

It follows that there is a built in mechanism within the 15 year exemption to enable owners to extract the benefit of applying the exemption within a company without having to liquidate. That is, any payment in relation to the exempt amount made to a CGT concession stakeholder, within two years of the CGT event, is disregarded for income tax purposes.

Illustration
Jack has been a director and shareholder of Greene Pty Ltd since it started operating in 1990. At all times Jack has owned 70 percent of the shares in the company. Jack's wife, Jill, owns the remaining 30 percent. In 2022, Greene Pty Ltd sells a warehouse used in its importing business for a gain of $100,000. The warehouse has been held continuously since 1990. Jack and Jill are both over 60 and arranged for Greene Pty Ltd to sell the warehouse because they wish to retire. Assuming that the basic conditions have been met, the 15-year exemption can be applied to the $100,000 gain on the basis that: • the warehouse (being the CGT asset) has been held continuously for at least 15 years; • Jack (and Jill for that matter) has been a significant individual in Greene Pty Ltd (i.e. owned at least 20 percent of the shares) for at least 15 years during which the company owned the warehouse; and

- Jack is over 55 years of age and has arranged for Greene Pty Ltd to sell the warehouse because he is retiring.

In 2023 Greene Pty Ltd makes a payment of the $100,000 exempt gain to Jack and Jill in proportion to their percentage shareholding in the company.

The payments to Jack and Jill in relation to the exempt gain are not included in Jack and Jill's assessable income on the basis that they are both CGT concession stakeholders in Greene Pty Ltd.

The amount of the payment which is disregarded is limited to each stakeholder's percentage interest in the company, as follows:

CGT concession stakeholder	Stakeholder participation interest	Exempt gain made by Greene Pty Ltd	Limit on disregarded payment
Jack	70%	$100,000	$70,000
Jill	30%	$100,000	$30,000

4.1 The 'two-year' rule in detail

There are a number of points to note about the 'two-year' rule outlined above:

- To benefit from the tax neutral treatment, the payment must be made within two years of ***the CGT event,*** not settlement of the contract or receipt of proceeds (unless these things happen at the same time as the CGT event of course).

- The two year time limit may be extended by the Commissioner (s 152-125(4)). Intriguingly, there are no parameters, such as 'in special circumstances', placed on the Commissioner's discretion in this regard.

- The tax-neutral treatment that applies to payments made by the company to CGT concession stakeholders within two years of the CGT event is limited to the exempt gain rather than the capital proceeds. So if an asset with a cost base of $60 is sold by the company for $100, only $40 can be paid out to concession stakeholders within two years under shelter of the rule in s 152-125.

- Unlike for the retirement exemption, payment of the exempt amount to CGT concession stakeholders within two years is <u>not</u> a condition of the exemption. In other words, the company remains eligible for the exemption even if it does not meet the two year deadline. Similarly, it is open to the company to pay out something less than the exempt amount. This might be relevant where the company did not receive any capital proceeds (for example if the asset was the object of an intergenerational gift). However, if the two-year deadline cannot be, or is not, met for some reason, the payment of the exempt amount from a company will potentially give rise to an unfranked dividend (unless the company is wound up and the payment forms part of a liquidator's distribution – refer above).

- Payments to <u>all</u> CGT concession stakeholders are covered, not only payments to the significant individual(s) who are over 55 at the time of the CGT event and retiring or permanently incapacitated. Consider for example a business operated through a company owned by four unrelated individual shareholders (mere business partners) as to 20 percent each. The remaining 20 percent is held as to five percent each by each of the principal shareholders' spouses. All eight shareholders are therefore CGT concession stakeholders in the company. Provided the company satisfies all the conditions for the 15 year exemption, in particular, that a significant individual of the company just before the CGT event was over 55 at that time and the event happened in connection with their retirement, any payments the company makes relating to the CGT event will be tax-free to all shareholders, notwithstanding they may not be significant individuals (i.e. have a less than 20 percent shareholding) nor yet over 55 and retiring.

