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CGT Small Business Reliefs

8th edition

The comprehensive practitioner's handbook

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Preface

The CGT small business reliefs are an increasingly important consideration for practitioners when advising clients, both in relation to setting up and operating businesses and asset-owning structures and in relation to the disposal of CGT assets.

Developments that affect the way the CGT small business reliefs operate in practice continue to come regularly. On the legislative front, there have recently been consequential amendments that flowed from the enactment of the CGT earnout amendments by the *Tax and Superannuation Laws Amendment (2015 Measures No. 6) Act 2016*. There have also been some significant cases, including a decision of the Full Federal Court which considered, in the context of a particular factual situation, the operation of the direct small business participation percentage definition, and a decision of the AAT (currently on appeal) which considered how the market value of a minority shareholding was to be determined where all of the shares in the company were disposed of in the one transaction. Also, there have been some releases from the Commissioner, including a final ruling on how unpaid present entitlements are to be treated when applying the maximum net asset value test.

Although the relevant statutory provisions are not lengthy, they have always contained major difficulties — and each new amendment has added its share to these difficulties. This means that advising clients can now only be undertaken with a sound understanding of how the provisions currently operate, and with regard to any relevant decisions and publicly released information that expresses the views of the ATO.

The law is stated for developments which had become known by 25 April 2016.

John Gaal
TaxCounsel
April 2016

About the author

For over 30 years, John Gaal has written extensively on a wide range of taxation matters for a number of publishers. He also assisted in authoring major joint submissions on the rewrite of the CGT law which were prepared on behalf of various professional associations for presentation to the Tax Law Improvement Project and the Parliamentary Joint Committee of Public Accounts and Audit. The Taxing Issues and Tax Tips columns in The Tax Institute's *Taxation in Australia* journal are authored by John, and he also consults on various tax matters.

Contacting the author

This book was largely written from the author's technical knowledge and years of experience in income tax cases and matters. If any reader believes that an important topic or issue is not covered, or that the commentary is incomplete or even incorrect, they are invited to contact the author through The Tax Institute at publications@taxinstitute.com.au.

About the publisher

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Abbreviations

ITAA36:	*Income Tax Assessment Act 1936*
ITAA97:	*Income Tax Assessment Act 1997*
Post-CGT:	after 19 September 1985
Post-CGT asset:	CGT asset acquired afer 19 September 1985
Pre-CGT:	before 20 September 1985
Pre-CGT asset:	CGT asset acquired before 20 September 1985
ATO Advanced Guide:	*Advanced Guide to capital gains tax concessions for small business 2013-14* (published by the ATO)
GSTR:	ATO goods and services tax ruling
ID:	ATO interpretative decision
NTLG:	National Taxation Liaison Group
PS LA:	ATO law administration practice statement
TD:	ATO taxation determination
TR:	ATO taxation ruling

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Chapter 1

Eligibility checklist

¶1-100 Determining eligibility for CGT small business relief

The following is a simple checklist for the operation of the CGT small business reliefs, where the CGT event that gives rise to the capital gain happens in the 2015-16 income year. It is assumed that the CGT asset involved is a post-CGT asset (or that the CGT event that has happened does not depend for its operation on there being a post-CGT asset) (see ¶12-110). The checklist is expressed on the basis that a CGT event has happened but can, of course, be readily applied for use where the CGT event is only in prospect. Further discussion of each issue can be found at the paragraph(s) indicated.

If the particular CGT asset is or has been an asset of a deceased estate, or is an interest in an asset acquired by survivorship on the death of a joint tenant, the possibility that the specific rule (which applies where a CGT event happens in relation to the asset within two years of death (see ¶19-105)) may be relevant should be checked.

Subject to the above, the steps to be taken to determine eligibility for the CGT small business reliefs are:

(1) What CGT event has happened (see ¶2-125)?

(a) If the CGT event is CGT event J5 or J6 (these events retrigger a rolled-over capital gain to the extent that it has not been utilised by the end of the replacement asset period), go to (14) below.

(b) If the CGT event is any other CGT event, go to (2) below.

(2) Do the anti-overlap provisions apply to reduce the capital gain to nil?[1]

(3) What CGT asset (see ¶2-105) has the CGT event happened in relation to (see ¶5-100) or, if the CGT event is CGT event D1 (the creation of a right), with which CGT asset is the right inherently connected (see ¶5-110)? If the CGT asset is a share or trust interest, see ¶4-110.

(4) At what time did the CGT event happen (see ¶2-125)?

(5) Identify the entities that are "connected with" the taxpayer (see ¶10-100).

(6) Identify the entities that are affiliates of the taxpayer (see ¶9-100) or are connected with the affiliates of the taxpayer (see ¶10-100).

(7) Is the CGT event that happened CGT event D1 (the creation of a right)?

(a) If no, go to (8) below.

(b) If yes, go to (9) below.

(8) Does the CGT asset identified in (3) above satisfy the active asset test (see ¶8-110 and ¶8-145)? If the CGT asset is a share or trust interest, see ¶8-115, ¶8-120 and ¶8-145.

(a) If no, the CGT small business reliefs are not available.

(b) If yes, go to (10) below.

(9) If the CGT event that happened is CGT event D1 (the creation of a right – for example, a restrictive covenant), does the CGT asset of the taxpayer (with which the right that is created is inherently connected) satisfy the active asset test (see ¶8-145)?

(a) If no, the CGT small business reliefs are not available.

(b) If yes, go to (10) below.

1 See ss 118-20, 118-24 and 118-25 ITAA97.

(10) If the active asset test can be met, is one of the following satisfied:

(a) the maximum net asset value test (see ¶6-100) – for this purpose, ascertain whether any CGT assets of an affiliate or of an entity connected with an affiliate are to be disregarded (see ¶6-135);

(b) the taxpayer is a small business entity for the income year in which the CGT event happened (see ¶7-100);

(c) if the taxpayer is a partner in a partnership and the CGT asset is an interest in an asset of the partnership, the partnership is a small business entity for the income year in which the CGT event happened (see ¶7-100);

(d) the taxpayer does not carry on a business in the income year in which the CGT event happened (other than in partnership), the CGT asset is not an interest in an asset of a partnership, and at a time in the income year the CGT asset is used in (or is held ready for use in or is inherently connected with) a business carried on by an entity that both is a small business entity for the income year and is an affiliate of (or connected with) the taxpayer (see ¶4-105); or

(e) the taxpayer is a partner in a partnership that is a small business entity for the income year in which the CGT event happened, but does not carry on a business on his, her or its own account in the income year, the CGT asset is not an interest in an asset of the partnership, and the CGT asset at a time in the income year is used in (or is held ready for use in or is inherently connected with) the business carried on by the partnership (see ¶4-105).

(i) If no, the CGT small business reliefs are not available.

(ii) If yes, go to (11) below.

(11) For any CGT event other than CGT event J2 (change in replacement asset after roll-over (see ¶15-145)), are the conditions for the CGT 15-year small business exemption met (see ¶12-105 and ¶12-115)?

(a) If yes, this exemption applies.

(b) If no, go to (12) below.

(12) For any CGT event other than CGT event J2 (see ¶15-145), the CGT small business 50% reduction applies, unless the taxpayer chooses not to apply it (see ¶13-100 and ¶13-110).

(13) For any capital gain remaining after (12) above (or for the whole of the capital gain from CGT event J2 happening), either:

(a) the CGT small business retirement exemption (see ¶14-100); or

(b) the CGT small business roll-over relief (see ¶15-100),

or partly one of these concessions and partly the other, is available.

(14) If the CGT event that has happened is CGT event J5 (failure to acquire replacement asset etc after roll-over (see ¶15-130)) or CGT event J6 (cost of acquisition of replacement asset etc not sufficient to cover disregarded capital gain rolled over (see ¶15-140)), the CGT small business retirement exemption is the only relief available and can be claimed without the CGT small business basic conditions being met (see ¶15-155).

Pre-CGT asset

If the conditions for the CGT 15-year small business exemption to apply are met and the CGT asset is a pre-CGT asset owned by a company or trust, the flow-through concession may apply in relation to a distribution by the company or trust (see ¶12-150).

Chapter 2

Some general CGT issues

¶2-100 Background

The CGT small business reliefs are one feature of the CGT provisions of the ITAA97. It is assumed that readers are familiar with how the CGT provisions operate.

While it is beyond the scope of this handbook to provide any general discussion of how the CGT regime operates, this chapter considers several CGT issues that are of a more general nature, and are particularly relevant to the CGT small business reliefs.

¶2-105 CGT asset

A CGT asset is defined as:

- any kind of property; or
- a legal or equitable right that is not property.[1]

To avoid doubt, the following are CGT assets:

- part of, or an interest in, an asset (as defined above);
- goodwill (or an interest in it);
- an interest in an asset of a partnership; and
- any other interest in a partnership.[2]

If an entity owns an interest in a CGT asset and acquires another interest in the asset, the ATO takes the view that the interests remain separate CGT assets for CGT purposes.[3] This can, for example, mean that:

- a CGT asset owned by a taxpayer is comprised of a pre-CGT interest (which would not give rise to a capital gain on its disposal (see ¶2-110)) and a post-CGT interest (which may give rise to a capital gain on its disposal); and
- an interest in a CGT asset owned by a taxpayer may satisfy the active asset test that is relevant to the CGT small business reliefs (see ¶8-145), but another interest in the asset may not.

¶2-110 Pre-CGT assets

Usually, if an asset was acquired pre-CGT (ie before 20 September 1985), any capital gain or capital loss arising from its disposal (CGT event A1) will be disregarded for the purposes of the CGT provisions. There are, however, some CGT events that may happen in relation to such an asset that can give rise to a capital gain; for example, if a call option is granted over the asset that is not exercised, or if the forfeiture of a deposit gives rise to CGT event H1 happening.

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1 S 108-5(1) ITAA97.

2 S 108-5(2) ITAA97.

3 TD 2000/31. This determination gives an example of a taxpayer who acquired a 50% interest in land pre-CGT and the other 50% interest post-CGT and who later sells a 50% interest. The example indicates that the taxpayer could decide which interest was sold or what parts of the two interests (giving a total of 50%) were sold.

Also, CGT event K6 can happen where a specified CGT event (including CGT event A1 and C2) happens in relation to a pre-CGT share in a company or a pre-CGT interest in a trust.[4]

In addition, there are circumstances in which there may be a deemed separate asset in relation to a pre-CGT asset. For example, a post-CGT building or structure constructed on pre-CGT land is deemed to be a separate CGT asset. These deemed separate CGT asset rules are contained in Subdiv 108-D ITAA97.

In the case of a company or trust, a pre-CGT asset will lose that status if and when majority underlying interests in the asset cease to be maintained.[5]

¶2-115 Special asset rules

A number of CGT rules apply to specific kinds of assets, and these should be noted in the context of the CGT small business reliefs.

Depreciating assets

A capital gain or capital loss made from a CGT event (which is also a balancing adjustment event) that happens to a depreciating asset is disregarded.[6] However, this does not affect a capital gain or capital loss that may be made when CGT event J2 happens (ie where there is a change in relation to a replacement or an improved asset after CGT small business roll-over relief (see ¶15-145)) or CGT event K7 happens (ie where a depreciating asset was not used, or installed ready for use, for a taxable purpose during a period of its ownership).

Note that certain intangible assets may be depreciating assets, including items of intellectual property (patents, registered designs and copyrights).

Trading stock

A capital gain or capital loss made from a CGT asset is disregarded if, at the time of the CGT event, the asset is trading stock.[7]

¶2-120 The CGT events

A capital gain or capital loss can only be made if a CGT event happens.[8] There are currently over 50 CGT events.

4 S 104-230 ITAA97.

5 Div 149 ITAA97.

6 S 118-24 ITAA97.

7 S 118-25 ITAA97.

8 S 102-20 ITAA97.

Each provision that specifies the circumstances in which a CGT event happens also provides for:

- the time when the event is to be taken as happening;
- how a capital gain or capital loss from the event is to be calculated; and
- the exemptions or exclusions that apply specifically to the CGT event.

There are, of course, more general exemptions, exclusions and concessions that may apply.

The CGT events that are most commonly encountered in the context of the CGT small business reliefs are briefly noted at ¶2-125.

Importance of the time when a CGT event happens

Relevant income year

The time of a CGT event is relevant to determine the income year in which a capital gain or capital loss from the event is recognised.[9]

CGT small business reliefs

There are other reasons why the time of a CGT event can be important. For example, in the context of the CGT small business reliefs, the time when the CGT event (that has given rise to a capital gain being tested for eligibility for the reliefs) happened is relevant when:

- applying the maximum net asset value test (see ¶6-100);
- applying the active asset test (see ¶8-100); and
- determining whether the significant individual test is met by a company or trust (see ¶11-105).

Commencement of amendments

Over the years, amendments made to the CGT small business reliefs have usually applied to CGT events that happen in a particular income year or a later income year, or that happen after a particular date or time. When applying the amendments, it is, of course, important to determine whether a relevant CGT event happened before or after the commencement of the particular income year or after the particular date or time.

More than one CGT event potentially happens

The general rule is that if, in the particular circumstances, two or more CGT events potentially happen, the CGT event that is most specific applies.[10] There are some qualifications to this general rule, including:

- CGT event D1 (creating contractual or other rights (see ¶2-125)) and CGT event H2 (receipt for event relating to a CGT asset (see ¶2-125)) only apply if no other CGT event can apply, and CGT event D1 applies before CGT event H2; and

9 S 102-20 ITAA97.

10 S 102-25 ITAA97.

- in the context of the CGT small business reliefs, if roll-over relief is chosen for a capital gain, and the capital gain is subsequently retriggered by CGT event J2 (see ¶15-145), two CGT events may be relevant – the CGT event that gave rise to the circumstances that caused CGT event J2 to happen, and CGT event J2 itself.[11]

¶2-125 Particular CGT events

The following are brief details of a selection of the more common CGT events that may be encountered when applying the CGT small business reliefs.

CGT event A1: disposal of a CGT asset

CGT event A1 happens if a taxpayer disposes of a CGT asset.[12]

There will be a disposal of a CGT asset if a change of ownership occurs from the taxpayer to another entity, whether because of some act or event, or by operation of law. There will, however, not be a relevant change of ownership if there is a change of legal ownership in the CGT asset and the taxpayer continues to be the beneficial owner, or merely because of a change of trustee.

Generally, CGT event A1 happens when the contract for the disposal is entered into or, if there is no contract, when the change of ownership occurs.

A capital gain or capital loss from the happening of CGT event A1 is disregarded if the CGT asset is a pre-CGT asset.

CGT event C2: cancellation, surrender and similar endings

CGT event C2 happens if a taxpayer's ownership of an intangible CGT asset ends by the asset (inter alia):

- being redeemed or cancelled;
- being released, discharged or satisfied;
- expiring; or
- being abandoned, surrendered or forfeited.[13]

For example, CGT event C2 would happen in relation to a share in a company if the company is liquidated, or in relation to a unit in a unit trust if the unit is redeemed.

CGT event C2 happens when the contract that results in the asset ending is entered into or, if there is no contract, when the asset ends.

11 S 102-25(2A) ITAA97.

12 S 104-10 ITAA97.

13 S 104-25 ITAA97.

A capital gain or capital loss from the happening of CGT event C2 is disregarded if the taxpayer acquired the asset pre-CGT. A capital gain or capital loss is also disregarded if it is made because CGT event C2 happens in relation to a look-through earnout right received by the taxpayer (s 118-575 ITAA97).

CGT event D1: creation of contractual or other rights

CGT event D1 happens if a taxpayer creates a contractual right or other legal or equitable right in another entity.[14] CGT event D1 would happen, for example, if an agreement creating a restrictive covenant is entered into. CGT event D1 happens when the contract is entered into or the other right is created.

A capital gain or capital loss is disregarded if it is made because CGT event D1 happens when the taxpayer creates a look-through earnout right in another entity (s 118-575 ITAA97).

CGT event E4: capital payment for trust interest

CGT event E4 happens if a trustee of a trust makes a payment in respect of a unit or interest in the trust that is wholly or partly non-assessable.[15] The event does not happen if any of a number of other events (including CGT event A1 or C2) happens in relation to the unit or trust interest.

CGT event E4 happens just before the end of the income year in which the trustee makes the payment. However, if another CGT event (other than CGT event E4) happens in relation to the unit or interest before the end of that income year, CGT event E4 will be taken to happen just before the other event happens.

If CGT event E4 happens, the non-assessable amount of the payment reduces the cost base and reduced cost base of the unit or interest, and any excess over the cost base is a capital gain. CGT event E4 cannot give rise to a capital loss.

A capital gain from the happening of CGT event E4 is disregarded if the taxpayer acquired the unit or interest pre-CGT.

There are provisions that exclude amounts from, or reduce, what would otherwise be the non-assessable part of the payment for the purposes of CGT event E4.

For further explanation of CGT event E4, see ¶17-115.

14 S 104-35 ITAA97.

15 S 104-70 ITAA97.

CGT event G1: capital payment for shares

CGT event G1 happens if a company makes a payment to a taxpayer in respect of a share that the taxpayer owns in the company (except for CGT event A1 or C2 happening), and some or all of the payment is not a dividend or an amount that is taken to be a dividend on the liquidation of the company.[16] CGT event G1 happens when the company makes the payment.

Apart from the timing rule, CGT event G1 operates in a way that is similar to the way that CGT event E4 operates.

CGT event H1: forfeiture of deposit

CGT event H1 happens if a deposit paid to a taxpayer is forfeited because a prospective sale or other transaction does not proceed.[17] CGT event H1 happens when the deposit is forfeited.

CGT event H2: receipt for event relating to a CGT asset

CGT event H2 happens if:

- an act, transaction or event occurs in relation to a CGT asset that the taxpayer owns; and
- the act, transaction or event does not result in an adjustment being made to the asset's cost base or reduced cost base.[18]

CGT event H2 happens when the act, transaction or event occurs. There are a number of exclusions from the happening of CGT event H2.

CGT event J2: change in status of small business replacement asset

CGT event J2 provides for a capital gain that has been rolled over under CGT small business roll-over relief to be retriggered after the end of the replacement asset period, in certain circumstances. This event is considered at ¶15-145.

CGT events J5 and J6: failure to satisfy roll-over relief conditions

CGT events J5 and J6 apply (broadly) where a taxpayer has chosen CGT small business roll-over relief, but has failed to acquire a replacement asset or incur relevant fourth element expenditure within the replacement asset period (CGT event J5), or where a replacement asset has been acquired or relevant fourth element expenditure has been incurred but the whole amount of the rolled-over capital gain has not been utilised (CGT event J6). These CGT events are discussed at ¶15-130 (CGT event J5) and ¶15-140 (CGT event J6).

16 S 104-135 ITAA97.

17 S 104-150 ITAA97.

18 S 104-155 ITAA97.

¶2-130 Calculating net capital gain or net capital loss

The assessable income of a taxpayer under the CGT provisions includes the "net capital gain" of the taxpayer for an income year.

If, on the other hand, the taxpayer has a "net capital loss", this is not an allowable deduction, but is carried forward for the purpose of calculating the taxpayer's net capital gain for a subsequent income year.

Net capital gain

There is a method statement for working out the amount of a net capital gain for an income year.[19] The steps in the method statement apply unless there is some specific exception or modification that is relevant. The steps are:

(1) Reduce the capital gains made by the taxpayer during the income year by the capital losses (if any) made by the taxpayer during the income year.

The taxpayer can choose the order in which to reduce the capital gains.

If the CGT 15-year small business exemption applies, the capital gain is simply disregarded and is not taken into account in the method statement.

(2) Apply any previously unapplied net capital losses from earlier income years to reduce the amounts (if any) remaining after reducing the capital gains under (1) above (including any capital gains not reduced under (1) because the capital losses were less than the total of the taxpayer's capital gains).

The taxpayer can choose the order in which to reduce the amounts.

(3) If the taxpayer is entitled to the CGT discount capital gain concession, reduce by the discount percentage each amount of a discount capital gain remaining after (2) above (if any).

(4) If any of the taxpayer's capital gains (whether or not they are discount capital gains) qualify for any of the CGT small business 50% reduction, retirement exemption or roll-over relief, apply those concessions.

(5) The sum of any capital gains remaining after (4) above is the taxpayer's net capital gain for the income year.

Net capital loss

If a taxpayer's capital losses made during an income year exceed the capital gains made by the taxpayer during the year, the excess is the taxpayer's net capital loss for the income year.[20]

19 S 102-5 ITAA97.

20 S 102-10 ITAA97.

¶2-135 Making choices

A number of choices may need to be made for the purposes of the CGT small business reliefs. For example:

- a choice can be made for the CGT small business 50% reduction not to apply (see ¶13-110); and
- a choice can be made for the CGT small business retirement exemption or roll-over relief to apply in respect of all or part of a capital gain (see ¶14-100 and ¶15-100).

The general rules for making choices under the CGT provisions are in s 103-25 ITAA97. So far as is relevant, these rules are:

(1) a choice that can be made under the CGT provisions must be made by the day on which the income tax return of the taxpayer for the income year in which the relevant CGT event happens is lodged, or within a further time allowed by the Commissioner;[21] and

(2) the way that the income tax returns of the taxpayer and any other entity making the choice are prepared is sufficient evidence of the making the choice.[22]

However, there are some exceptions to these rules. For example, the specification of the CGT- exempt amount for the purposes of the CGT small business retirement exemption must be made in writing (see ¶14-130 and ¶14-170).

No choice

In ID 2003/103, the taxpayer was eligible for the CGT small business reliefs but, due to an oversight by the taxpayer's then tax agent, the return was prepared without any consideration being given to those reliefs. This meant that the taxpayer had not made any choice in relation to the CGT small business reliefs. Accordingly, the taxpayer could apply for an amendment of the return to claim the 50% reduction and request the Commissioner to grant an extension of time to make a choice for the CGT small business retirement exemption or the CGT small business roll-over relief to apply in respect of the balance of the capital gain.

Change of choice?

Once a choice is made (eg a choice for the CGT small business roll-over relief to apply), this cannot be subsequently altered (eg to a choice for the CGT small business retirement exemption to apply).[23]

By way of exception, the statutory CGT look-through earnout rules permit taxpayers to amend a choice made previously where the choice relates to a capital gain or loss that can be affected by financial benefits provided under a look-through earnout right. See further ¶3-110.

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21 S 103-25(1) ITAA97.

22 S 103-25(2) ITAA97.

23 ID 2003/103. Of course, in such a situation, if nothing more were done, CGT event J5 would happen at the end of the replacement asset period and the capital gain that would arise would qualify for the CGT small business retirement relief (¶15-115).

Executor making choice

The executor or administrator of a deceased estate could make a CGT small business relief choice in relation to a period before the deceased's death for the purposes of preparing an income tax return of the deceased for a period before death.[24]

Extensions of time

While each application for an extension of time to make a choice is determined on its merits, the ATO Guide lists the following as being factors that are considered:

- whether there is evidence of an acceptable explanation for the period of extension requested and whether it would be fair and equitable in the circumstances to provide such an extension;
- whether there is any prejudice to the Commissioner if the additional time is allowed (however, the mere absence of prejudice is not enough to justify the granting of an extension);
- whether there is any unsettling of people, other than the Commissioner, or of established practices;
- the need to ensure fairness to people in like positions and the wider public interest;
- whether there is any mischief involved; and
- the consequences of the decision.

Where the Commissioner refuses a request for an extension of time within which to make a choice, it would seem that the taxpayer would usually not be able to utilise the objection/review/appeal process provided for by Pt IVC of the *Taxation Administration Act 1953* as it would be somewhat unlikely that there would be an assessment or decision which would fall within the ambit of that Part.[25] This would mean that an administrative review of the Commissioner's decision could not be obtained. Judicial review proceedings may, of course, be available, but the limited nature of such proceedings and their cost and often uncertain outcome are deterrents to the commencement of such proceedings.

24 S 254 ITAA36; s 260-140, Sch 1 of the *Taxation Administration Act 1953*.

25 *Phelps and FCT* [2009] AATA 780. See also *Isaacs v FCT* [2006] FCAFC 105; and *FCT v Administrative Appeals Tribunal* [2011] FCAFC 37.

Chapter 3

Legislative changes

¶3-100 A historical note

The CGT small business relief provisions were originally enacted by the *New Business Tax System (Capital Gains Tax) Act 1999* (Act No. 165 of 1999). As enacted, the reliefs applied (broadly) to CGT events that happened after 21 September 1999.

Since then, there have been considerable and significant legislative amendments that have affected many aspects of the reliefs. By way of illustration, amendments affecting the following have been made:

- the maximum net asset value test (including increasing the threshold and enabling a negative net value of assets of an entity to be taken into account);
- the concept of an affiliate;
- expanding the basic conditions to include (as alternatives to the maximum net asset value test) tests based on the small business entity concept;
- the active asset test;
- the connected entity tests;
- the 15-year exemption, the retirement exemption and roll-over relief; and
- the treatment of CGT assets of a deceased estate.

Subject, in some circumstances, to transitional provisions, the amendments have applied prospectively. But it is important to note that the general rule has been that, where a CGT event happens after an amendment has commenced, then, if eligibility for the CGT small business reliefs is dependent on a state of affairs that existed before the happening of the CGT event, the law as it applies at the time of the happening of the CGT event is what is relevant.

For example, if a capital gain were to be made as the result of the happening of a CGT event on 10 May 2016 and it were necessary to determine whether two entities were connected entities for, say, the period 5 March 2008 to 10 May 2016, that determination would be made on the basis of the connected entity rules that apply as at 10 May 2016. The fact that the rules may have been amended during the period 5 March 2008 to 10 May 2016 would not be relevant.

The practical effect of this is that, over time, the way the CGT provisions operated before amendments were made has become somewhat academic. This book has been prepared on the basis that only the more recent legislative amendments need explanation. The most recent amending Acts are noted at ¶3-105.

¶3-105 Recent amendments

The following are the more recent legislative amendments which have affected the CGT small business relief provisions.

Earnout arrangements

The *Tax and Superannuation Laws Amendment (2015 Measures No. 6) Act 2016*, which enacted a comprehensive CGT regime governing the treatment of "earnout" arrangements, made some amendments to the CGT small business reliefs. For example, amendments relating to the following were made:

- the "replacement asset period" which applies for the purposes of the operation of the CGT small business roll-over relief;
- the calculation of the net value of the CGT assets of an entity; and
- the circumstances in which capital proceeds will be taken to have been received in instalments for the purposes of retirement relief.

For further information, see ¶3-110.

Small business entity roll-over

The *Tax Laws Amendment (Small Business Restructure Roll-over) Act 2016* made a consequential amendment to the CGT small business 15-year exemption which has the effect of including any period before the transaction for which small business entity restructure roll-over is claimed for a CGT asset when calculating whether the 15-year period requirement is met.

¶3-110 CGT earnout amendments

The *Tax and Superannuation Laws Amendment (2015 Measures No. 6) Act 2016* amended the ITAA97 to enact a code to govern the CGT treatment of the sale and purchase of businesses involving certain earnout rights, that is, rights to future payments linked to the performance of an asset or assets after sale.

As a result of the amendments, capital gains and losses arising in respect of "look-through earnout rights" are disregarded. Instead, payments received or paid under the earnout arrangements affect the capital proceeds and cost base of the underlying asset or assets to which the earnout arrangement relates.

It is beyond the scope of this book to consider the amendments in any detail. However, the following is a brief description. The amending Act also made a number of consequential amendments to the CGT small business relief provisions and, where these are relevant to the text, they are noted.

What is an earnout arrangement?

More particularly, an earnout arrangement is an arrangement under which, as part of the sale of a business or the assets of a business, the buyer and seller are not able to agree on a fixed payment and instead agree that subsequent financial benefits may be provided based on the future performance of the business or a related business in which the assets are used.

In a standard earnout arrangement, the buyer agrees to pay the seller additional amounts if certain performance thresholds are met within a particular time. In a reverse earnout arrangement, the seller agrees to repay amounts to the buyer if certain performance thresholds are not met within a particular time. Some earnout arrangements combine the features of both a standard earnout and a reverse earnout, as both the buyer and the seller may be obligated to provide financial benefits depending on performance.

For example, assume that two parties are negotiating the sale of the business where a significant part of the value of the business is linked to its customer base, that is, its goodwill. There is considerable uncertainty about how the sale and other factors may impact on this goodwill. The parties could agree to a price based on the best available estimate of the value of the business, but there would be a significant chance that the estimate would not reflect the actual future economic performance of the business. Alternatively, the parties could agree to an earnout arrangement under which part of the consideration for the sale was linked to the future economic performance of the business. This avoids the need to rely on an estimate by linking financial benefits to future events.

CGT and earnout arrangements

The Commissioner's view on how, before their amendment, the CGT provisions of the ITAA97 operated in relation to earnout rights was set out in in a draft public ruling that was released in 2007 (TR 2007/D10).

Under the view taken in the draft ruling, where the sale of a business involves an earnout arrangement, the earnout right or rights created were separate CGT assets. This had the consequence that the CGT small business reliefs could not apply in relation to either the amounts paid for the creation of an earnout right or the subsequent financial benefits provided under the right. While the right might be linked to a business, it was a separate CGT asset with different characteristics and, unlike the business assets, would not satisfy the tests for relevant concessions (including the active asset test that applies for the purposes of the CGT small business reliefs (see ¶8-110)).

The effect of the amendments

The broad effect of the amendments is that taxpayers may disregard capital gains or losses that arise in relation to a qualifying right to financial benefits — a "look-through" earnout right. Instead, taxpayers must include financial benefits provided or received under or in relation to such rights when determining the capital proceeds of the disposal of the underlying asset (for the seller) or the cost base and reduced cost base of the underlying asset (for the buyer).

A number of related CGT amendments were made in relation to the amendment of assessments, interest charges, the recognition of capital losses and access to the CGT (and other) concessions to ensure that the new treatment provided taxpayers with outcomes broadly consistent with those that would have arisen had the value of all of the financial benefits under the earnout right been included in the capital proceeds from the disposal of the underlying asset for the seller and the cost base or reduced cost base of the underlying asset for the buyer at the time of the relevant CGT event.

The following chart from the explanatory memorandum to the amending Bill sets out how the key features of the new law differ from the previous law.

New law	Previous law
Capital gains and losses in respect of a look-through earnout right are disregarded.	No special rules apply to capital gains or losses in respect of rights to future financial benefits under earnout arrangements.
Financial benefits under or in respect of a "look-through" earnout right are included when determining the capital proceeds or cost base of the underlying business assets to which the arrangement relates.	No special rules apply to financial benefits provided under or in respect of earnout rights.
A taxpayer's assessment for a tax-related liability that can be affected by financial benefits provided or received under a "look-through" earnout right may be amended for up to four income years after the end of the income year in which the last potential financial benefit under the right was due to be paid.	No special rules apply to financial benefits provided under or in respect of earnout rights.

Application date

Most of the CGT earnout amendments apply to earnout arrangements entered into on or after 24 April 2015. There are, however, transitional provisions under which taxpayers that have reasonably and in good faith anticipated changes to the tax law in this area as a result of the announcement by the former government will have their current income tax treatment preserved.

Chapter 4

Basic conditions to be met

¶4-100 Context

A number of basic conditions must be met if a capital gain that is made from the happening of a CGT event is to qualify for the CGT small business reliefs. When the basic conditions are met, any specific requirements for a particular relief to apply must, of course, be satisfied.

These basic conditions need to be considered separately in relation to:

- the happening of CGT event D1 (creation of contractual or other rights) (see ¶4-115);
- the happening of other CGT events where the CGT asset is not a share or trust interest (see ¶4-105); and
- the happening of other CGT events where the CGT asset is a share or trust interest (see ¶4-110).

For the circumstances in which CGT event D1 will happen, see ¶2-125.

Exception: CGT event J5 or J6

By way of exception, the basic conditions do not need to be met where the capital gain is made from the happening of CGT event J5 or J6. These CGT events happen when a capital gain rolled-over under CGT small business roll-over relief has not been utilised in whole or in part by the end of the replacement asset period (see ¶15-155).

¶4-105 CGT asset other than share or trust interest

If a share or trust interest is not the relevant CGT asset (and CGT event D1 is not the CGT event that gives rise to the capital gain being tested for the CGT small business reliefs), the following basic conditions must be met for the CGT small business reliefs to be available in relation to the capital gain:

(1) the CGT event must happen in relation to a CGT asset of the taxpayer (see ¶5-100);

(2) at least one of the following must apply:

  (a) the taxpayer satisfies the maximum net asset value test (see ¶6-100);

  (b) the taxpayer is a small business entity for the income year in which the CGT event happens (see ¶7-100);

  (c) the taxpayer is a partner in a partnership that is a small business entity for the income year in which the CGT event happens, and the CGT asset is an interest in an asset of the partnership (see ¶18-110); or

  (d) the taxpayer satisfies one or other of two passive asset tests for the income year that rely on small business entity status (see "Passive assets" below); and

(3) the CGT asset must satisfy the active asset test (see ¶8-100).[1]

1 S 152-10(1), (1A) and (1B) ITAA97. Note that condition (2) as set out in the text applies in relation to CGT assets that happen in the 2007-08 or a later income year.

Passive assets

As stated in (2)(d) above, there are two alternative potential passive asset tests which, if met, will mean that basic condition (2) is satisfied.

These passive asset tests can only be met if the taxpayer does not carry on a business, in the income year in which the CGT event happens, otherwise than in partnership.

One of these tests will be met if, at a time in the income year in which the CGT event happened, the CGT asset is used in (or is held ready for use in, or is inherently connected with) a business that is carried on by an entity that is either an affiliate of, or is connected with, the taxpayer and is a small business entity for the income year (s 152-10(1A) ITAA97) (see ¶4-105 and ¶7-100).

The other passive test will be met if the taxpayer is (in the income year in which the CGT event happened) a partner in a partnership that is a small business entity and at a time in the income year the CGT asset is used in (or is held ready for use in, or is inherently connected with) the business that the taxpayer carries on as a partner in the partnership (s 152-10(1B) ITAA97) (see ¶4-105 and ¶7-100).

Small business entity status: partnerships

To assist in understanding how basic condition (2) above applies, the way that the condition operates in relation to small business entity status and in relation to a partner is set out below.

Access via small business entity status

The following summarises the way that small business entity status may provide a taxpayer with access to the CGT small business reliefs, providing the CGT event happens in relation to an asset of the taxpayer and the CGT asset satisfies the active asset test. If no small business entity requirement is met, access will, of course, be available if the taxpayer satisfies the maximum net asset value test.

Small business entity status will mean that basic condition (2) above will be met if:

- the taxpayer is a small business entity (see ¶7-100) for the income year in which the CGT event takes place;
- the CGT asset is a partnership asset, the partnership is a small business entity for the income year in which the CGT event happens, and the taxpayer is a partner in the partnership; or
- the CGT asset is used in a business carried on in the income year by an entity that is a small business entity and is an affiliate of the taxpayer or is an entity connected with the taxpayer and the taxpayer does not carry on a business (otherwise than in a partnership) (s 152-10(1)(c)(i), (ii) and (iv), (1A) and (1B) ITAA97). For the circumstances in which an entity will be an affiliate of another entity, see ¶9-110. For the circumstances in which one entity will be connected with another entity, see ¶10-100.

Access by a partner

The following summarises how condition (2) above can be satisfied because the taxpayer is a partner in a partnership. Providing a CGT event happens in relation to an asset of the taxpayer and the active test is met, basic condition (2) will be met if:

- the taxpayer is a partner in a partnership that is a small business entity (see ¶7-100) for the income year and the CGT asset is an interest in a partnership asset; or
- the taxpayer is a partner in a partnership that is a small business entity for the income year, the CGT asset is not an interest in a partnership asset, and the asset is used in the partnership business during the income year in which the CGT event happens (s 152-10(1)(c)(iii), (1A) and (1B) ITAA97).

Of course, basic condition (2) would be met if the taxpayer satisfied the maximum net asset value test.

Illustrative charts

The following charts further illustrate how the basic conditions set out above for the CGT small business reliefs to apply operate in different situations.

Chart A: CGT asset not a partnership asset or used by a partnership

The CGT asset is not an interest in a partnership asset and is not used in a business carried on by a partnership in which the taxpayer is a partner. It is assumed that the CGT asset is not a share or trust interest and that the CGT event that happens is not CGT event D1.