- In contrast to paying the retirement exemption out of a company, (where payments must be made by reference to each individual's percentage of the relevant CGT exempt amount as chosen by the company in accordance with s 152-315(5)), the 15 year exemption amount can be paid to ***CGT concession stakeholders*** only in accordance with their stakeholder participation percentage[7] (s152-125(2)). There is no ability to choose to make a payment to one stakeholder to the exclusion (in whole or part) of the other. However, taxpayers may be able to preserve some discretion in practice where shares in the company are held (directly or indirectly) by discretionary trusts. That is because CGT concession stakeholders in the company in those circumstances are largely determined by the trustee shareholder's decisions regarding distributions from the trust (Item 3 of the table in s 152-70(1) read with s 152-75). In other words, if there is a desire for whatever reason to direct payment of the 15 year exemption amount to one individual to the exclusion of another this may be achievable by the trustee shareholder making distributions in such a way as to make that individual a CGT concession stakeholder for the CGT event year (not necessarily the year of payment, given that payment can happen up to two years after the CGT event) but not the other. A word of caution however – be aware that if, for whatever reason, the 15 year exemption payment is channelled through the discretionary trust shareholders to CGT concession stakeholders in the company by way of trust distributions, such distributions may themselves determine who the CGT concession stakeholders in the company actually are.

- The ability to distribute an exempt gain tax-free, without having to liquidate the company, extends to gains made on pre-CGT assets. This is in contrast to pre-CGT gains in a company which could not otherwise qualify for the 15 year exemption. The only way to avoid such gains giving rise to unfranked dividends would be to liquidate the company (refer above for more information). Where company gains are pre-CGT, and the 15 year exemption is available, the advantages of using the two-year payment rule over getting the monev out via liquidator's distribution[8] is that it can be contributed to super under shelter of the CGT cap (s 292-100).

- Further, where an asset of the company acquired pre-CGT but 'refreshed' under Div 149 due to a change in majority underlying ownership is subject to the 15 year exemption, the company can distribute the entire gain to CGT concession stakeholders within two years – both the tax-free (pre-CGT) gain that accrues prior to the change in underlying ownership, and the post-CGT gain exempted by the 15 year exemption that accrues following that change (s 152-125(1)(iv)).

- The two year clock starts ticking at the time of the CGT event, regardless of when capital proceeds are received.[9] It follows that, where an asset is disposed of under deferred terms or sale proceeds are received in instalments, it may be necessary to fund the payment to CGT concession stakeholders out of sources other than capital proceeds in order to take advantage of the two year rule. This might require

[7] Where the taxpayer is a company, a CGT concession stakeholder's stakeholder participation percentage (SPP) is equal to their small business participation percentage (SBPP) (s 152-125(2)(a)). The same cannot necessarily be said where the taxpayer is a discretionary trust, in which case each CGT stakeholder is taken to have an equal stakeholder participation percentage in the trust regardless of their small business participation percentage (s 152-125(2)(b)).
[8] Query whether, provided it is made within two years of the CGT event, a liquidator's distribution that includes a pre-CGT gain that would otherwise qualify for the 15 year exemption would qualify as a 'payment relating to the exempt amount' for the purposes of the two-year rule. Presumably not, on the basis that the connection is too remote.
[9] An exception to this is where there is a look-through earnout right involved, in which case the deadline is 6 months after the latest time a possible financial benefit becomes or could become due under the look-through earnout right relating to that CGT asset and the disposal (s 152-125(1)(b(ii))

external borrowings or in specie distributions of other assets. Alternatively, consider seeking the Commissioner's discretion under s 152-125(4) to extend the deadline.

- A payment from the taxpayer company sheltered by the 15 year exemption does not trigger CGT event G1 (Capital payment for shares) (s 104-135(1A)(c)).