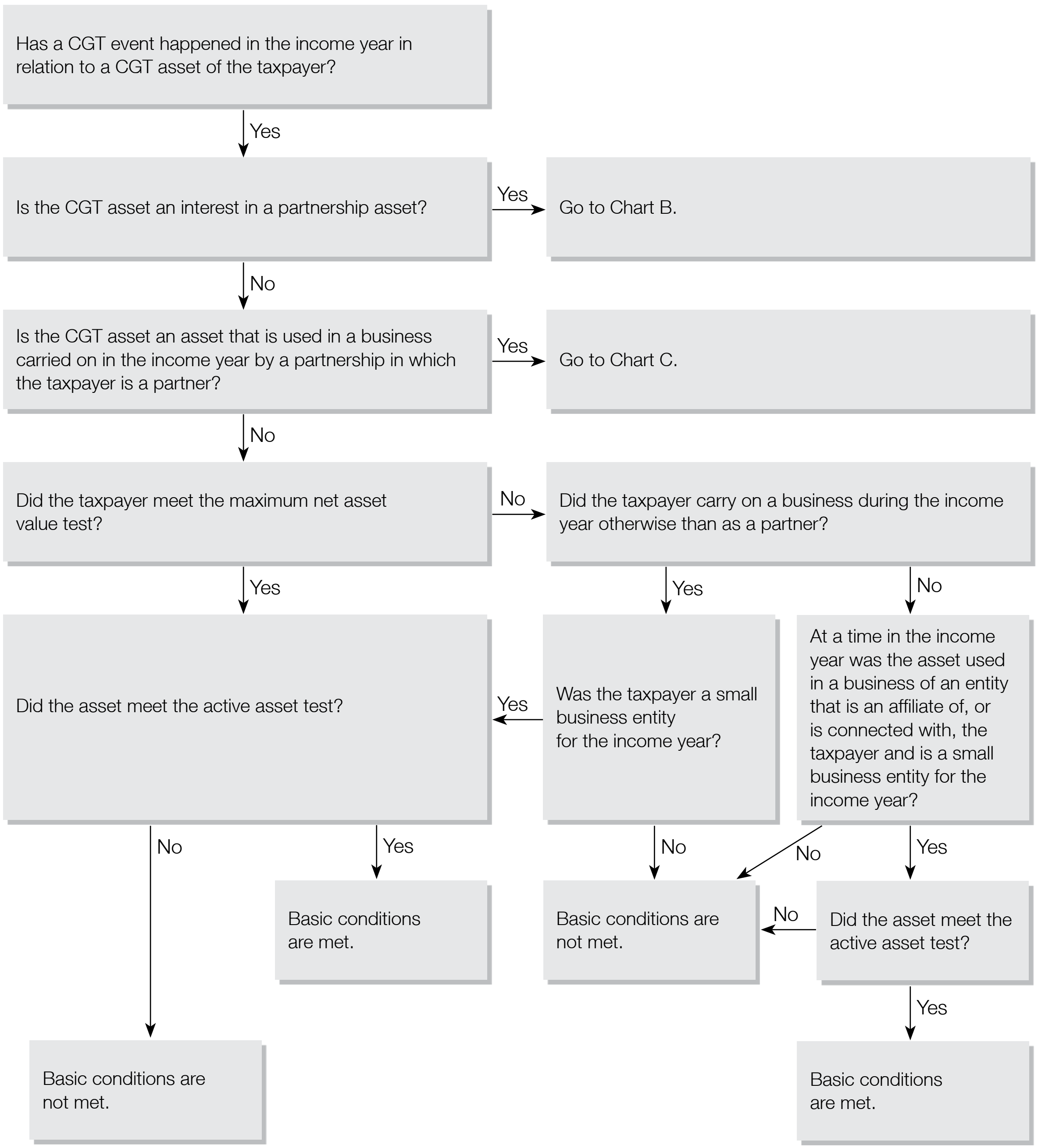


Chart B: CGT asset an interest in a partnership asset

The CGT asset is an interest in a partnership asset. It is assumed that the CGT asset is not a share or trust interest and that the CGT event that happens is not CGT event D1.

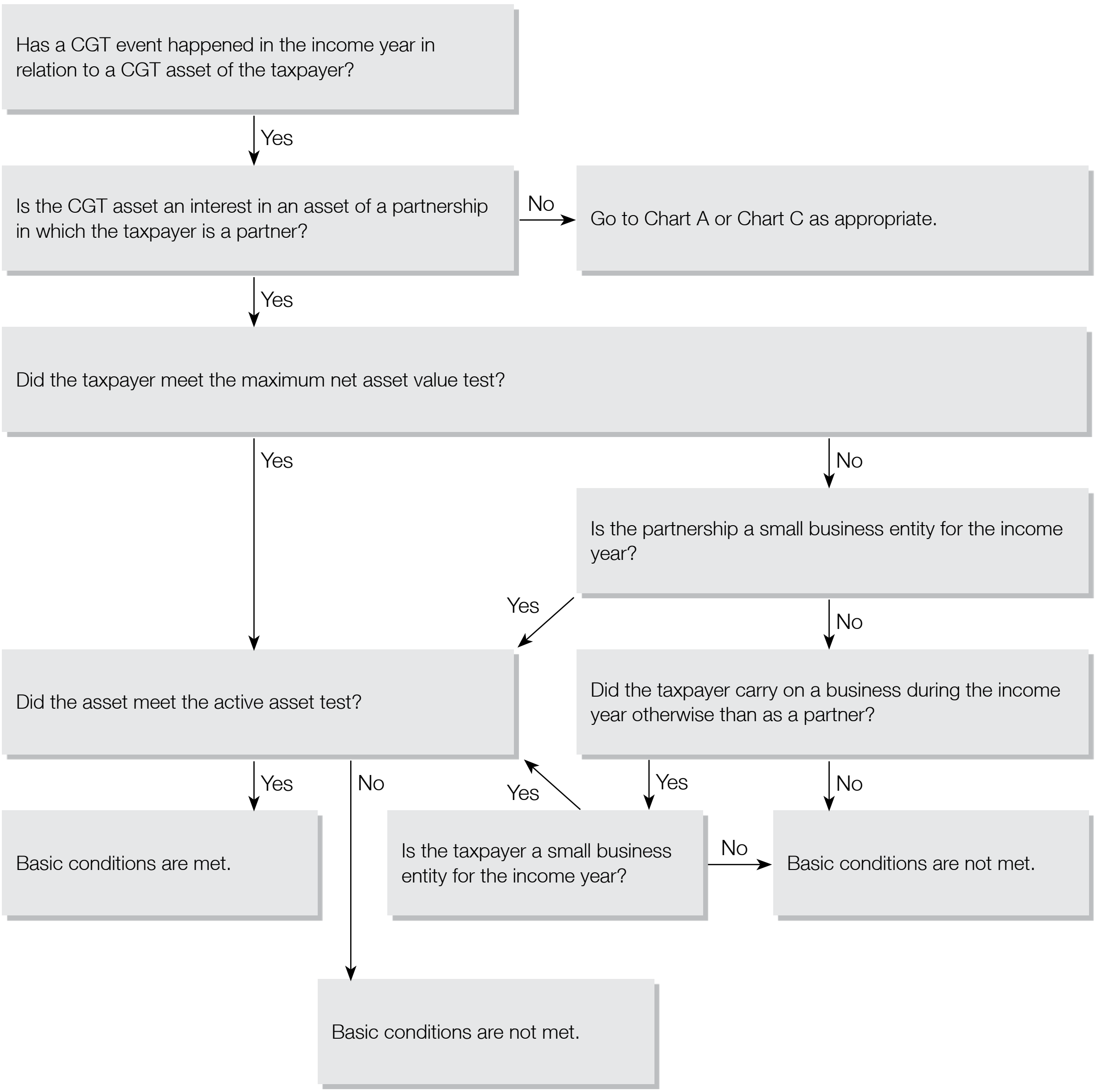
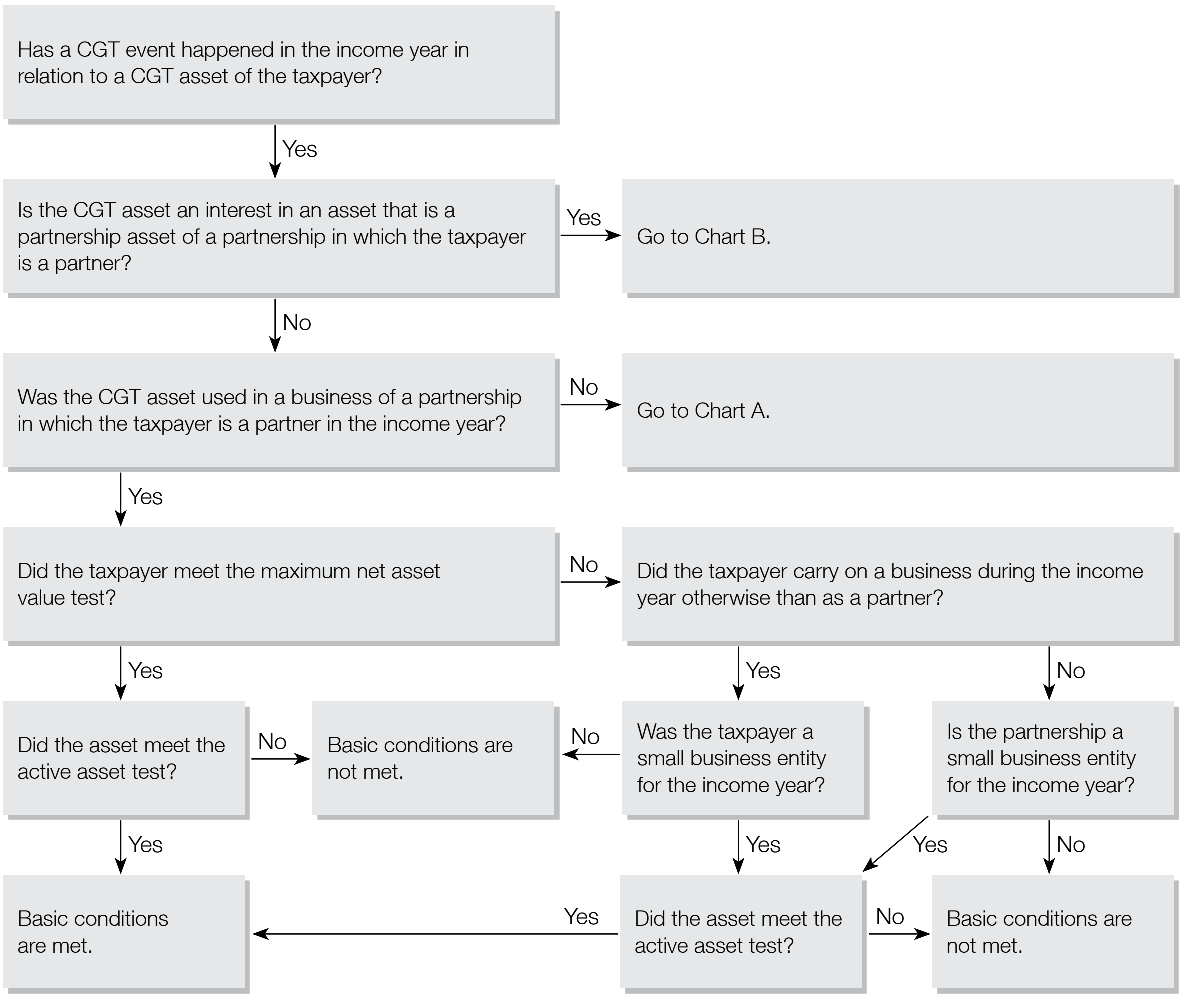


Chart C: CGT asset used in a partnership business but not a partnership asset

The CGT asset is not an interest in a partnership asset but is used in a business of a partnership in which the taxpayer is a partner. It is assumed that the CGT asset is not a share or trust interest and that the CGT event that happens is not CGT event D1.



¶4-110 Share or trust interest

If a capital gain is made from the happening of a CGT event in relation to a share in a company or an interest in a trust, then, in addition to the basic conditions set out at ¶4-105, one or other of two further basic conditions must be met for the CGT small business reliefs to be available in relation to the capital gain.[2]

2 S 152-10(2) ITAA97.

The additional conditions

If the CGT asset is a share in a company or an interest in a trust (called the "object company or trust"), the CGT small business reliefs will only be available if one or other of the following further basic conditions are satisfied just before the CGT event:[3]

(1) the taxpayer is a CGT concession stakeholder in the object company or trust; or

(2) where the taxpayer is a company or trust, CGT concession stakeholders in the object company or trust together have a small business participation percentage in the taxpayer company or trust of at least 90%.[4] This test is referred to in the explanatory memorandum as the "90 per cent test" and, in practical terms, means that a capital gain made by a company or trust from a CGT event happening to a share or trust interest that it owns may qualify for CGT small business relief.

Although it is provided that an "additional" basic condition must be met where the CGT asset is a share in a company or an interest in a trust, it is somewhat difficult to apply several of the alternative tests in the basic conditions provided for by s 152-10(1)(c) ITAA97 (see (2) at ¶4-105) in the case of a share or trust interest. For example, it is somewhat difficult to apply the basic condition that applies where the CGT asset is an interest of a partner in an asset of the partnership (see (2)(c) at ¶4-105) because the relevant asset for the purposes of that basic condition (2)(c) is an interest in an asset of the partnership, whereas the asset that is relevant for the alternative additional basic conditions is described as a share in a company or an interest in a trust. The Commissioner's views are not known.

However, it is submitted that, on their proper construction, the introductory words to condition (2) above ("at least one of the following applies") impose an additional condition where what might be called "the ordinary basic conditions" set out in (2) at ¶4-105 are met. Thus, if one of the ordinary basic conditions could not be met in the case of a share or trust interest, the additional conditions would be irrelevant.[5]

CGT concession stakeholder

Whether the terms of additional condition (1) above are met depends on the application of the definition of CGT concession stakeholder (see ¶11-115). The practical effect of the definition is that up to eight individuals can qualify as CGT concession stakeholders of a company or trust; that is, four significant individuals and their spouses (provided they hold a small business participation percentage in the company or trust).

Because a CGT concession stakeholder must be an individual, and because additional basic condition (1) refers to the person who makes the capital gain, this condition can only be satisfied by an individual who has a direct interest in the object company or trust. This could be a significant

3 For the more common CGT events that may be relevant in a CGT small business relief context and the time of the happening of those events, see ¶2-125.

4 S 152-10(2) ITAA97.

5 S 152-10(1), (1A), (1B) and (2) ITAA97.

individual or a spouse of a significant individual who has a direct small business participation percentage in the company or trust.

Significant individual (and, hence, CGT concession stakeholder) status, however, may be attained not only by reference to a direct small business participation percentage but also by reference to an indirect small business participation percentage (or a combination of direct and indirect small business participation percentages). This means that additional basic condition (1) may be satisfied by an individual who has a direct small business participation percentage in the object company or trust that is less than 20%, provided the individual:

- is a spouse of a significant individual; or
- has an indirect small business participation percentage in the object company or trust that, when added to the direct small business participation percentage, results in a total small business participation percentage of 20% or more. However, only the share(s) or trust interest(s) that represent a direct small business participation percentage would be the relevant CGT asset for the purpose of additional basic condition (1) above.

Example

There are 1,000 issued shares in Octopus Pty Ltd (all of one class) that are beneficially held as follows:

- 150 by Donald; and
- 850 by Trooper Pty Ltd, which also has 1,000 issued shares (all of one class).

This means that Donald has a 15% direct small business participation percentage in Octopus Pty Ltd.

If Donald beneficially holds 59 shares in Trooper Pty Ltd, he would have an indirect small business percentage in Octopus Pty Ltd of 5.015% (ie 5.9% × 85%). His small business participation percentage in Octopus Pty Ltd would, therefore, be 20.015% (ie 15% + 5.015%) and he would be a CGT concession stakeholder in Octopus Pty Ltd. A capital gain from the shares that he holds in Octopus Pty Ltd could, therefore, qualify for CGT small business relief, provided they satisfy the active asset test and Donald either meets the maximum net asset value test or is a small business entity.

See also the case studies at ¶4-130.

The 90% test: share or trust interest held by company or trust

The effect of the 90% test (ie additional basic condition (2) above) is that a capital gain made by a company or trust from a CGT event happening in relation to a share or an interest in a trust can qualify for CGT small business relief.

For the 90% test to be met in relation to a share or trust interest in the object company or trust that is owned by another company or trust (the "interposed company or trust"), CGT concession stakeholders (see ¶11-115) in the object company or trust must together have a small business participation percentage in the interposed company or trust of at least 90%.

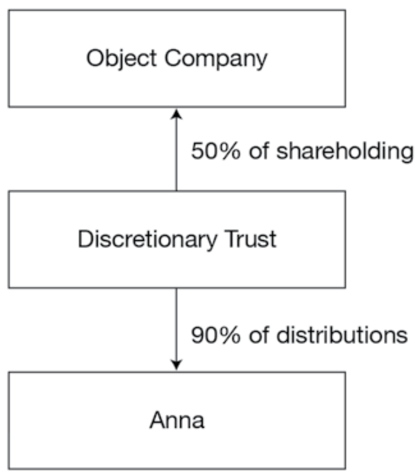
It will be seen that the application of the 90% test depends on identifying:

(1) individuals who are CGT concession stakeholders (taking into account direct and indirect small business participation percentages) in the object company or trust; and

(2) individuals who have small business participation percentages (taking into account direct and indirect interests) in the interposed company or trust.

If individuals who are common to both (1) and (2) above can be identified, the 90% test will be satisfied if the common individuals have a small business participation percentage of at least 90% in the interposed company or trust. The level of shareholding or interest in the object company or trust held by the interposed company or trust is immaterial.

An example at the end of s 152-10(2) ITAA97 (which is intended to illustrate the operation of the 90% test), as well as examples in the ATO Guide and in the explanatory memorandum to the relevant amending Bill,[6] assume that an indirect small business participation percentage in a company or fixed trust can be traced through a trust. The example at the end of s 152-10(2) ITAA97 may be represented diagrammatically as follows:



The example states that the trust can satisfy the 90% test in relation to the shares held in Object Company because:

- Anna is a CGT concession stakeholder in Object Company because her indirect small business participation percentage in the company is 45% (ie 90% × 50%); and
- Anna's small business participation percentage in Discretionary Trust is 90%.

However, as explained at ¶11-125, ¶11-130 and ¶11-135, there is a question as to the circumstances in which an indirect small business participation percentage in a company or trust can be traced through a trust. This question arises because, for an entity to have a direct small business participation

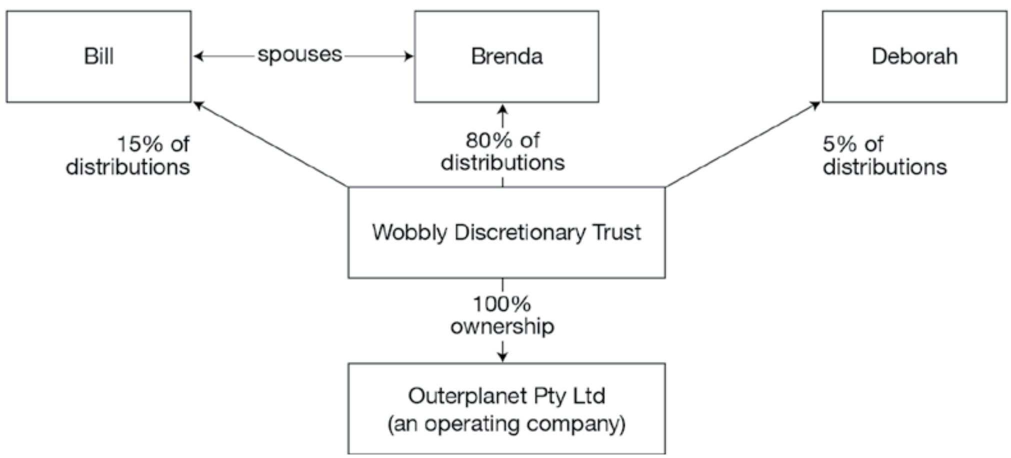
6 The Tax Laws Amendment (2006 Measures No. 7) Bill 2006.

percentage in a company, the entity must hold the legal and equitable interests in shares in the company and, for an entity to have a direct small business participation percentage in a trust, the entity must be beneficially entitled to relevant distributions of income and capital. It is submitted that this means that, technically, there may be circumstances in which tracing through a trust is not possible.

On the other hand, the examples indicate what the intended position is, and presumably this is how the legislation will be applied in practice. It is submitted, however, that clarifying amendments should be made to the definition of direct small business participation percentage to ensure that the intended outcome is achieved in all circumstances.

Subject to the point just made, the following is an adaptation of one of the examples in the explanatory memorandum.

Example



Brenda, a significant individual and a CGT concession stakeholder of Outerplanet Pty Ltd, has an 80% small business participation percentage in the Wobbly Discretionary Trust.

Bill (Brenda's spouse), a CGT concession stakeholder of Outerplanet Pty Ltd, has a 15% small business participation percentage in the Wobbly Discretionary Trust.

Deborah, who is not a CGT concession stakeholder of Outerplanet Pty Ltd, has a 5% small business participation percentage in the Wobbly Discretionary Trust.

At least 90% of the small business participation percentages in the Wobbly Discretionary Trust are held by CGT concession stakeholders of Outerplanet Pty Ltd. Therefore, the Wobbly Discretionary Trust satisfies the 90% test and, if it sells its shares in Outerplanet Pty Ltd, it can access CGT small business relief in respect of those shares (provided the other CGT small business relief conditions are met).

¶4-115 CGT event D1: creation of rights

If the capital gain being tested for CGT small business relief is made from the happening of CGT event D1 (creation of contractual or other rights), then basic conditions (1) (a CGT event happens in relation to a CGT asset) and (3) (the CGT asset satisfies the active asset test) at ¶4-105 do not apply. Instead, it is a basic condition that the right the taxpayer created that triggered the happening of CGT event D1 must be inherently connected with a CGT asset of the taxpayer that satisfies the active asset test (see ¶8-145) (s 152-12 ITAA97).

The other basic conditions set out at ¶4-105 must be met.

It would seem that, if the CGT asset with which the right created is connected is a share or trust interest, one of the further basic conditions set out at ¶4-110 would need to be met.

For the circumstances in which CGT event D1 happens, see ¶2-125.

Note that a capital gain or capital loss is disregarded if it is made because CGT event D1 happens when the taxpayer creates a look-through earnout right in another entity (s 118-575 ITAA97). See also ¶3-110.

¶4-120 CGT event K7: depreciating asset

A capital gain that is made from the happening of CGT event K7 cannot qualify for the CGT small business reliefs.[7]

CGT event K7 happens if a balancing adjustment event occurs for a depreciating asset, and at some time when the entity held the asset the entity used it, or had it installed ready for use, for a purpose other than a taxable purpose.[8]

¶4-130 Case studies

Case study 1

Patrick beneficially holds 15% of the issued shares (which are all of one class) in Lensmake Pty Ltd, which carries on the business of manufacturing prescription lenses. Of the remaining issued shares, 1% are beneficially held by Muriel (Patrick's spouse), 30% are beneficially held by Gainco Pty Ltd, and 54% are held by the Maxibenefit Discretionary Trust.

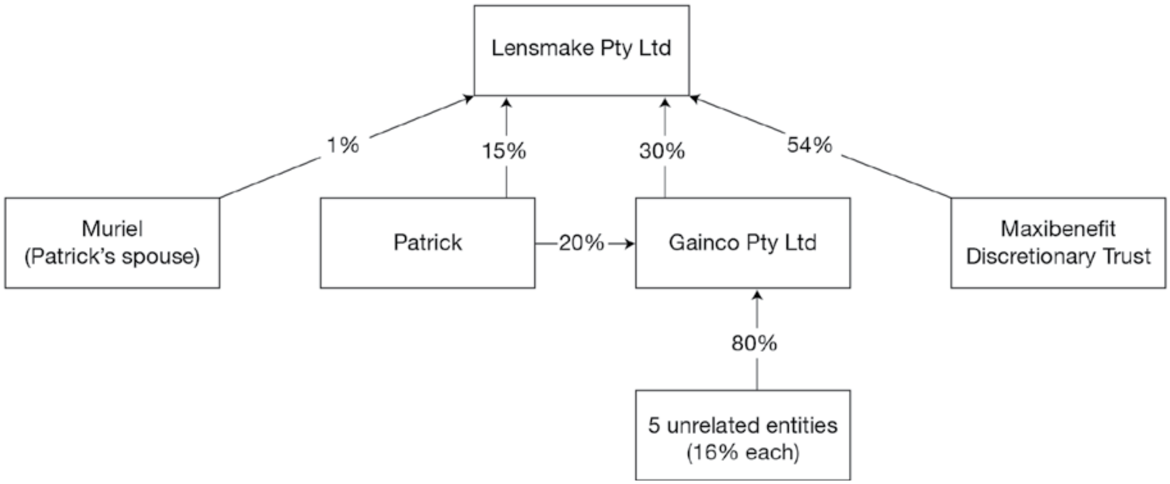
The issued shares in Gainco Pty Ltd (which are all of one class) are beneficially held as to 20% by Patrick and as to 80% equally by five entities that are unrelated to each other or to the other shareholders of Lensmake Pty Ltd. The trustee and the beneficiaries of the Maxibenefit Discretionary Trust are unrelated to Patrick or the other shareholders of Gainco Pty Ltd.

7 S 152-10(1) ITAA97.

8 S 104-235(1) ITAA97.

In May 2016, Patrick, Muriel and Gainco Pty Ltd receive an attractive offer to buy their shares in Lensmake Pty Ltd.

The factual situation may be represented diagrammatically as follows:



Patrick

Patrick has the following small business participation percentages in Lensmake Pty Ltd:

Direct small business participation percentage	15%
Indirect small business participation percentage (20% × 30%)	6%
Total small business participation percentage	21%

This means that Patrick is a significant individual and a CGT concession stakeholder in Lensmake Pty Ltd. Accordingly, subject to satisfying the other basic conditions for CGT small business relief (ie the active asset test and either the maximum net asset value test or the small business entity test), Patrick will be able to claim CGT small business relief in respect of any capital gain made on the disposal of his shares in Lensmake Pty Ltd.

Muriel

Because Muriel is Patrick's spouse and holds a small business participation percentage in Lensmake Pty Ltd, she is a CGT concession stakeholder in Lensmake Pty Ltd. This means that, potentially, the CGT small business reliefs would be available to her for any capital gain made on the disposal of her 1% interest in Lensmake Pty Ltd.

Gainco Pty Ltd

Although Patrick is a CGT concession stakeholder of Gainco Pty Ltd, his small business participation percentage in Gainco Pty Ltd is less than 90%, so Gainco Pty Ltd could not claim the CGT small business reliefs for any capital gain made by it in relation to the disposal of its 30% interest in Lensmake Pty Ltd.

Case study 2

If, in case study 1, the unrelated entities beneficially held only 9% of the shares in Gainco Pty Ltd and Muriel beneficially held 71% of the shares, Gainco Pty Ltd could potentially claim the CGT small business reliefs in relation to the disposal of its shares in Lensmake Pty Ltd. This is because CGT concession stakeholders in Lensmake Pty Ltd would have small business participation percentages totalling 91% in Gainco Pty Ltd (ie 20% (Patrick) and 71% (Muriel)).

Chapter 5

CGT event in relation to CGT asset

¶5-100 The condition

With the exception of CGT event D1, it is a basic condition that, for the CGT small business reliefs to be available, the CGT event that gives rise to the capital gain happens in relation to a CGT asset of the taxpayer.[1] This is so whether the CGT asset is a share or trust interest (see ¶4-110) or some other kind of asset (see ¶4-105).

The decided cases in which the expression "in relation to" has been considered have emphasised that the words are wide-meaning, and do no more, at least without reference to context, than signify the need for there to be some relationship or connection between two subject matters.

The phrase "in relation to" has been said to be both "vague and indefinite" and, like "in respect of", will not normally apply to all connections or relationships, no matter how remote. The extent of the relationship required will depend on the context in which the words are used.[2]

In most cases, it will be clear whether or not this condition is met.

¶5-105 Examples

The following examples illustrate situations in which a CGT event will happen in relation to a CGT asset:

- if a CGT asset is disposed of, CGT event A1 (see ¶2-125) would happen in relation to the asset;
- if a call option is granted, CGT event D2 would happen in relation to the CGT asset that is the subject of the option;[3]
- if a lease is granted, CGT event F1 would happen in relation to the property that is leased;[4]
- if a payment is made by the trustee of a unit trust in respect of a unit and CGT event E4 (see ¶17-115) happens, the event would happen in relation to the unit;[5]
- if a lessee receives a payment for the variation of the terms of a lease, CGT event F4 would happen in relation to the lease; and
- if a purchaser under a contract for the sale of a CGT asset defaults, and the contract is terminated and the deposit is forfeited, CGT event H1 (see ¶2-125) would happen for the vendor in relation to the asset that was being sold under the contract.[6]

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1 S 152-10(1)(a) ITAA97. CGT event D1 is concerned with the creation of contractual or other rights (see ¶2-125).

2 See *Australian Competition and Consumer Commission v Maritime Union of Australia* [2001] FCA 1549; *Harris v FCT* [2002] FCAFC 226; *Vision Super Pty Ltd v Poulter* [2006] FCA 849; *Woodside Energy Ltd v FCT* [2006] FCA 1303; *Travelex Ltd v FCT* [2010] HCA 33; and *Transtar Linehaul Pty Ltd v DCT* [2011] FCA 856.

3 ID 2011/45.

4 ID 2004/650.

5 TD 2006/71.

6 ID 2003/346.

The position in relation to the residual CGT event (ie CGT event H2, receipt for an event relating to a CGT asset (see ¶2-125)) is clear because, for that event to happen, an act, transaction or event must occur "in relation to" a CGT asset owned by the taxpayer.[7]

The ATO has confirmed that, if a put option is granted in relation to the assets of a business, CGT event D2 happens "in relation to" those assets.[8] Further, where the option relates to assets that do not give rise to capital gains (eg depreciable plant and trading stock), those assets are CGT assets and may satisfy the active asset test.

¶5-110 Special rule for CGT event D1

If CGT event D1 (creation of contractual or other rights) is the CGT event that has given rise to the capital gain being tested for the CGT small business reliefs, the relevant basic condition is that the right the entity creates that triggers CGT event D1 happening must be inherently connected with a CGT asset of the entity that satisfies the active asset test.[9]

The operation of this basic condition is illustrated by ID 2004/391. The facts considered involved a primary producer whose property, which had always been used in the course of carrying on a primary production business in New South Wales, contained a 10 hectare forest. The taxpayer granted a carbon sequestration right (as defined in s 87A of the *Conveyancing Act 1919* (NSW)) to an investor by entering into an agreement for 20 years.

The agreement allowed the taxpayer to continue grazing livestock in the forest, but the taxpayer was prevented from cutting down any of the trees in the forest because, according to the terms of the agreement, all carbons sequestered by the trees belonged to the investor during the term of the agreement. The agreement granting the carbon sequestration right was registerable as an interest in the land, and would bind all future owners of the land.

It is concluded that, because the carbon sequestration right existed only in relation to the land, and was permanent and inseparable from the land for the duration of the agreement, this satisfied the ordinary meaning of "inherently connected" for the purposes of s 152-12 ITAA97.

7 S 104-155(1) ITAA97.

8 Refer to the minutes of the NTLG Losses and CGT Subcommittee meeting of 19 November 2008, item 9. See also ID 2011/45.

9 S 152-12 ITAA97. For the circumstances in which CGT event D1 will happen, see ¶2-125.

Chapter 6

Maximum net asset value test

¶6-100 Context

For a capital gain to be eligible for the CGT small business reliefs, it is a basic condition that the entity making the gain:

(1) satisfies the maximum net asset value test; or

(2) satisfies one of the small business entity test requirements for the income year.[1]

The current maximum net asset value test threshold is $6m. It may be noted that this threshold amount has remained unaltered since the 2007-08 income year. The threshold prior to that income year was $5m. The alternative small business entity test requirements first applied in relation to CGT events that happened in the 2007-08 income year.

For the circumstances in which an entity will be a small business entity for an income year, see ¶7-100.

¶6-105 The test

For an entity that makes a capital gain from a CGT event that happens in the 2007-08 or a later income year to satisfy the maximum net asset value test, the total of the "net value of the CGT assets" of the following entities must not exceed $6m just before the happening of the CGT event that gives rise to the capital gain:

(1) the entity that makes the capital gain that is being tested for the CGT small business reliefs;

(2) any entities that are connected with the entity that makes the capital gain; and

(3) any affiliates of the entity that makes the capital gain and any entities connected with those affiliates.[2]

Any assets that are counted for the purposes of (2) above are excluded from (3) above to avoid double counting. There are circumstances in which an asset of an affiliate, or of an entity connected with an affiliate, is excluded. These circumstances, contained in s 152-20(3) and (4) ITAA97, have also been applied to exclude assets otherwise included under (2) above (see ¶6-135).

For a discussion of the circumstances in which:

- one entity will be connected with another entity, see ¶10-100; and
- an entity will be an affiliate of another entity, see ¶9-100.

"Just before the CGT event"

The maximum net asset value test must be applied "just before the CGT event".[3] The ATO view (which, it is considered, is correct) is that the reference to "just before the CGT event" is a reference to the time when the particular CGT event is taken to happen under the relevant CGT event rule.[4]

1 S 152-10(1)(c) ITAA97. See further ¶4-100.

2 S 152-15 ITAA97.

3 S 152-15 ITAA97.

4 ID 2003/744. See also *FCT v Byrne Hotels Qld Pty Ltd* [2011] FCAFC 127.

Example

Peter has carried on a farming business on land he acquired in 1992. On 8 August 2015, he enters into a contract to sell the land, and settlement of the contract takes place on 15 November 2015.

Although CGT event A1 can only happen if there is a change in ownership of the land (which occurs on 15 November 2015), the time of the CGT event is, by virtue of s 104-10(3) ITAA97, when the contract is entered into (ie 8 August 2015). Accordingly, the maximum net asset value test for the purposes of applying the CGT small business reliefs in relation to a capital gain from the sale of the farm would be applied just before the contract for sale is entered into on 8 August 2015.

The expression "just before the CGT event" means immediately before the CGT event.[5] This means that any fluctuation in the market value of an asset (eg a listed company share) on the day when the CGT event happens and before the actual time when the CGT event happens must be taken into account.[6]

The requirement that the maximum net asset value test be applied just before the CGT event does not prevent liabilities that are a necessary and integral part of the event from being taken into account (see ¶6-145).

However, an advance made by a bank to a related company the day after the happening of the CGT event, albeit pursuant to a mortgage entered into on the day of the happening of the CGT event pursuant to a company restructure, was held not to be a liability at the relevant time.[7]

Where the relevant CGT event is CGT event A1 (disposal of a CGT asset) and there is a contract under which the disposal occurs, the time of CGT event A1 is when the contract is entered into (s 104-10(3)(a) ITAA97). Not infrequently, questions arise as to whether a contract has in fact been concluded, for example, whether correspondence between the parties evidences the making of a contract or whether conditions contained in a document are conditions precedent to the formation of a contact or are conditions precedent to the performance of a contract. For a decision of the AAT in which it was held that conditions expressed in correspondence as conditions precedent were conditions precedent to performance, see *Scanlon and FCT*.[8]

Partner

The net value of the CGT assets of a partnership is only taken into account in the calculation of the net value of the CGT assets of a partner if the partnership is an entity connected with the partner by virtue of the right to distribution control rule (see ¶10-140, ¶18-110 and ¶18-135). This is illustrated in case studies 3 and 4 at ¶18-140.

5 ID 2003/745.

6 For a decision of the AAT in which questions as to whether a number of liabilities were in existence just before the CGT event, see *Excellar Pty Ltd and FCT* [2015] AATA 282.

7 *Phillips and FCT* [2012] AATA 219.

8 [2014] AATA 725. An appeal by the taxpayers to the Federal Court from the decision of the AAT was discontinued.

In such a case, the whole of the net value of the CGT assets of the partnership would (unless the excluding rule explained in ¶6-135 applied) be taken into account when determining whether the partner met the maximum net asset value test; but to avoid double counting, the partner's interest in the partnership would be excluded from the net value of the CGT assets of the partner (see ¶6-115).

¶6-110 What is net value of the CGT assets of an entity?

The net value of the CGT assets of an entity is determined by comparing:

(1) the sum of the market values of those assets; and

(2) the sum of the liabilities of the entity that are related to the assets and provisions of certain kinds (see ¶6-140).[9]

The net value of the CGT assets of an entity may be a positive or negative amount, or nil.

Example

Sneeze-Free Pty Ltd manufactures medication to alleviate flu and cold symptoms. It sells its factory premises under a contract entered into on 15 March 2016. Just before entering into the contract, the net value of the CGT assets of Sneeze-Free Pty Ltd relevant for the purposes of the maximum net asset value test was $3m, and the net values of the CGT assets of other entities that are to be taken into account when determining whether Sneeze-Free Pty Ltd satisfies the maximum net asset value test were as follows:

- Brian — $1.2m;
- Mary — $0.5m;
- Research Pty Ltd — ($0.9m); and
- VB & M Family Discretionary Trust — $2m.

Sneeze-Free Pty Ltd will meet the maximum net asset value test even though the sum of the positive net values are more than $6m. This is because, when the negative value of Research Pty Ltd is taken into account, the maximum net asset value threshold of $6m is not exceeded.

CGT assets

Unless a particular CGT asset is excluded, all CGT assets of an entity, wherever situated, are taken into account when calculating the net value of the CGT assets of the entity. It is, for example, immaterial if the particular CGT asset:

- is a pre-CGT asset;
- is a CGT asset from which a capital gain would otherwise be disregarded because of a CGT exemption (eg trading stock or a depreciating asset); or
- is or is not a business asset.

9 S 152-20(1) ITAA97.

Australian currency is taken to be a CGT asset by the ATO for this purpose.[10] Of course, a deposit with a financial institution would in any event be a chose in action (and, therefore, a CGT asset).[11] For what constitutes a CGT asset, see ¶2-105.

If the entity that makes the capital gain is a foreign resident of Australia, the worldwide CGT assets of the entity would be relevant when applying the maximum net asset value test.[12] It may be noted that a foreign resident will, broadly, only be subject to CGT if a CGT event happens in relation to taxable Australian property.

"Statute-barred debt"

In *Breakwell v FCT*,[13] the Federal Court held that the fact that the recovery of a debt owing to an entity may be "statute-barred" does not mean that the debt is not to be taken into account when calculating the net value of the CGT assets of the entity.