- A gain subject to the 15 year exemption in a company can be contributed to superannuation for the benefit of CGT concession stakeholder(s) using the CGT cap (s 292-100). However, the contribution must be made *by the CGT concession stakeholder* – it cannot go directly from the company to the super fund. It follows that the company must first pay the amount to the CGT concession stakeholder, subsequent to which the stakeholder can make a contribution to their super fund. Note that the issue of whether s 292-100(4) shelters only the capital gain (as opposed to proceeds) where the 15 year exemption is being used by a company was raised in the NTLG Superannuation Technical Sub-group minutes for 4 December 2007, and responded to by the ATO in the 31 March 2008 minutes. The ATO (correctly, in the author's view) says that s 292-100(4) does not limit the CGT cap to the capital gain (as opposed to proceeds) as there is nothing stopping the entity paying out more than the gain within 2 years (the relevant amount covered by s 292-100(4)(b)(i)). This conclusion is supported by PBR 1051709853131. However it was acknowledged by the ATO at the NTLG meeting that a payment in excess of the gain, while potentially sheltered by s 292-100(2) for super contribution purposes, will *not* be sheltered from tax by s 152-125 so may be an assessable amount.

- Where the CGT concession stakeholder has a debit loan with the company, query whether the doctrine of set-off referred to by the High Court in the case of *FCT v Steeves Agnew & Co.*[10] can be applied to treat an amount offset against the stakeholder's debit loan as being a 'payment' for the purposes of s 152-125 or whether the ATO would insist on a physical payment being made to the shareholder followed by the shareholder paying that amount back to the company in satisfaction of its debit loan. Some light is thrown on the Commissioner's view of the doctrine of set-off in GSTD 2004/4.

- Where shareholders have a material cost base in their shares, account should be taken of the fact that making a payment of the exempt amount to CGT concession stakeholders to take advantage of the two year rule may result in a capital loss for shareholders when a subsequent CGT event happens to their shares (disposal or cancellation).

- The legislation is non-prescriptive regarding how a payment of the 15 year exemption amount to CGT concession stakeholders under shelter of the two year rule is characterised from a non-tax point of view (beyond making it clear via a 'Note' to s 152-125(1) that normal business payments, such as wages, would not qualify for the tax-free treatment afforded by the two-year rule). For example, can it be put through the accounts as an above-the-line expense, or can it only be paid out in the form of a dividend? If the latter, and there are non-CGT concession stakeholder shareholders in the company, part of the payment will be an assessable dividend to those shareholders (presumably unfranked). However, where there are non-CGT concession stakeholder shareholders in the company, treating payment of the 15 year exemption amount as an above-the-line expense presumably allows it to be directed to CGT concession stakeholders to the exclusion of non-CGT concession stakeholders. That percentage of the payment corresponding to the stakeholder percentage of non-CGT concession stakeholders will then remain with the company to be distributed as an ordinary dividend at another time or as part of a liquidator's distribution(s). Alternatively, and only with appropriate care (with regard to value shifting issues in particular[11]), consider issuing a Dividend Access Share to the CGT concession stakeholder(s).

[10] [1951] HCA 26

[11] There would be no consequences for a direct value shift caused by the issue of Dividend Access Shares if, more likely than not, it will be reversed within four years (s 725-90)

Illustration
A Company makes a capital gain of $1 million which it disregards by applying the 15 year exemption. The company has two individual unrelated shareholders – one owns 90 percent and the other 10 percent. Section 152-125 allows the company to make a tax-free payment of up to $900,000 to its 90 percent shareholder within two years of the CGT event. To make this payment by way of dividend would involve also paying a $100,000 (assessable dividend) to the 10 percent shareholder. However, it is presumably open to the company to expense a $900,000 payment to the 90 percent shareholder, and retain the remaining $100,000 to be dealt with in the normal course of its dividend policy and/or as part of a liquidator's distribution when the company is wound-up

Note that expensing payment of the 15 year exemption amount in this way will not give rise to an allowable deduction (s 152-125(2)).

5. Tips and traps of getting the retirement exemption amount out

The retirement exemption may be used to disregard a capital gain to the extent that the company's CGT concession stakeholder(s) lifetime **CGT retirement exemption limit** of $500,000 is not exceeded (s 152-310, s 152-320). The CGT concession stakeholders of the company will be required to contribute the exempt amount into a complying superannuation fund or RSA if they are under 55 at the relevant time (s 152-325(7)).