The debt in question was owed by one of the taxpayers to a discretionary trust of which he was a beneficiary. The taxpayers contended that the debt should be regarded as of nil value because any recovery by the trustee from the taxpayer had become statute-barred by virtue of s 35(a) of the *Limitation of Actions Act 1936* (SA). White J held that the reliance on the *Limitation of Actions Act 1936* was misplaced because:

- it is well established that provisions (such as s 35(a)) bar the remedy, but not the cause of action; and
- the taxpayers' contention overlooked the fact that the Act provided the courts with the power to extend the limitation period.

More fundamentally, however, the effect of s 32(1) of the *Limitation of Actions Act 1936* (which was not referred to by the parties in their primary submissions) effectively provided that there was no limitation period for an action by a trust to recover trust property (which the loan was).

Excluded assets

For the CGT assets excluded from the net value of the CGT assets of an entity, see ¶6-115 to ¶6-135.

Market value

In some cases, whether the aggregate of the net value of the CGT assets of relevant entities exceeds or does not exceed $6m will be clear. But, not infrequently, the position will not be clear and, in these cases, probative evidence of the market value of the non-excluded CGT assets of each relevant entity at the relevant time should be obtained.

10 ID 2003/166.

11 See *Excellar Pty Ltd and FCT* [2015] AATA 282.

12 ID 2010/126.

13 [2015] FCA 1471.

In *Spencer v Commonwealth*,[14] Griffith CJ said that the test of value of land is to be determined not by inquiring what price a man desiring to sell could actually have obtained for it on a given day (ie whether there was in fact on that day a willing buyer), but by inquiring, "What would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for a fair price but not desirous to sell?".

In *Flemington Properties Pty Ltd v Raine & Horne Commercial Pty Ltd*,[15] Lehane J pointed out that the fact that several valuers valuing the same property on the same basis on the same date produce different assessments does not mean that only one of them is right, that any of them is wrong, or that any of the valuers was negligent; the cases speak of an "acceptable range of figures that a competent valuer using due skill and care would reach" and "an acceptable margin of error". Lehane J said that that range may vary, depending particularly on the difficulty of a particular valuation taken at a particular time.

It is important to note certain observations of Dixon J in *Commissioner of Succession Duties (SA) v Executor Trustee & Agency Co of SA Ltd*.[16] Dixon J stated that, while the basis of valuation was the same for revenue purposes as when assessing compensation to a dispossessed owner, there were differences in principle that might affect the application of that test. His Honour said:

> "I should like, however, to add for myself that there is some difference of purpose in valuing property for revenue cases and in compensation cases. In the second the purpose is to ensure that the person to be compensated is given a full money equivalent of his loss, while in the first it is to ascertain what money value is plainly contained in the asset so as to afford a proper measure of liability to tax. While this difference cannot change the test of value, it is not without effect upon a court's attitude in the application of the test. In a case of compensation doubts are resolved in favour of a more liberal estimate, in a revenue case, of a more conservative estimate."

In *Gregory v FCT*,[17] Gibbs J agreed with this approach.[18]

In *Miley and FCT*,[19] the taxpayer was one of three equal shareholders in a company. All of the shareholders sold their shares to a purchaser in an arm's length transaction for $17.7m, of which the taxpayer's entitlement was $5.9m. When applying the maximum net asset value test in relation to the taxpayer, the Commissioner treated the market value of the taxpayer's shares as being $5.9m. The taxpayer, however, contended that what he received was not necessarily the market value of the shares just before the CGT event. What was sold was all of the shares in the company and, so it was contended, a discount (of 16.7%) was to be applied because of the fact that the taxpayer's shareholding was a minority shareholding. The AAT, upholding the taxpayer's contention, said:

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14 [1907] HCA 82.

15 (1997) 148 ALR 271.

16 [1947] HCA 10.

17 [1971] HCA 2.

18 For AAT decisions in which taxpayers failed to discharge the onus of proof in relation to the valuation of assets, see *Venturi and FCT* [2011] AATA 588 and *Syttadel and Holdings Pty Ltd and FCT* [2011] AATA 589.

19 [2016] AATA 73.

> "I find that the consideration that Mr Miley [the taxpayer] received for his shares, which formed part of the consideration paid by the Buyer for all the shares in the Company, is more than a hypothetical willing but not anxious purchaser would have paid if it had purchased Mr Miley's shares alone – and that is the basis on which the market value of Mr Miley's shares should be determined. Therefore, while the actual consideration received by Mr Miley should not be ignored as an indicator of the market value of his shares just before the time of the CGT event …, it is not determinative of that market value.
>
> The market value of Mr Miley's shares, arrived at by reference to the correct enquiry, is $5,900,000 less 16.7% of that amount, for lack of control. That equates to $4,914,700."

The Commissioner has appealed to the Federal Court from the decision of the AAT.

The statutory definition

The expression "market value" is defined in the dictionary (in s 995-1 ITAA97) to have a meaning affected by Subdiv 960-S ITAA97. The expression "market values" is asterisked in the definition of "net value of the CGT assets" of an entity.

So far as is relevant, s 960-405 ITAA97 provides that the market value of an asset (other than an asset the supply of which cannot be a GST taxable supply) at a particular time is reduced by the amount of the GST input tax credit (if any) to which "you" would be entitled, assuming "you" had acquired the asset at that time, and the acquisition had been solely for a creditable purpose. This means that, where the taxpayer is GST-registered and would have been entitled to a GST input tax credit on the hypothesis required by the definition of market value, the market value is the GST-exclusive amount.

¶6-115 Disregarded assets: interest in interposed entities

When working out the net value of the CGT assets of an entity (X), shares, units or other interests (except debt) in another entity that is connected with X or with an affiliate of X are disregarded.[20] However, any liabilities that are related to any such shares, units or interests are included in the calculation.

The purpose of this disregarding rule is to avoid the double counting that would otherwise occur because, since the entities are connected, the assets of the other entity would have to be taken into account in the calculation of the net value of the CGT assets of X or the affiliate of X.

The following simple example illustrates this.

20 S 152-20(2)(a) ITAA97.

Example

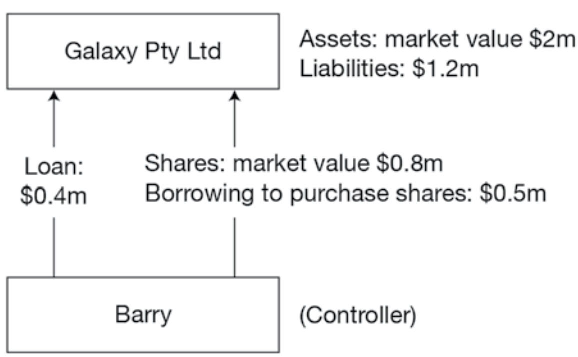
Brian is considering selling a CGT asset that is an active asset. He owns an equal tenant in common interest in a rental property with Cathy. Because they jointly receive income from the rental property, Brian and Cathy are partners for the purposes of the ITAA97 (see ¶18-100). There is an issue whether a tax law partnership can be a connected entity (see ¶18-110) but, assuming that it can, because Brian has a 50% interest in the net income of the partnership, he controls the partnership. Therefore, Brian and the partnership are connected entities.

This means that the net value of the CGT assets of the partnership (broadly, the market value of the rental property, less related liabilities) is brought to account when applying the maximum net asset value test to Brian. However, the value of Brian's interest in the partnership is excluded from the calculation of the net value of his CGT assets.

The inclusion (in the calculation of the net value of the CGT assets of an entity) of liabilities that are related to shares, units or other interests in a relevant connected entity recognises the fact that, if the shares, units or other interests were disregarded, this would (without a provision to the contrary) have the consequence that borrowings that were made to acquire the shares, units or other interests would be disregarded.

The following simple example illustrates this.

Example



The net value of the CGT assets of Galaxy Pty Ltd would be $0.8m (ie $2m – $1.2m). The liabilities of $1.2m would include the debt of $0.4m owed to Barry.

The liability of $0.5m relating to the purchase of the shares in Galaxy Pty Ltd would be included in the calculation of the net value of Barry's CGT assets.

¶6-120 Disregarded assets: individuals

When working out the net value of the CGT assets of an individual, the following are to be disregarded:

(1) assets being used solely for the personal use and enjoyment of the individual, or the individual's affiliate (see ¶9-110), except a dwelling (or an ownership interest in a dwelling) that is the individual's main residence, including any adjacent land to which the CGT main residence exemption can extend because of s 118-120 ITAA97;

(2) subject to the special rule noted below, the market value of a dwelling (or an ownership interest in a dwelling) that is the individual's main residence (including any relevant adjacent land);[21]

(3) a right to, or a right to any part of, any allowance, annuity or capital amount payable out of a superannuation fund or an approved deposit fund;

(4) a right to, or a right to any part of, an asset of a superannuation fund or of an approved deposit fund; and

(5) a policy of insurance on the life of an individual.[22]

Asset being used for personal use and enjoyment

The exclusion of assets being used solely for the personal use and enjoyment of the particular individual (see (1) above) raises some issues.

"Being used"

The Commissioner takes the view (in ID 2011/37) that the use of an asset over its ownership period is taken into account when determining whether it can be said that it is an asset being used solely for the individual's personal use and enjoyment so that it is disregarded from the net value of the individual's CGT assets under (1) above.

The facts on which the interpretative decision is based involved an individual taxpayer who made a capital gain from the sale of a business asset. The individual also owned a dwelling (separate from their business) which had been leased to tenants for a period of five years from the time of acquisition until one month before the sale of the business asset. From the time the leasing of the dwelling ceased until after the sale of the business asset, the dwelling was used solely for the personal use and enjoyment of the individual (but not as a main residence). The individual was not a small business entity (within the meaning of s 328-110 ITAA97) at any time.

The interpretative decision states:

> "The question arises as to whether subparagraph 152-20(2)(b)(i) of the ITAA 1997 requires only a consideration of the use of an asset immediately before the relevant CGT event or requires a consideration of the use of the asset throughout its ownership period to determine whether it is an asset being used solely for personal use and enjoyment.

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21 See below under "Special main residence rule".

22 S 152-20(2)(b) ITAA97.

> It is considered that if regard was had only to an asset's use at a single point in time, that is, immediately before the relevant CGT event, the result would not necessarily reflect the true nature of the use of the asset. Accordingly, it is considered that regard must be had to the use of an asset over its ownership period in order to ascertain whether the asset is being used solely for personal use and enjoyment. As the provision refers to sole personal use, any non-personal use of an asset over its ownership period will mean the asset is not disregarded under subparagraph 152-20(2)(b)(i) of the ITAA 1997.
>
> In this case, the individual has used their dwelling for non-personal use for nearly the entire period of ownership up to the time of the sale of the business asset. Accordingly, the dwelling is not an asset being used solely for the personal use and enjoyment of the individual and is not disregarded under subparagraph 152-20(2)(b)(i) of the ITAA 1997. The dwelling must be included in the net value of the individual's assets under section 152-15 of the ITAA 1997."

It is suggested that the underlying premise on which the interpretative decision is based (that is, that any non-personal use of an asset over its ownership period will mean that the asset is not disregarded) is erroneous. The maximum net asset value test must be satisfied at a particular point in time ("just before the CGT event" (see ¶6-105)) and the "being used" test in (1) above requires attention to be directed to that point in time. It is submitted that it is a question of fact whether it can be said that an asset is being used in the way described in (1) above and that this does not necessarily preclude an examination of the use of the asset for a reasonable period before, and a reasonable period after, the happening of the CGT event.

Stroud's Judicial Dictionary of Words and Phrases (4th ed) states:

> "(1) 'Being', as used in a sense similar to that of the ablative absolute, has sometimes been translated as 'having been', but it properly denotes a state or condition existent at the time when the conclusion of law or fact has to be ascertained."

It is submitted that "being used" in s 152-20(2)(b)(i) ITAA97 is used in its ordinary sense. This is, however, not to say that past and, indeed future, use may not shed light on the use at the relevant time, particularly where the position is not clear. For example, where a house is used on a regular basis as a holiday house, the fact that it was vacant just before the happening of the relevant CGT event should not, of itself, lead to the "being used" test not being met. This, in essence, was the approach taken by the AAT in *Altnot Pty Ltd and FCT*,[23] where the AAT said that the decision to be made was about an activity at a particular point in time and not one requiring account to be taken of predictable developments as such. The principle is no different, though. The AAT said that, in order to make a decision about what was happening at a particular point in time, it must be first asked what was happening in the time surrounding that particular point in time so that the point in time is looked at in its context. The *Altnot* decision is further considered below.

23 [2013] AATA 140.

What may be regarded as a somewhat analogous position can arise in the context of land tax exemptions. In *Leda Manorstead Pty Ltd v Chief Commissioner of State Revenue* (*NSW*),[24] the issue was whether certain land was exempt under s 10AA of the *Land Tax Management Act 1956* (NSW) which (so far as is relevant) exempted land used for primary production, and required that the dominant use of the land was for a primary production activity and that that use had a significant and substantial purpose or character. Under the Act, land tax is charged on land as owned at midnight of 31 December immediately preceding the year for which land tax is levied. Gzell J said:

> "But inquiry is not limited to the use to which land is put on the relevant date. It extends to a consideration of its use during a reasonable period preceding and following the relevant date (*Longford Investments Pty Ltd v Commissioner of Land Tax* (NSW) (1978) 8 ATR 656 at 660-661). In my view, six months before and after the relevant date is a reasonable period for inquiry in this case. It allows for consideration of financial records pertaining to the uses to which the land was put."

It is suggested that an approach along these lines in relation to the "being used" requirement in s 152-20(2)(b)(i) ITAA97 would produce fair and common sense results.

Moreover, the Commissioner's underlying premise could lead to what would appear to be unintended results. For instance, if an individual bought a dwelling subject to a tenancy that had six months to run and thereafter only used the dwelling as a holiday house, on the Commissioner's view, the dwelling could not satisfy the "being used" test. This, it is considered, is unlikely to have been the intended result.

If the legislature intended all past use to be relevant, it could have simply said so. For example, it could have been drafted along the lines "assets that have at all times been used solely …". It is significant that, when it was thought necessary that past use be taken into account (as in the case of a main residence), the legislation has specifically provided for this.[25]

Of course, the construction suggested may give rise to somewhat anomalous results in particular circumstances, for example, where a main residence that has been used for income-producing purposes comes to be used as a holiday house. The avoidance of such results requires the attention of the legislature.

AAT decision

Some of the issues raised above were considered by the AAT in *Altnot Pty Ltd and FCT*.[26] In that case, the AAT considered that the requirement of the maximum net asset value test was to consider both assets and liabilities at a particular point in time and therefore excluded both assets and liabilities that were transacted either before or after that point in time. In this sense, the AAT noted:

24 [2010] NSWSC 867. An appeal from the decision of Gzell J was dismissed: *Leda Manorstead Pty Ltd v Chief Commissioner of State Revenue* [2011] NSWCA 366.

25 See below.

26 [2013] AATA 140. An appeal by the Commissioner from the AAT's decision on another point was allowed (see *FCT v Altnot Pty Ltd* [2014] FCA 362).

> "The ordinary meanings of the word 'use', when used as a verb as it is in s 152-20(b)(i) include that of '*to put to a particular use*'.[16] When used as a noun, its relevant ordinary meaning would seem to be '*a practical purpose a thing can be put to.*'[17] The word '*being*' is a participle used to express continuous action. Therefore, when s 152-20(b)(i) refers to a CGT assets '*being used … for the personal use and enjoyment of the entity …*', it is referring to a CGT assets' being put to a practical purpose with some continuity. I will come back to what I mean by '*some continuity*'. For the moment, I note that Division 152-A itself draws a distinction between something that is '*being used*' and something that is '*held ready for use*'. It uses the latter term, for example, in the sense of a CGT asset's '*not … held ready for use*' in s 152-20(4). A CGT asset that is being held ready for use is not '*being used*' in the sense in which that expression is used in s 152-20(2)(b)(i)."

Based on the above grammatical application, the AAT concluded that:

> "At one level, the concept of a point in time test might seem somewhat at odds with a test that incorporates an element of continuity. I do not think that it is, though. There will be some CGT assets which will be in use, and so '*being used*' for the personal use and enjoyment of the entity just before the CGT event but that does not mean that only those that are actually in use for the purpose at that time have that necessary element of continuity or even that those that are actually in use at that point in time have that necessary element of continuity. A holiday house provides an example. The owners of the house may not be in residence just before the CGT event and so may not be using it at that moment but that does not mean that the house, which is the CGT asset, is not being used by them as a holiday house at that time. Equally, the fact that they are in residence just before the CGT event may not mean that the house is being used solely for their personal use and enjoyment. Whether it is being used as a holiday house solely for their personal use will depend on a conglomerate of matters. They include such matters as the pattern of use by the owners and others leading up to that time, the amount of time for which it is used as a holiday house and how the owners view it."

Solely

The requirement that the asset be used "solely" for the personal use and enjoyment of the individual or his or her affiliate (see (1) above) means that the use of the asset must be confined to the use stipulated, and precludes any use of the asset for any purpose, however minor in importance, that is collateral or independent, as distinguished from incidental to the stipulated use.[27] It is possible, however, that a de minimis other use could be disregarded.[28]

Affiliate issues

The concept of an affiliate is narrower than the former concept of a small business CGT affiliate that applied in relation to CGT events that happened in the 2006-07 and earlier income years. For example, spouses are not automatically affiliates of each other, and a child who is under 18 years of age is not automatically the affiliate of each of his or her parents. This also affected the scope of (1) above. The position was relaxed to some extent with the enactment of the special spouse/child under 18 affiliate

27 *Randwick Municipal Council v Rutledge* [1959] HCA 63 per Windeyer J.

28 *FCT v Dixon Consulting Pty Ltd* [2006] FCA 1748.

rule by the *Tax Laws Amendment (2009 Measures No. 2) Act 2009* (see ¶9-135). The circumstances in which this rule will apply in the present context are limited.

If the "used soley" test is applied strictly, it may mean that, if an asset is owned by an individual and the asset is used by the individual's spouse, the asset could only be excluded under (1) above if the spouse is carrying on a business and is an affiliate because (broadly) of the individual's involvement in the business or, if that is not the case, the special spouse/child under 18 affiliate rule applies.[29]

The Commissioner, however, takes what can only be described as a generous view. In ID 2011/39, the view is taken that the personal use of a holiday house by an individual's spouse and children under the age of 18, in conjunction with the individual's personal use, would not by itself stop the holiday house from being an asset used solely for the personal use and enjoyment of the individual.

The interpretative decision states:

> "As the individual's spouse and children are not affiliates of the individual, the question arises as to whether their personal use of the holiday house means that the holiday house is not being used solely for the personal use and enjoyment of the individual.
>
> It is considered that the personal use of the holiday house by the individual's spouse and children under the age of 18, in conjunction with the individual's personal use, is still nevertheless a part of the personal use and enjoyment of the holiday house by the individual. Such use will not therefore by itself stop the holiday house from being an asset used solely for the personal use and enjoyment of the individual."

The Commissioner's view is, in fact, even more generous. In ID 2011/40, the view is taken that the personal use by others of an individual's holiday house for which no rent is paid would not of itself mean that the holiday house is not an asset being used solely for the personal use and enjoyment of the individual. The facts considered in the interpretative decision involved a holiday house that was either used for the personal use and enjoyment of the individual (for occasional holidays, but never as a main residence) or for the personal use and enjoyment of the individual's friends or relatives (none of whom were the individual's affiliates) on a rent-free basis, although payments were often made to cover the use of utilities such as electricity, gas and water. The interpretative decision states:

> "It is considered that the personal use of the holiday house by the individual's friends and relatives for which no rent is paid is still nevertheless a part of the personal use and enjoyment of the holiday house by the individual. This is so even if amounts are paid to cover the use of utilities. Such use will not therefore by itself stop the holiday house from being an asset used solely for the personal use and enjoyment of the individual."

On the other hand, ID 2011/41 concludes that, where rent is paid by others for the use of an individual's holiday house, this would mean that the holiday house is not an asset being used solely for the personal use and enjoyment of the individual. This is consistent with ID 2011/37, although, as pointed out above, the correctness of the underlying premise in ID 2011/37 is open to question.

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29 It may be noted that the position was otherwise under the former definition of small business CGT affiliate (which was the relevant concept when applying exclusion (1) for CGT events that happened in the 2006-07 or an earlier income year). Spouses were automatically small business CGT affiliates of each other. Moreover, as noted in the text, a child under 18 years of age of an individual was automatically a small business CGT affiliate of the individual, but is not automatically the affiliate of the individual.

It is not clear in what circumstances ID 2011/39 would apply that would not be covered by ID 2011/40. Indeed, ID 2011/39 tends to create some confusion having regard to its limitation to use by an individual's spouse and children under the age of 18 during periods in conjunction with the individual's use. Having regard to ID 2011/40, those limitations are simply not relevant.

It is submitted that the correctness of ID 2011/40 is somewhat doubtful, as the interpretative decision overlooks the force of the word "solely" (see above). Taking the facts considered in ID 2011/39, it may arguably be said that there was incidental use, but this could not be said to be so in relation to the facts considered in ID 2011/40.

If an asset is being used solely for the personal use and enjoyment of spouses, some potential difficulties could be overcome if the asset was jointly owned by them.

Special main residence rule

The special rule referred to in (2) above applies where:

- a dwelling of an individual, an ownership interest in a dwelling or any relevant adjacent land was used (during all or part of the ownership period of the dwelling) by the individual to produce assessable income to a particular extent; and
- the individual satisfied s 118-190(1)(c) ITAA97 at least to some extent (ie if interest had been incurred on a borrowing to acquire the dwelling, the interest would have been wholly or partly deductible).[30]

In that event, such amount as is reasonable (having regard to the extent to which s 118-190(1)(c) ITAA97 was satisfied) is included in the net value of the CGT assets of the individual.

The relevant explanatory memorandum[31] points out that if the dwelling has had some income-producing use, the percentage of income-producing use is multiplied by the current market value in order to work out the value of the dwelling that should be included. This will take into account the length of time and percentage of income-producing use of the dwelling. For further discussion, including an example, see ¶6-125.

Superannuation fund

A "superannuation fund", for the purposes of (3) and (4) above, is a fund that is an indefinitely continuing fund and is a provident, benefit, superannuation or retirement fund. It also includes a public sector superannuation scheme.[32] It is not relevant whether the superannuation fund is a

30 S 152-20(2A) ITAA97. In ID 2011/38, the view is taken that the reference to "dwelling" in s 152-20(2A) ITAA97 only refers to a dwelling that is an individual's main residence. This, it is considered, is clearly correct.

31 The explanatory memorandum to the Tax Laws Amendment (2006 Measures No. 7) Bill 2006.

32 S 995-1 ITAA97.

complying or non-complying fund. For a decision in which the concept of a superannuation fund was considered, see *Cameron Brae Pty Ltd v FCT*.[33]

Interest-bearing bank account

An interest-bearing personal bank account of an individual would not be used solely for the account holder's personal use and enjoyment because of the interest earned, even if the account holder only pays personal living expenses from the account.[34]

Vacant land

Vacant land owned by an individual, on which he or she intends to construct a dwelling in the future for private use, is not being used solely for personal use and enjoyment and, accordingly, is not disregarded in working out the net value of the CGT assets of the individual.[35]

¶6-125 Dwellings

A dwelling, or an ownership interest in a dwelling, may be wholly or partly excluded from the calculation of the net value of the CGT assets of an individual.

There are two possible exclusions (from the calculation of the net value of the CGT assets of an individual) that can apply in relation to a dwelling. These exclusions are applied when the individual's net value of CGT assets is being calculated and are expressed as follows:

(1) assets being used solely for the personal use and enjoyment of the individual, or the individual's affiliate (except a dwelling, or an ownership interest in a dwelling, that is the individual's main residence, including any adjacent land to which the main residence exemption can extend because of s 118-120 ITAA97); and

(2) except for an amount included under the special rule explained below, the market value of a dwelling, or an ownership interest in a dwelling, that is the individual's main residence (including any relevant adjacent land).[36]

Under s 118-120 ITAA97, the CGT main residence exemption can extend to land that is adjacent to a dwelling (to the extent that it is used primarily for private or domestic purposes in association with the dwelling) up to a maximum of two hectares (including the area of the land on which the dwelling is built).

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33 [2007] FCAFC 135.

34 ID 2009/33. Does this mean that taking an amount out of a private interest-bearing account and putting it into a non-interest-bearing account would mean that the amount (or, more accurately, the chose in action representing the account) would be an excluded asset (subject to any application by the Commissioner of Pt IVA ITAA36)?

35 ID 2009/34.

36 S 152-20(2)(b)(i) and (ii) ITAA97.

The expressions "dwelling" and "ownership interest" have the same meanings as in the CGT main residence exemption.[37]

Exclusion (1)

The exclusion in (1) above can operate in relation to a dwelling other than a dwelling that is the individual's main residence at the time when the maximum net asset value test is being applied. This means that the area of the land that is adjacent to a dwelling will only be an issue in the calculation of the net value of the CGT assets of an individual if the dwelling is being used as the individual's main residence, ie if (2) above applies.

Whether the "being used solely" requirement in exclusion (1) above is met in a particular case would largely be a question of fact. This issue is discussed at ¶6-120 where relevant interpretative decisions issued by the Commissioner are considered.

An important point is that the only use permitted under the exclusion in (1) above is use by the individual or the individual's affiliate. The limited circumstances in which one person will be an affiliate of another (see ¶9-110) means that the potential for the operation of this exclusion is rather limited. For further discussion, see ¶6-120.

Exclusion (2)

For the exclusion in (2) above to apply, the dwelling must be the individual's main residence at the time when the maximum net asset value test is being applied. If this is so, it is immaterial what earlier use the dwelling may have been put to by the individual during the time that the individual had an ownership interest in the dwelling, unless that use was an income-producing use (see below). It is also immaterial whether there is any other individual or entity that has an ownership interest in the dwelling, or uses the dwelling, and what use (if any) is made of the dwelling by any such other individual or entity.

Income-producing use of main residence

The special rule referred to in exclusion (2) above applies if the dwelling, the individual's ownership interest in it or any relevant adjacent land was used by the individual (during all or part of the individual's ownership period) to produce assessable income to a particular extent, and the individual satisfied s 118-190(1)(c) ITAA97 (at least to some extent). That provision will be satisfied if, assuming (even if this was not the case) that the individual borrowed to acquire the dwelling and had incurred interest on the borrowing, he or she would have been able to deduct some or all of the interest from assessable income because of an income-producing use of the dwelling at some time or times during his or her ownership period.

In that event, there is not a total exclusion from, or inclusion in, the net value of CGT assets calculation. When working out the net value of the CGT assets of the individual, the amount included in respect of the dwelling is "such amount [of the market value of the dwelling] as is reasonable having regard to the

37 Ss 118-115 and 118-130 ITAA97.

extent to which" s 118-190(1)(c) ITAA97 was satisfied.[38] The explanatory memorandum to the relevant amending Bill[39] states that this will take into account the length of time and percentage of income-producing use of the dwelling.

Note that the operation of this special rule extends beyond the situation where the dwelling is used by the individual as his or her main residence and, concurrently, for an income-producing purpose. The special rule can also apply where the dwelling has been previously used wholly for income-producing purposes for a period (eg if it were leased out). This is because s 118-190(1)(c) ITAA97 will be satisfied if "some or all" of the interest (on the hypothesis that it was incurred) would be deductible.

When would interest be partly deductible?

According to the ATO Guide, an individual would be entitled to deduct part of the interest on money borrowed to purchase a dwelling if:

- part of the dwelling is set aside exclusively as a place of business and is clearly identifiable as such; and
- that part of the dwelling is not readily adaptable for private use (eg a doctor's surgery located within a doctor's home).

Calculation of amount to be included

The following example, adapted from the explanatory memorandum, illustrates the calculation of the amount of the market value of a dwelling (that is an individual's main residence) that is to be included in the net value of the CGT assets of the individual where the (hypothetical) interest deductibility rule applies.

Example (adapted from explanatory memorandum)

Ben owns a dwelling (which is his main residence) that has a market value of $750,000 just before applying the maximum net asset value test. Ben has owned the house for 12 years – for the first three years, 20% of it was used for producing assessable income; for the following two years, 40% of it was used for producing assessable income; for the next two years, it was used solely as a main residence; and for the last five years, 10% of it was used for producing assessable income.

Ben's dwelling has had 15.8333% income-producing use, calculated as:

(3/12 × 20%) + (2/12 × 40%) + (2/12 × 0%) + (5/12 × 10%).

Ben will include $118,750 in the calculation of the net value of his CGT assets ($750,000 × 15.8333%).

The explanatory memorandum goes on to state that, if Ben had a liability of $500,000 that was related to the dwelling, 15.8333% ($79,167) of the liability would also be included when calculating the net value of

38 S 152-20(2A) ITAA97. In ID 2011/38, the view is taken that the reference to "dwelling" in s 152-20(2A) ITAA97 only refers to a dwelling that is an individual's main residence. This, it is considered, is clearly correct.

39 The Tax Laws Amendment (2006 Measures No. 7) Bill 2006.

the CGT assets of Ben. There does not seem to be any clear legislative basis for this statement. Although only part of the market value of the dwelling is included in the net value of CGT assets calculation under the main residence provisions, it is the liabilities of the individual that are related to the dwelling that are subtracted; there are no words of apportionment that are relevant to determining the amount of liabilities that are to be taken into account.

Moreover, while the result contemplated in the explanatory memorandum may be superficially attractive, there are a number of latent issues. For example, what would the position be if the liability was incurred to extend the dwelling in a way that was wholly unrelated to the income-producing use of the dwelling (which, indeed, may have already ceased) or, to take the contrary case, if the liability was incurred solely in relation to the income-producing use of the dwelling? If the liability was incurred for a private purpose that was wholly unrelated to the use of the dwelling (eg to fund an extended overseas holiday for the family), it would seem that it would be unlikely that the liability could be said to relate to the dwelling in the relevant sense (see ¶6-150). If the liability was incurred for business purposes (eg to fund the carrying on of a business), the liability would presumably relate to the business asset(s), not the dwelling (see ¶6-150).

Use by individual

For the special main residence income-producing rule to have any application in the calculation of the net value of the CGT assets of an individual, the income-producing use of the dwelling must be use by the individual whose net value of CGT assets is being calculated.

For example, assume that an individual owns a dwelling that is his or her main residence, and his or her spouse, who does not have an interest in the dwelling, uses it for income-producing purposes. In that event, it would seem that the dwelling would nevertheless be potentially wholly excluded from the calculation of the net value of the individual's CGT assets (unless the land area was to exceed the two-hectare limitation in the CGT main residence exemption).

Main residence exemption deeming provisions not relevant

The deeming provisions that apply for the purposes of the CGT main residence exemption, and which may deem a dwelling (contrary to fact) to be a taxpayer's main residence, are not relevant for the purposes of determining whether the dwelling is an excluded (or partly excluded) asset when calculating the net value of the CGT assets of an individual.

Adjacent land

The personal use and enjoyment exclusion from the calculation of the net value of the CGT assets of an individual, which is reflected in (1) above, uses the general expression "assets", which could, of course, include a dwelling (or an ownership interest in a dwelling). Potentially, therefore, all of the land associated with a dwelling (that is not the taxpayer's main residence) without any area limitation would be an excluded asset if it were being used solely for the personal use and enjoyment of the individual or the individual's affiliate.

If, however, the adjacent land was on the same title as the dwelling and was not being used solely for the personal use and enjoyment of the individual (or the individual's affiliate), the personal use and enjoyment exclusion may be prevented from operating at all.

If a dwelling is an individual's main residence, the dwelling and adjacent land (up to the two-hectare limit) is excluded from the personal use and enjoyment category of CGT assets, and is dealt with under (2) above.

Jointly-owned dwelling

If a dwelling and/or adjacent land is jointly owned, the exclusions that potentially apply in relation to a dwelling would need to be considered separately in relation to each joint owner.

¶6-130 Summary of dwelling rules

The following table sets out (in broad terms) the way in which the net value of CGT assets exclusion rules operate in relation to dwellings (for further discussion, see ¶6-125).

Situation	Full exclusion if	Adjacent land	Effect of income-producing use
Dwelling is not the individual's main residence.	Dwelling is being used solely for the personal use and enjoyment of the individual or the individual's affiliate.	Excluded on the same basis as the dwelling, regardless of the area.	If the income-producing use is current, the "being used" solely requirement could not be met. If the income-producing use is in the past and has ceased, the Commissioner's view is that the "being used" solely requirement could not be met but this, it is submitted, is not correct (see ¶6-120).
Dwelling is the individual's main residence.	Dwelling has never been used by the individual for income-producing purposes.	Excluded on the same basis as the dwelling, up to a maximum total area of two hectares.	Effectively only a partial exclusion, whether the individual's income-producing use is current or in the past.

¶6-135 Certain assets of affiliates and their connected entities disregarded

When applying the maximum net asset value test in relation to an entity (for convenience, called the "tested entity"), the net value of the CGT assets of any affiliate of the tested entity or of entities connected with such affiliates is included (see ¶6-105).

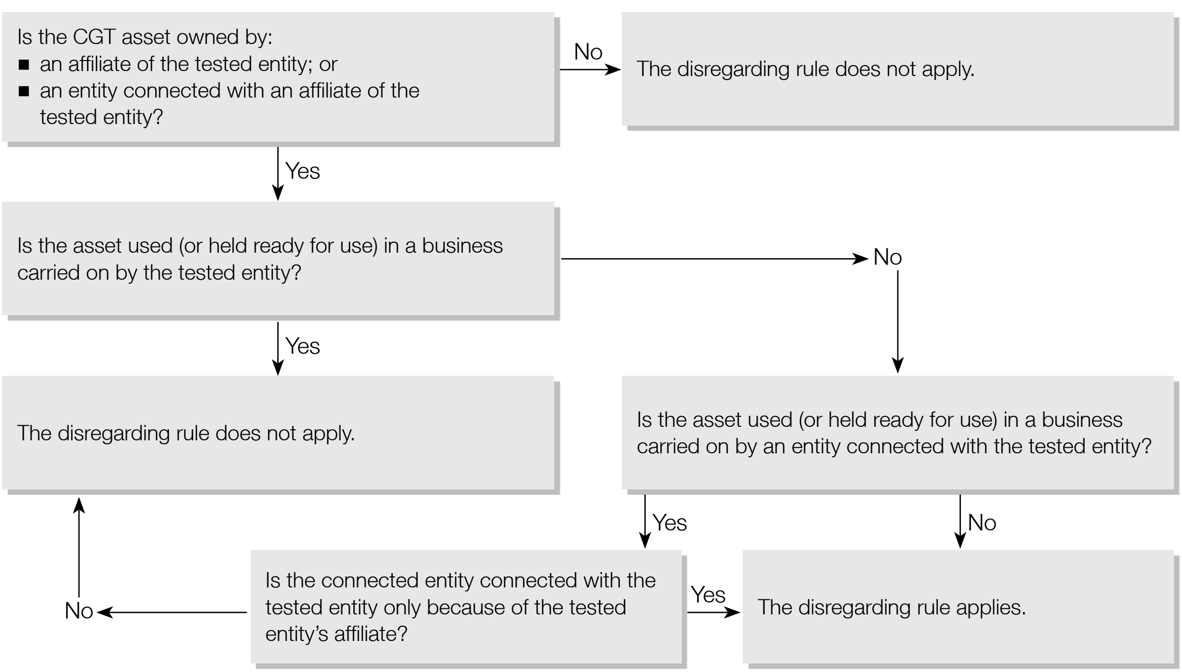
However, this is subject to an important modification. Assets of an affiliate of the tested entity or of an entity that is connected with such an affiliate are only included in the net value of the CGT assets of the particular entity if they are used, or held ready for use, in the carrying on of a business (whether alone or jointly with others) by:

- the tested entity; or
- an entity that is connected with the tested entity, unless the connection is only because of the tested entity's affiliate.[40]

For the definition of affiliate, see ¶9-110 and ¶9-135, and for the rules that determine whether one entity is connected with another entity, see ¶10-100.

Chart of operation

The following chart sets out how the disregarding rule under discussion applies.



40 S 152-20(3) and (4) ITAA97.

The following example illustrates the operation of the disregarding rule.

Example

Colin operates a newsagency business as a sole trader. His spouse (Sally) carries on her own florist business (which is unrelated to the newsagency business) in circumstances such that Sally is an affiliate of Colin. Sally owns the land and building from which the newsagency is conducted and leases it to Colin.

When determining whether he satisfies the maximum net asset value test, Colin includes the market value of the land and building owned by Sally (because it is used in his newsagency business) but does not include Sally's other assets used in her florist business (because they are not used in the newsagency business).

Disregarding rule operates one way only

The fact that the disregarding rule operates to disregard the net value of the assets of an entity (entity A) when applying the maximum net asset value test to another entity (entity B), does not necessarily mean that the net value of the CGT assets of entity B are disregarded when applying the maximum net asset value test to entity A. The following example illustrates this point.

Example

David's spouse (Denise) is the sole director/beneficial shareholder of Productrange Pty Ltd, which carries on a wholesale business in which David has no involvement. David carries on his own business as an architect. Because of David's involvement with a small business carried on by Denise on her own account, Denise is an affiliate of David.

David is contemplating selling an active asset.

Productrange Pty Ltd is connected with David only because of his affiliate and, therefore, when applying the maximum net asset value test to David, the disregarding rule will operate to disregard the net value of the assets of Productrange Pty Ltd.

However, if Productrange Pty Ltd were considering whether to dispose of an active asset and if it were necessary to apply the maximum net asset value test to Productrange Pty Ltd, it would seem that the disregarding rule would not operate to disregard the net value of the CGT assets of David (who, on the assumptions made, controls, and is therefore connected with, Productrange Pty Ltd). This is because David is not an affiliate of Productrange Pty Ltd and, even if Denise were to be regarded as an affiliate of Productrange Pty Ltd, David is not an entity connected with Denise.