To qualify for the retirement exemption a company must satisfy the following conditions, in addition to the conditions applying to all taxpayers (outlined above):

- It must have at least one significant individual in the company just before the CGT event (s 152-305(2)(b)).
- It must make a choice in writing to apply the exemption and, where there is more than one CGT concession stakeholder, specify each stakeholder's percentage of the exempt amount (s 152-315(5)). There is no requirement for each CGT concession stakeholder's percentage of the CGT exempt amount to correspond to their small business participation percentage (essentially their percentage ownership) in the company.
- If the company receives capital proceeds from the event[12], it must make a payment equal to the lesser of the exempt amount or the capital proceeds from the event to at least one CGT concession stakeholder (s 152-325(1)). If the payment is made to more than one stakeholder, the payment must be made in accordance with each stakeholder's percentage of the exempt amount (s 152-325(3)). Payments must be made by the later of seven days after the company chooses to disregard the capital gain and seven days after it receives capital proceeds for the CGT event (s 152-325(4)).
- If the CGT concession stakeholder is under 55 just before receiving a payment, the company must make the payment to a complying superannuation fund or an RSA (s 152-325(7)). For superannuation income tax purposes this will be treated as a personal contribution made by the CGT concession stakeholder (s 152-325(8)). Such contribution is not deductible to the stakeholder (s 290-150(4)(b)).

Illustration
Bob and Ben each have a 50 percent ownership interest in B&B Pty Ltd. As such, they are both significant individuals and CGT concession stakeholders in the company. The company makes a gain of $200,000 (which is less than the capital proceeds from the event) and wants to apply the retirement exemption to the gain. The basic conditions in Div 152 are satisfied. B&B Pty Ltd makes a choice in writing to apply the retirement exemption and specifies each stakeholder's percentage of the exempt amount (Bob 20 percent and Ben 80 percent). The company makes a payment to each stakeholder in accordance with their percentage of the exempt amount (i.e. $40,000 to Bob and $160,000 to Ben). The payment does not result in the CGT retirement exemption for either stakeholder being exceeded. Bob is only 50 years old just before B&B Pty Ltd makes his payment of $40,000. The payment must therefore be contributed directly to Bob's complying superannuation fund.

[12] An exception to this requirement is where the capital gain to be exempted arises from CGT events J2, J5 or J6. Where that is the case, a payment must be made notwithstanding that no capital proceeds have been received (s 152-325(1)(a)).

Ben is 57 years old just before B&B Pty Ltd makes his payment of $160,000. There is therefore no requirement to make a contribution of this amount to Ben's complying superannuation fund. Ben is free to spend the money as he wishes, or contribute it to superannuation voluntarily.

The $200,000 capital gain made by B&B Pty Ltd is disregarded in full, and the payments made to, or for the benefit of, Bob and Bill are non-assessable non-exempt exempt (s 152-310(2)).

5.1 The requirement for a company to pay the CGT exempt amount to CGT concession stakeholders

There are a number of points to note about the requirement to make a payment of the exempt amount (or capital proceeds if less) to at least one CGT concession stakeholder:

- The payment is non-assessable non-exempt income (NANE) of the CGT concession stakeholder to whom it is made, and not allowed as a deduction to the company (s 152-310(2)). Similarly, to the extent the payment is passed through interposed entities, the paying entity is not entitled to a deduction and the payment will be NANE of the receiving entity (s 152-310(3)). Furthermore it is not a dividend (including a deemed dividend under s 109 or Div 7A (s 152-325(11)) or a frankable distribution (s 152-325(10)).
- There is no requirement to make a payment where the capital gain to be exempted arises from a CGT event other than J2, J5 or J6 and there are no capital proceeds received (s 152-325(1)).
- It is not necessary to make payments to CGT concession stakeholders in accordance with their small business participation percentage in the entity. In fact, provided there are two or more CGT concession stakeholders, it is open to the company or trust to choose a zero percentage for a particular stakeholder such that there is no requirement to make a payment to them (s 152-315(5)).
- If the CGT concession stakeholder to whom a payment is made is under 55 at the time of payment the company must contribute the amount directly to a complying superannuation fund or RSA (s 152-325(7)(a)) – **it is not acceptable to transfer the funds to the CGT concession stakeholder first**. This should be contrasted with the requirement to make payment to the CGT concession stakeholder first, and then from the stakeholder to the superannuation fund, in order to get access to the CGT cap for:
  - the retirement exemption payment to a CGT concession stakeholder who is 55 or over at the relevant time; and/or
  - a 15 year exemption payment (tax-free to the CGT concession stakeholder if paid within two years – refer above).
- A company must make payments, or superannuation contributions where the CGT concession stakeholder is under 55, equal to the CGT exempt amount by the later of:
  - seven days after the company or trust makes the choice to apply the exemption (generally when the tax return for the year in which the CGT event took place is lodged); and
  - seven days after the company or trust receives an amount of capital proceeds from the CGT event.