"Only because"

For the purpose of applying the disregarding rule, if an entity is connected with the tested entity, it is necessary to determine whether the connection is "only because" of the tested entity's affiliate.

Under the control rules in s 328-125(2) ITAA97, an entity will control another entity "if the first entity, its affiliates, or the first entity together with its affiliates" satisfy any of the paragraphs of the subsection (see ¶10-120).

The "only because" requirement can give rise to difficulty. For example, assume that there are 100 issued shares of one class in M Pty Ltd, of which A beneficially holds one share and his spouse (B) beneficially holds the remaining 99 shares. In this scenario, if B is an affiliate of A, is M Pty Ltd connected with A "only because" of B? Relevantly, the *Macquarie Dictionary* defines "only" as "without others or anything further; alone; solely" and defines "because" as "for the reason that; due to the fact that".

It is submitted that if, as envisaged, A beneficially holds one share in M Pty Ltd, and B beneficially holds the remaining 99 shares, it is not clear whether the fact that A beneficially holds one share means that it could be said that A is connected with M Pty Ltd "only because" of B. It is considered, however, that, because A would not be connected with M Pty Ltd without B, the "only because" requirement would be met. This view is supported by the decision in *White*'s case which is noted below.

Does the disregarding rule also apply to assets of entities connected to the taxpayer?

It may have been assumed that the special provisions of s 152-20(3) and (4) discussed above applied only for the purposes of s 152-15(c) (which includes the net value of CGT assets of any affiliates of the taxpayer or entities connected with the taxpayer's affiliates) and not for the purposes of s 152-15(b) (which includes the net value of CGT assets of any entities connected with the taxpayer).

However, in *White v FCT*,[41] both the taxpayers and the Commissioner agreed that whether the net value of assets of an entity connected with the taxpayer was included under s 152-15(b) was subject, so far as is relevant, to the operation of s 152-20(3) and (4). No explanation for this interpretation was given.

In that case, the taxpayers, who were husband and wife, were seeking CGT small business relief in relation to the sale of shares in a company. The husband owned 30% of the issued capital of the company and the wife owned 28.2% of the issued capital of the company. Together, therefore, they owned 58.2% of the issued capital of the company. The balance of the shareholding was held by unrelated third parties.

By virtue of the operation of the legislation as it then applied, the spouses were, without more, treated as being small business CGT affiliates of each other. On this basis, the company was connected with each of the taxpayers. But for the application of s 152-20(3) and (4), therefore, the net value assets of the company would have been included when determining whether the maximum net asset value test had been satisfied.

The Federal Court (Gordon J) held that each taxpayer was connected with the company only because his or her spouse had a shareholding which, together with the other spouse's shareholding, exceeded the 40% threshold. But for that circumstance, each taxpayer would not have been connected with the company. Accordingly, the court held that s 152-20(4) operated to disregard the value of the net assets of the company.

Because this case relies on an unexplained concession by the Commissioner, it must be treated with caution.

41 [2012] FCA 109.

Look-through earnout right

The amending Act that introduced the specific CGT rules relating to look-through earnout rights (see ¶3-110) amended the provisions governing the maximum net asset value test to provide that, when working out the value of an entity's CGT assets just before the time of a CGT event, a taxpayer may elect not to include the value of any look-through earnout right that the entity may hold, but instead to take into account any financial benefits that the entity may have provided or received under the look-through earnout right after that time (s 152-20 ITAA97). An election may only be made once no further financial benefits can be provided under the look-through earnout right.

There are special rules that ensure that the value of the financial benefits is not taken into account multiple times where the look-through earnout right relates to an asset that the entity holds at the time of the valuation.

¶6-140 Amounts that reduce the net value of CGT assets

When calculating the net value of the CGT assets of an entity, the sum of the market values of the relevant CGT assets is reduced by:

- the "liabilities" (see ¶6-145) of the entity that are "related to" (see ¶6-150) the assets; and
- certain provisions (see ¶6-145).

¶6-145 "Liabilities" and provisions

In TD 2007/14, it is stated that the term "liabilities" in the context of the maximum net asset value test has its ordinary meaning. It extends to legally enforceable debts that are due for payment, and to presently existing legal or equitable obligations to pay either a sum certain or ascertainable sums. The term does not extend to future obligations, expectancies or liabilities that are uncertain as both a theoretical and a practical matter.

In *Scanlon and FCT*,[42] the AAT held that a director's resolution that the company pay eligible termination payments to its two shareholders did not create a liability in the company. The AAT took the view that the passing of a resolution by the Board of Directors of a company could not, by itself, create a legal or equitable liability which could be enforceable against the company by persons who stand to benefit should the company act in accordance with the resolution. Also, there was no relevant consideration flowing from the shareholders; the only consideration that could be pointed to was past consideration and any payment to give effect to the resolution would be a gratuitous payment.

42 [2014] AATA 725. An appeal by the taxpayers to the Federal Court from the decision of the AAT in this case was withdrawn.

Contingent liabilities

Future obligations, expectancies or liabilities that are uncertain as both a theoretical and a practical matter are not "liabilities" for the purposes of the definition of the "net value of the CGT assets" of an entity.[43]

A contingent liability is defined in TD 2007/14 as a liability that will become due only on the occurrence of an event that may or may not happen – for example, a possible obligation to pay damages in the future if the judgment in a pending lawsuit is unfavourable.

However, a liability that is contingent on the occurrence of the same thing that will result in the happening of the particular CGT event (for example, in the case of the disposal of an asset under a contract, the completion of the contract) may be a relevant liability when applying the maximum net asset value test.[44] Thus, in the case of CGT event A1, the costs of sale of a CGT asset, such as accounting fees, legal costs (in each case, up to the time of the CGT event) and agent's commission, are to be taken into account. In *FCT v Byrne Hotels Qld Pty Ltd*,[45] Greenwood J (with whom Dowsett J agreed) said:

> "The source of the obligation [between the taxpayer entity and agent] is to be found in the mutual bundle of rights and obligations cast upon the parties by their exclusive agency contract, out of which the obligation to pay the agreed commission arose. The entity, just before the CGT event, was burdened with that obligation, according to its terms. It is important to remember that in determining whether the maximum net asset value test is satisfied, regard is to be had to the net value of the CGT asset of the taxpayer entity (apart from the other aggregation considerations in s 152-15) and the burden cast upon the entity by the obligations arising under the contract with [the agent] was a contingent burden which properly falls within the notion of a 'liability' in determining the net value."

In TD 2007/14, it is stated that, although the court in the *Byrne Hotels* case referred to "contingent liabilities" as being relevant for the purpose of the net asset calculation, it was clear that the judges were contemplating presently existing legal or equitable obligations where the only contingency is enforcement (the solicitor's fees) or obligations that are technically, but not "truly", contingent because the contingencies are formalities or procedural matters where nothing remains to be done by the relevant party to perfect its entitlement (the agent's commission). As such, the Commissioner is of the view that the decision does not stand for any principle that contingent liabilities in general fall within the meaning of the term "liabilities" for the purpose of s 152-20(1) ITAA97. A "truly contingent" liability in the sense of a future or potential obligation, expectancy or liability that is otherwise uncertain as a theoretical and practical matter will not be included as a liability for the purpose of s 152-20(1) ITAA97.

43 TD 2007/14. See also *Excellar Pty Ltd and FCT* [2015] AATA 282.

44 *FCT v Byrne Hotels Qld Pty Ltd* [2011] FCAFC 127. See also *Cannavo and FCT* [2010] AATA 591.

45 [2011] FCAFC 127 at [126].

Where an entity is the guarantor of a loan taken out by another entity, there can be no relevant liability of the guarantor entity where there has been no default that has triggered the operation of the guarantee.[46]

The following further examples of amounts that are not included in the expression "liabilities" are listed in TD 2007/14:

- provisions for liabilities in respect of an earn-out contract;
- provisions for the guarantee of a loan;
- accounting liabilities arising as a result of receiving prepaid income; and
- provisions for such things as a quantity rebate and the like.

Provisions taken into account

The following provisions made by an entity are taken into account when calculating the net value of the CGT assets of the entity:

(1) provisions for annual leave;

(2) provisions for long service leave;

(3) provisions for unearned income; and

(4) provisions for tax liabilities.[47]

The amount of the provisions to be taken into account may require accounts to be prepared for the period up to the time when the maximum net asset value test is being applied.

What constitutes "tax liabilities" depends on the meaning of "tax". "Taxation" has been defined as a compulsory exaction of money by a government for public purposes, being neither a pecuniary penalty nor a fee for services rendered.[48] Tax liabilities would therefore potentially extend beyond the typical federal taxes (income tax, FBT, GST etc) to state taxes (eg payroll tax, land tax and stamp duty) and local government taxes (eg rates).

Limitation of actions

The fact that the recovery of a debt owing to an entity may be "statute-barred" does not mean that the debt is not to be taken into account when calculating the net value of the CGT assets of the entity.[49] The relevant limitations legislation did not have the effect of extinguishing a claim in contract (or for repayment of a debt) after six years; what was barred was the remedy not the cause of action. Also, the legislation conferred power on the court to extend the particular limitation period. In any event, the

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46 *Tingari Village North Pty Ltd and FCT* [2010] AATA 233. See also *Excellar Pty Ltd and FCT* [2015] AATA 282.

47 S 152-20(1)(b) ITAA97.

48 *Matthews v Chicory Marketing Board (Vic)* (1939) 60 CLR 263. For a decision in which the meaning of taxation was considered and it was held that the superannuation guarantee charge was a tax, see *Roy Morgan Research Pty Ltd v FCT* [2011] HCA 35.

49 *Breakwell v FCT* [2015] FCA 1471.

debt was owing to a trust and the effect of the relevant limitations legislation was that there was no limitation period for an action by a trust to recover trust property.

Unpaid present entitlement

Where a beneficiary that is connected with a trust has an unpaid present entitlement (UPE) to receive an amount of income or capital from the trust, the value of the UPE is included once, and once only, when determining whether or not the trust satisfies the maximum net asset value test (TR 2015/4).

The way in which the value of that UPE is so included will vary depending on the character of the beneficiary's entitlement and the way that funds representing the UPE are held.

Where the funds representing the connected beneficiary's UPE have been set aside on a separate (sub) trust, the net asset value calculation for the main trust will include (in the net value of the CGT assets of the sub-trust (which would be an entity connected with the main trust)) the funds representing the UPE without any corresponding liability.

If there is no sub-trust, the net asset value calculation for the main trust will include the UPE in the net value of the CGT assets of the connected beneficiary.

Where a connected beneficiary's UPE is an absolute entitlement to one or more trust assets, the net asset value calculation for the trust will include (as an asset of the beneficiary) the value of any asset to which the connected beneficiary is absolutely entitled to receive.

The propositions in the ruling apply equally for the purpose of calculating the net value of the CGT assets of a trust where it is "connected with" another entity seeking to satisfy the maximum net asset value test, or the other entity's affiliate.

GST and liabilities

"Liabilities" is not defined for the purposes of the ITAA97 and has its ordinary meaning. Relevantly, "liabilities" means debts due for payment, which necessarily refers to the amount (inclusive of any GST) that is owed. A taxpayer's entitlement to input tax credits does not have any relevant implications, especially as the entitlement to claim input tax credits arises when a taxpayer's net amount of GST for a tax period is worked out pursuant to the provisions of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) and not at the time of incurring the expenses. Furthermore, a taxpayer's entitlement to claim input tax credits for any GST charged is independent of the obligation owed to the supplier.[50]

50 See *Excellar Pty Ltd and FCT* [2015] AATA 282.

¶6-150 When does a liability relate to a CGT asset?

Whether a particular liability is "related to" the assets can raise difficult issues[51] and the Full Federal Court decision in *Bell*[52] tends to indicate the very specific nature of the relationship between a CGT asset and a liability.

In its review report, the Board of Taxation stated that whether or not a liability "relates to" an asset is a question of fact in each circumstance, and that, "arguably", the phrase embodies sufficient flexibility to be used in the context of the calculation of the net value of the CGT assets of an entity, without being narrow and prescriptive. The Board considered that the purpose of the phrase appears to be to ensure that, when an asset is included in the test, a liability with some connection to that asset may be included. Conversely, if the liability relates to assets that are excluded from the test, the liability should also be excluded.

It is thought that the fact that a CGT asset is charged with a liability would not of itself mean that the liability "related to" the asset in the relevant sense. For example, if X borrows money on the security of business premises that he owns, and applies the borrowed money to acquire a dwelling that he uses as his main residence, the borrowing would relate to the dwelling, not the business premises.

On the other hand, assume that Y borrows money secured on his main residence, and uses the borrowed money to purchase business premises. In this instance, the borrowing could be said to be "related to" the business premises, not the dwelling.

The approach to be adopted is to trace the application of the moneys borrowed to determine their use, so that in the second illustration given, but not the first, the borrowing would relate to the business premises.

It should be noted that TD 2007/14, which considers the meaning of "liabilities" for the purposes of the maximum net asset value test, gives several examples where the liabilities include mortgages secured over the relevant business premises. The amounts secured by the mortgages are taken into account in the examples as relevant liabilities for the purposes of the net value of CGT assets calculation. The determination does not state for what purpose the moneys borrowed under the mortgages were applied. There is, however, a possible implication in the explanation section of the determination (see para 21), which supports the tracing approach suggested above.

In *Bell*, the Full Federal Court (Jessup, Jagot and Robertson JJ) considered the relationship between a liability associated with moneys borrowed to make payments to extinguish beneficiary entitlements so as to preserve the assets of the trust rather than sell the assets to satisfy the entitlements. There is some disturbing analysis in the decision concerning the relationship of continuing liabilities with assets of an entity.

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51 The relationship must exist between the liabilities and the assets of the entity in issue, not any asset held by other connected entities (*Tingari Village North Pty Ltd and FCT* [2010] AATA 233).

52 *Bell v FCT* [2013] FCAFC 32.

The court first analysed the situation where moneys were borrowed to pay the beneficiary's entitlements:

> "In addressing this question of relationship, it is useful to return to, and to develop a little, some of the matters discussed by the primary judge in [65] and [66] of her reasons, set out above. The starting point must be the Trust with net CGT assets of, say, $X. Once the trustee resolved to distribute $2.018m to the appellant, the net asset position was ($X–$2.018m) because, as explained above, the resolution gave rise to a liability which related to the assets of the fund. Had that liability been discharged by payment to the appellant, the net assets would still be ($X–$2.018m), but in a different way: the liability which 'related' to the assets would no longer exist, but the Trust would be $2.018m the poorer for having made the distribution. Had the Trust then borrowed $2.018m to restore its cash position, its net assets would still be ($X–$2.018m), made up of $X in assets and a new liability of $2.018m to the lender. As to this last scenario, we do not understand the Commissioner to contend that a debt brought into existence by the borrowing of funds would not relate to those funds as an asset in the hands of the borrower.
>
> Next, let the order of things subsequent to the resolution to distribute the $2.018m to the appellant be reversed. Instead of paying the appellant immediately, suppose the Trust to have borrowed to make that payment. Having received the funds from the lender, the net asset position of the Trust would have been ($X+$2.018m–$2.018m–$2.018m), ie ($X–2.018m). That is to say, in addition to its original assets of $X, the Trust would have had the cash received from the lender. It would still have been in debt to the appellant in the amount of $2.018m because of the unpaid distribution; and it would now also be in debt to the lender in the amount of $2.018m. Each of those liabilities would have related to the assets of the Trust: the first because it was based on a resolution to distribute capital to a beneficiary, and the second because it corresponded with the funds received from the lender. If, having reached this stage, the Trust then made the payment of the distribution to the appellant, the Trust's net asset position would be ($X – $2.018m) because its cash position would have moved adversely by $2.018m, but it would no longer have a liability to the appellant."

That is to say, we now have a different liability that is not related to the original asset. This outcome is further explained by the court in the following passage:

> "The clarity of the central issues which require consideration here is compromised somewhat by the circumstance that, where money is borrowed, the 'asset' may well, and will usually, have been added to the general cash assets of the entity in question. The position presents more clearly if it be assumed that the borrowing was for the purpose of acquiring a tangible asset, say a motor vehicle. Its indebtedness under the borrowing would then be a liability which related to the vehicle. If the vehicle were traded in on a second vehicle (assuming, perhaps unrealistically, that this was a straight swap without money changing hands), it might then be the case that the liability to the original lender related to the second vehicle. However, if, instead of trading in the first vehicle, the Trust sold it and used the cash to make a distribution to a beneficiary under cl 12.7(a), the asset to which the loan liability had originally related would no longer exist. It could not then be said that the liability related to assets of the Trust."

It is clear from the court's decision that the tracing of and relationship between a CGT asset and a liability will be more specific and relevant in a business entity where the normal business operation has ebbs and flows of liabilities.

In *Scanlon and FCT*,[53] the AAT considered that, even if eligible termination payments that were to be paid to its two shareholders were in fact liabilities, these liabilities did not relate to the assets of the business in the relevant sense. The taxpayers contended that the liability of the company to pay the eligible termination payments related to the assets of the company as a whole or, alternatively, specifically to the goodwill of the business of the company. The AAT said that, given that an amount paid for goodwill is in fact a monetary sum attributed to expected future earnings and that the eligible termination payments were said to have been a payment in recognition of the past work of the shareholders, it was difficult to envisage how any such payment could be related to a specific CGT asset. The AAT went on to say that that view was reinforced by the fact that, when working out the enterprise value of the company, the purchaser did not take into account the liability of the company to make eligible termination payments. The payments were more appropriately described as a gratuitous payment or a golden handshake which could not be related to the CGT assets.

¶6-155 General liabilities

In some instances, there may be a liability that cannot be specifically attributed to a particular CGT asset. For example, a taxpayer carrying on a business may draw down funds under a general business overdraft facility to meet various business liabilities, including the day-to-day running costs of the business, the purchase of trading stock, and so on.

It is clear, and it is accepted by the ATO, that the liabilities of an entity that may be taken into account in the net value of CGT assets calculation can include liabilities that relate to the CGT assets of the entity more generally, for example, a bank overdraft or other short-term financing facility that provides working capital for the operation of a business.[54]

¶6-160 Case studies

Case study 1

(adapted from TD 2007/14)

In November 2015, Dingdong Pty Ltd is selling its mobile telephone business. The assets and liabilities of the company are as follows:

53 [2014] AATA 725. An appeal by the taxpayers to the Federal Court from the decision of the AAT was discontinued.