  (Section 152-325(4))

  It follows that, if capital proceeds are received **before** a company or trust makes the choice to apply the exemption, those proceeds can be put to an alternative use until seven days after the choice is made, at which time they must be paid to, or in respect of, CGT concession stakeholders of the entity as required.

- The amount of the payment required to be made by a company to CGT concession stakeholders in order to get access to the retirement exemption is the lesser of:
  - The capital proceeds *received* (or where the retirement exemption is being applied to a gain earlier deferred by the small business roll-over and now being reinstated by CGT event J2, J5 or J6 – the amount of the reinstated gain); and
  - The relevant CGT exempt amount (which obviously cannot be greater than the $500,000 lifetime CGT retirement exemption limits of CGT concession stakeholders in the company)

  (Section 152-325(5))
- Query whether, where the CGT concession stakeholder has a debit loan with the company, the requirement for the company to make a payment of the CGT exempt amount can be satisfied by way of set-off against the stakeholder's loan account.[13] Refer to GSTD 2004/4 for a good explanation of the Commissioner's approach to this doctrine in the context of GST consideration.

5.2 Applying the retirement exemption in an asset sale and subsequent liquidation scenario

Close attention may need to be paid to the age of a CGT concession stakeholder in a company that applies the retirement exemption to a sale of its business and subsequently liquidates. In such a case there are two applications of the retirement exemption, and therefore two moments in time, where the age of the CGT concession stakeholder is relevant:

1. For the purposes of the company applying the retirement exemption the company must make payment to a complying superannuation fund if the CGT concession stakeholder is under 55 at the time the payment is made. Payments must be made *no later than* the latest of seven days after the company chooses to disregard the capital gain and seven days after it receives capital proceeds for the CGT event.
2. For the purposes of an individual shareholder in the company seeking to apply the retirement exemption to a gain made when CGT event C2 happens upon cancellation of their shares, the CGT exempt amount must be contributed to a complying superannuation fund if they are under 55 just before they make the choice to apply the exemption (s 152-305(1)(b)). The choice must be made in writing *no later than* the day of lodgement of the taxpayer's income tax return for the year of the CGT event.

Note that a contribution of the CGT exempt amount to a complying superannuation fund can be made under shelter of the CGT cap regardless of the member's age i.e. the benefit of the CGT cap is not limited to amounts that are *required* to be paid into superannuation in order to get access to the retirement exemption because the taxpayer or CGT concession stakeholder is under 55 at the relevant time.

With this in mind (that a CGT concession stakeholder over 55 has the choice whether or not to contribute the retirement exemption amount to super, whereas a stakeholder who is under 55 has no such choice), where a CGT concession stakeholder is on the cusp of 55 around the time of the business sale and subsequent liquidation and it is their preference not to have to contribute the exempt amount to super:

- where possible push payment of the exempt amount to the stakeholder out until the stakeholder is 55 or over – payment can be made by the company as late as seven days after it lodges its tax return for the year of the CGT event (or seven days after receipt of capital proceeds if later); and

[13] In accordance with the doctrine of set-off referred to by the High Court in the case of *FCT v Steeves Agnew & Co.* [1951] HCA 26

- consider delaying making the choice for the shareholder to use the retirement exemption on the gain it makes on cancellation of its shares (i.e. lodging the individual's return for the year the shares are cancelled) until they are over 55.

Illustration
Summit Pty Ltd is owned in equal shares by Jill and Claudia. The company contracts to sell its business in March 2022. Proceeds are received in April of the same year. The company applies the small business 50 percent reduction and the retirement exemption to reduce the gain it makes to nil. In May 2022 CGT event C2 happens to Jill and Claudia's shares when they wind up the company. They both apply the CGT discount, the small business 50 percent reduction and the retirement exemption to reduce the resulting gain to nil. Jill turns 55 on 10 June 2023. Her preference is not to have to contribute any amount to superannuation. Jill's preferred outcome will be achievable if: • the company pays her share of the CGT exempt amount to her after 10 June 2022; and • she makes the choice to apply the retirement exemption to her C2 gain (i.e. lodges her 2021-22 return) after her 55th birthday. Claudia turns 55 on 17 November 2022. Claudia would like to maximise her superannuation balance and would therefore like to take advantage of the opportunity to contribute the exempt amount under shelter of the CGT cap. If the company makes payment of Claudia's share of the CGT exempt amount prior to her 55th birthday on 17 November 2022 it will be required to do so into Claudia's superannuation fund, consistent with her preference. Similarly, if she makes the choice to apply the retirement exemption to the C2 gain on cancellation of her shares before turning 55 on 17 November 2022, the CGT exempt amount must be paid into super. However, note that Claudia can achieve her objective even if these dates are not met, because the CGT cap can be used to make contributions to superannuation regardless of the member's age (subject to restrictions on the fund accepting contributions for members 75 years or older).

6. 152-E rollover issues

A taxpayer who satisfies the basic conditions in Div 152 may be able to defer a capital gain by 'rolling it over' against a replacement asset acquired within two years. The deferred gain will be crystallised if the taxpayer fails to acquire a replacement asset within two years at a cost at least equal to the disregarded gain, or the replacement asset is disposed of or ceases to satisfy certain conditions (e.g. ceases to be an active asset).

As the small business CGT rollover is essentially a deferral rather than a permanent exemption, the issue of preserving the benefit of the small business CGT concessions when distributed to shareholders does not arise so much as it does for the other concessions in Div 152. However, a question arises as to whether a gain deferred by a company using the small business CGT rollover is crystallised if and when the company is wound up.

It is clear that, if a replacement asset acquired during the replacement asset period is disposed of as part of the winding up process, in addition to any gain made on the disposal of that asset, the deferred gain will be crystallised by CGT event J2. This J2 gain can be exempted using the retirement exemption (s 152-10(4)) and therefore extracted from the company using the rule in s 152-325. However, it cannot benefit from the 15 year exemption or the small business 50 percent reduction (s 152-10(4)) such that the above discussions regarding getting those amounts out of a company do not come into play.

It is less clear what the consequences are if a company which has deferred a gain using the small business CGT roll-over is wound up prior to expiry of the replacement asset period. In ordinary circumstances where a taxpayer fails to acquire a replacement asset, or where the cost of the replacement assets fail to cover the deferred gain, before the replacement asset period ends, the deferred gain is crystallised under CGT event J5 or J6 respectively. However, given those events don't happen until the replacement asset period ends (s 104-197(3) and 104-198(2)), arguably there is no mechanism for the ATO to collect on a deferred gain where the company ceases to exist before that time.

6.1 Interaction between the small business CGT rollover and the retirement exemption

The crystallisation of a gain deferred using the small business CGT rollover (whether it be because of CGT event J2, J5 or J6) may be able to be disregarded under the retirement exemption.[14] Where a company uses the retirement exemption to disregard such a gain the company must make a payment to CGT concession stakeholder(s) within seven days after the company makes the choice to use the retirement exemption to disregard the J2, J5 or J6 gain (s 152-325(4)(a)). This is generally when the tax return for the year in which the deferred gain is crystallised (i.e. the year the J event took place) is lodged. The payment(s) must be equal to the lesser of the amount of the deferred gain the company is choosing to exempt using the retirement exemption, and the CGT exempt amount (s 152-325(5)).

Note that, when it comes to determining how much of a crystallised J gain can be exempted using the retirement exemption and the individuals to whom a payment or superannuation contribution must be made, CGT concession stakeholders in the company just before the relevant J event happens are relevant as opposed to the CGT concession stakeholders just before the event that gave rise to the gain that was deferred using the roll-over.

[14] Note that there is no requirement to satisfy the small business CGT concessions basic conditions when seeking to apply the retirement exemption to CGT events J5 or J6 (s 152-305(4)).