54 TD 2007/14.

Assets:	**$**	**$**
Plant and machinery	1,500,000	
Freehold premises	3,500,000	5,000,000
Liabilities:		
Mortgage (used to buy, and secured over, the premises)	2,000,000	
Provision for leave of employees	500,000	
Accrued expense (business consultant)	200,000	
Provision for rebates	200,000	
Provision for possible damages payout	100,000	3,000,000
Net assets:		2,000,000

The net value of the CGT assets of the company is calculated as follows:

Assets:	**$**	**$**
Plant and machinery	1,500,000	
Freehold premises	3,500,000	5,000,000
Liabilities:		
Mortgage	2,000,000	
Provision for leave for employees	500,000	2,500,000
Net value of CGT assets:		2,500,000

The example in TD 2007/14 (from which the above case study is adapted) merely states that the mortgage liability is "secured over the premises". No indication is given in the determination as to what the principal moneys were applied for. Because the liability is incurred by a company, it would be expected that it would usually relate to the CGT assets of the company, but it should be noted that, as pointed out at ¶6-150, it would seem that the mere fact that a liability is secured by a mortgage over a CGT asset would not mean that the liability under the mortgage relates to that asset.

Case study 2

Richard controls Sample Pty Ltd (he is the sole director and shareholder) and his spouse (Rachel) controls Applepie Pty Ltd (she is the sole director and shareholder). Sample Pty Ltd is selling an active asset in December 2015 and wants to know which assets are to be brought to account for the purposes of the maximum net asset value test.

If these are the only relevant facts, the only other entity that is included when applying the maximum net asset value test to Sample Pty Ltd is Richard, as he controls Sample Pty Ltd, and is therefore a connected entity.

Case study 3

Barbara owns factory premises that are used by Get 'Em In Pty Ltd, which carries on an advertising business. The sole shareholder of the company is Barbara's spouse (Tim). In October 2015, Barbara is considering selling the factory premises to a third party, which will lease the premises to the company.

Assuming Tim is not otherwise Barbara's affiliate, for the purposes of determining whether Barbara and Get 'Em In Pty Ltd are connected entities, Tim would be taken to be Barbara's affiliate under the special spouse/child under 18 affiliate rule (see ¶9-135). Accordingly, Barbara and the company would be connected entities. However, for the purposes of applying the maximum net asset value test to Barbara, the assets of Get 'Em In Pty Ltd would be disregarded (see ¶6-135).

Case study 4

(adapted from TD 2007/14)

GoThere Pty Ltd is selling its travel agency business in October 2015. The net value of the CGT assets and liabilities of the company is as follows:

Assets:	**$**	**$**
Fixtures and fittings	300,000	
Freehold premises in Parramatta	4,500,000	
Freehold premises in Penrith	2,500,000	7,300,000
Liabilities:		
Bank overdraft	600,000	
Mortgage (used to buy, and secured over, Parramatta premises)	500,000	
Bill of exchange for Penrith premises	400,000	1,500,000
Net value of CGT assets:		5,800,000

The fixtures and fittings may be depreciating assets, and the gains from them may be treated as income rather than capital gains, but they are still CGT assets. Hence, they are included in the calculation of the net value of the CGT assets of GoThere Pty Ltd.

The bank overdraft is taken into account when working out the net value of the CGT assets of GoThere Pty Ltd, because it is a general liability that relates to all of the assets of the company.

The example in TD 2007/14 (from which the above case study is adapted) simply describes the mortgage as "secured over Parramatta premises" and does not indicate for what purpose the moneys borrowed on the security of the premises were used. Because the liability is incurred by a company, it would be expected that it would usually relate to the CGT assets of the company, but it should be noted that, as pointed out at ¶6-150, it would seem that the mere fact that a liability is secured over a CGT asset will not necessarily mean that the liability relates to that asset.

Case study 5

Richard is an architect who carried on his own business as a sole trader. He acquired a dwelling in a country town in October 1996, which he used as his main residence and for the purpose of carrying on his professional work. Subsequently, as a result of being admitted as a partner in a city firm, Richard acquired a dwelling in the city in April 2006, which he has used solely as his main residence, without any income-producing use. Richard retained his country dwelling and has used it (and its adjacent land) solely as a residence for himself and his spouse on most weekends.

It is necessary to determine the net value of Richard's CGT assets on 15 January 2016.

On the basis of ID 2011/37 (see ¶6-120), the Commissioner would presumably take the view that the income-producing use of the country residence would mean that it could not be said that that dwelling was "being used solely" for Richard's personal use and enjoyment. It is, however, considered that the business use would be irrelevant and that, having regard to the frequency of its use, it is arguable that the country residence could be said to be "being used" solely for the personal use and enjoyment of Richard and his spouse. However, unless Richard's spouse is his affiliate (which would broadly require that she be carrying on a business in which Richard was involved or that the special spouse/child under 18 affiliate rule was applicable), the dwelling would strictly not be excluded from the calculation of the net value of Richard's CGT assets. If she were Richard's affiliate, it would mean that this dwelling would be completely excluded from the calculation of the net value of Richard's CGT assets (regardless of the area of the adjacent land) (see ¶6-125). The Commissioner, however, would not regard the use by Richard's spouse as being a disqualifying factor even if she were not an affiliate (ID 2011/39).

The city dwelling would be wholly excluded from the net value of Richard's CGT assets because of the specific exclusion for an individual's main residence; provided, of course, that the two-hectare limitation were not exceeded.

Chapter 7

Small business entity test

¶7-100 Context

The basic conditions that must be met for the CGT small business reliefs to be available in respect of a capital gain made by an entity in an income year are explained in chapter 4 (see ¶4-100). One of the basic conditions is that at least one of the following applies:

(1) the entity is a small business entity for the income year;

(2) the entity satisfies the maximum net asset value test (see ¶6-100);

(3) the entity is a partner in a partnership that is a small business entity for the income year, and the relevant CGT asset is an interest in an asset of the partnership; or

(4) the entity does not carry on a business in the income year (other than in partnership), the CGT asset is not an interest in an asset of a partnership, and at a time in the income year either:

  (a) the CGT asset is used, or held ready for use, in the course of the carrying on of a business that is carried on by an affiliate of, or an entity that is connected with, the entity and the affiliate or connected entity is a small business entity for the income year; or

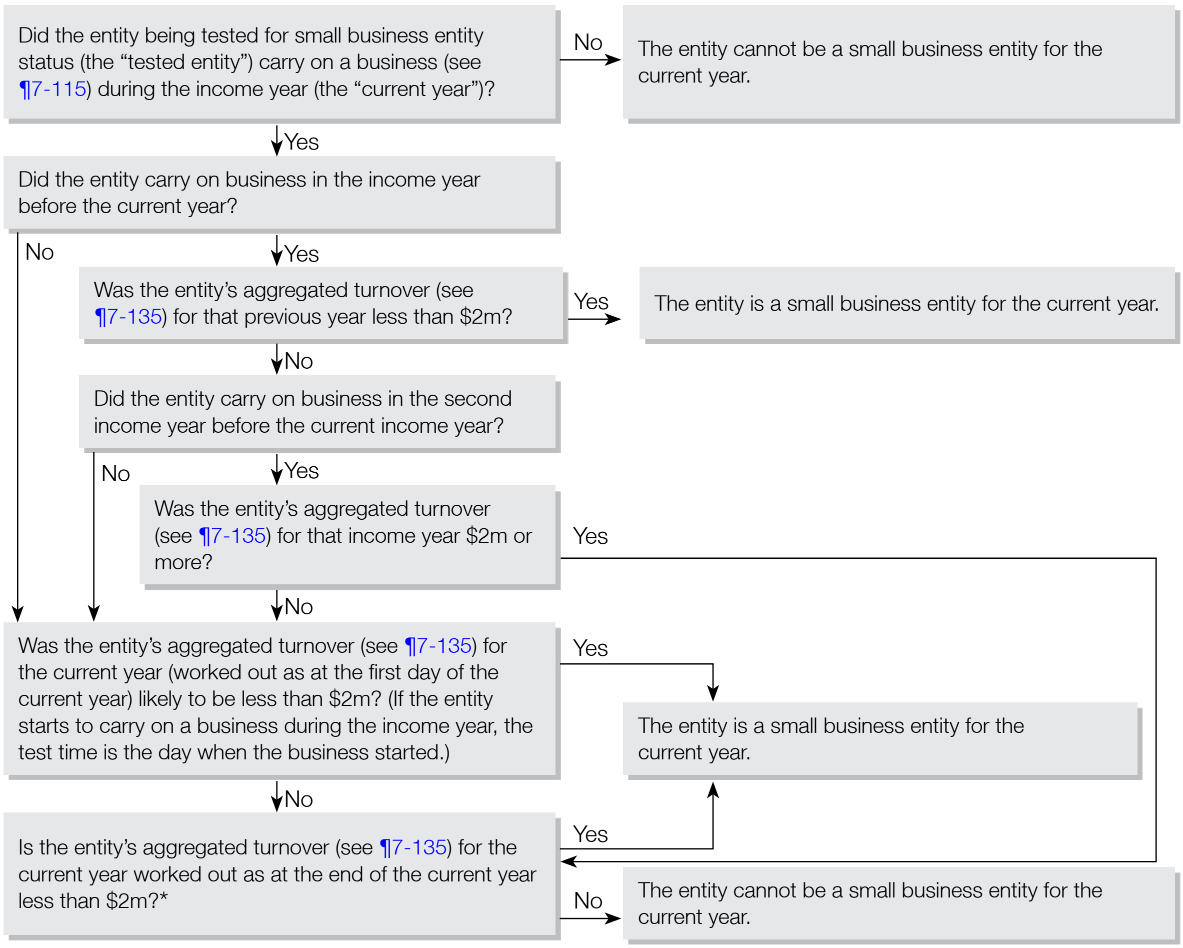
  (b) the CGT asset is used, or held ready for use, in the course of the carrying on of a business that is carried on by the entity as a partner in a partnership and the partnership is a small business entity for the income year.[1]

Whether an entity is a small business entity is relevant not only for the purpose of accessing the CGT small business reliefs, but also for the purpose of accessing a range of other taxation concessions available to small business taxpayers. There are, however, some special rules that apply for the purposes of the CGT small business reliefs.

1 S 152-10(1)(c), (1A) and (1B) ITAA97 (see ¶4-105). For the purposes of (d), if the CGT asset is an intangible asset, it may alternatively be inherently connected with a relevant business.

¶7-105 Operation of small business entity test

The following diagram sets out the circumstances in which an entity will be a small business entity for an income year (the "current year").



* If an entity that carries on business in the current year satisfies this requirement, it will in all cases be a small business entity for the current year.

¶7-110 Small business entity

An individual, a company, a trust or a partnership is an entity for tax purposes[2] and can qualify as a small business entity if the entity is carrying on a business, and one of three aggregated turnover tests is met. A partner in a partnership is not, in his or her capacity as a partner, a small business entity.[3]

2 S 960-10 ITAA97. The CGT small business relief provisions recognise that a partnership may be a small business entity (see s 152-10(1B)(b) ITAA97). See further ¶18-110.

3 S 328-110(6) ITAA97.

Business must be carried on

For an entity to be a small business entity for an income year (called the "current year"), the entity must carry on a business in the current year (see ¶7-115). Importantly, the CGT event giving rise to the gain can occur prior to the time that the entity carries on the business as long as the entity carries on the business in the same year as the CGT event.

For further discussion of what constitutes the carrying on of a business in this context, and for an explanation of the special rule that applies where a business that an entity formerly carried on is being wound up, see ¶7-115

Three possible tests

In addition to carrying on a business in the current year, an entity (to be a small business entity) must satisfy at least one of the following three aggregated turnover tests, which take into account the annual turnovers of the entity, connected entities and affiliates:

(1) the immediately preceding year test – this test operates by reference to the position for the income year immediately preceding the current year (see ¶7-120);

(2) the actual current year test – this test operates by reference to the actual position for the current year (see ¶7-125); or

(3) the likely current year test – this test operates by reference to the prospective position for the current year (see ¶7-130).[4]

¶7-115 What constitutes carrying on a business?

In the context of the small business entity provisions, whether an entity is carrying on a business is relevant for the following reasons:

(1) an entity will only be potentially eligible to be a small business entity for an income year (the "current year") if the entity carries on a business during the current year (see ¶7-110);

(2) an entity can only satisfy the immediately preceding year test if the entity, in addition to carrying on a business in the current year, also carried on a business during the income year immediately preceding the current year (see ¶7-120); and

(3) when determining the annual turnover of an entity for an income year, only ordinary income that the entity derives in the income year in the ordinary course of carrying on a business is relevant (see ¶7-140).

"Business" is defined for the purposes of the ITAA97 to include any profession, trade, employment, vocation or calling, but does not include occupation as an employee.[5]

4 S 328-110 ITAA97.

5 S 995-1 ITAA97.

The law reports are littered with cases in which the question of whether a business was being carried on has been considered. In the context of taxation, the question has frequently arisen (eg whether a business of share trading or primary production is being carried on) and, more recently, there have been a number of cases in which the question has been whether a participant in a tax avoidance arrangement can be said to be carrying on a primary production or other relevant business.[6]

However, as a guide, the ATO's ruling[7] on what constitutes an "enterprise" for GST purposes illustrates some of the salient points, albeit that the test for an enterprise is broader than the test for carrying on a business for the purposes of the small business entity rules.

It is not possible to consider in detail the decisions in which activities have been held (in the particular circumstances) to, or not to, amount to the carrying on of a business. Rather, several judicial observations of a general nature are noted.

In *Evans v FCT*,[8] Hill J said:

> "The question of whether a particular activity constitutes a business is often a difficult one involving as it does questions of fact and degree. Although both parties referred me to comments made in decided cases, each of the cases depends upon its own facts and in the ultimate is unhelpful in the resolution of some other and different fact situation.
>
> There is no one factor that is decisive of whether a particular activity constitutes a business. As Jessel MR said in the famous dictum in *Ericksen v Last* (1881) 8 QB 414 at p 416:
>
> 'There is not, I think, any principle of law which lays down what carrying on trade is. There are a multitude of things which together make up the carrying on of trade.'
>
> Profit motive (but cf *IR Commrs v Incorporated Council of Law Reporting* (1888) 22 QB 279), scale of activity, whether ordinary commercial principles are applied characteristic of the line of business in which the venture is carried on (*IR Commrs v Livingston* (1927) 11 TC 538), repetition and a permanent character, continuity (*Hope v Bathurst City Council* 80 ATC 4386 at p 4390; (1980) 144 CLR 1 at p 9; *Ferguson v FCT* 79 ATC 4261 at p 4264), and system (*Newton v Pyke* (1908) 25 TLR 127) are all indicia to be considered as a whole, although the absence of any one will not necessarily result in the conclusion that no business is carried on."

In *FCT v Bivona Pty Ltd*,[9] Bowen CJ, Lockhart and Einfeld JJ, in a joint judgment, said:

> "In *Hyde v Sullivan & Ors* (1956) SR (NSW) 113 Street CJ, Roper CJ in Eq and Herron J said at p 119, with respect to the definition of 'money-lender' in s 3(1) of the *Money-Lenders and Infants Loans Act 1941* (NSW):

6 See, for example: *Vincent v FCT* [2002] FCAFC 322; *Puzey v FCT* [2003] FCAFC 197; and *FCT v Sleight* [2004] FCAFC 94. For recent decisions of the Full Federal Court where one issue was whether the taxpayer was carrying on a business of money-lending, see *FCT v BHP Billiton Finance Ltd* [2010] FCAFC 25 (appeal to High Court on another issue dismissed (*FCT v BHP Billiton Ltd* [2011] HCA 17)) and *FCT v Ashwick (Qld) No. 127 Pty Ltd* [2011] FCAFC 49.

7 MT 2006/1.

8 89 ATC 4540.

9 90 ATC 4168.

> 'Speaking generally, the phrase "to carry on business" means to conduct some form of commercial enterprise, systematically and regularly, with a view to profit, and implicit in this idea are the features of continuity and system.'
>
> …
>
> The necessity for the repetition of acts or continuity is perhaps clearer from the phrase 'carries on business' than the word 'business' standing alone in a definition section (see the judgment of Mason J in *Hope v The Council of the City of Bathurst* at 80 ATC 4386 at p 4390; 144 CLR 1 at p 8); but for a business to exist there must be activity of the body concerned to constitute a commercial enterprise and generally one must look for system, regularity or recurrence."

In *Ell & Anor v FCT*,[10] Emmett J said:

> "Although not determinative, intention is relevant where, for example, a particular activity produces no income (see *John v FCT* (1989) 166 CLR 417) or where the first step in a business is undertaken (see *Fairway Estates Pty Ltd v FCT* (1970) 123 CLR 153). It is necessary to examine the activities engaged in, including their nature and extent (see *Martin v FCT* (1953) 90 CLR 470 at 474). Activities may constitute the carrying on of a business even though the activities are carried on in a small way and it is not for the Commissioner to dictate to a taxpayer in which business the taxpayer engages or how to run a business profitably or economically (see *Tweedle v FCT* (1942) 7 ATD 186). Provided that an activity said to constitute carrying on business is engaged in for the purpose of profit on a continuous and repetitive basis, that activity may constitute the carrying on of business (see *Hope v Bathurst City Council* (1980) 144 CLR 11)."

Emmett J went on to say that if there is no real expectation of making a profit from a particular activity, there will be real doubt as to whether engaging in that activity can be said to be carrying on a business. Later, his Honour said:

> "The state of mind or intention of a taxpayer may be relevant to the question of whether or not that taxpayer is carrying on a business. Even where a transaction produces no income, if the intention of the relevant taxpayer is that the transaction is the first step in a business, that subjective state of mind may be relevant … Further, it is not for the Commissioner to dictate to a taxpayer in what way a business should be run. A business may be carried on even though it is not profitable or economical (see *Tweedle v FCT* (1942) 7 ATD 186), provided it is carried on with the purpose of making a profit (see *FCT v Stone* 2005 ATC 4234 at 4243)."

The decision of the High Court in *Spriggs v FCT; Riddell v FCT*[11] should also be noted. In that case, the court (French CJ, Gummow, Heydon, Crennan, Keifel and Bell JJ), in a joint judgment, made the following points:

(1) the existence of a business is a matter of fact and degree and will depend on a number of indicia, which must be considered in combination and as a whole. No one factor is necessarily determinative. Relevant factors include, but are not limited to, the existence of a profit-making purpose, the scale of activities, the commercial character of the transactions, and whether the activities are systematic and organised; often described as whether the activities are carried out in a business-like manner;

10 [2006] FCA 71.

11 [2009] HCA 22. See also *Mould v CSR (Vic)* [2015] VSCA 285.

(2) where it is determined that a taxpayer is conducting a business, the next question will be the "scope" of that business. It may be that the taxpayer pursues two separate fields of endeavour, which are properly described as two separate businesses, or a business and some other non-business activity. On the other hand, a taxpayer may pursue separate income-producing activities as part of a single business. The question is one of fact, turning on the degree of connection and interdependence between the activities;

(3) it is possible to obtain and perform an employment contract as part of, and during the course of, running a business, as is illustrated by *Commissioner of Taxes (Vic) v Phillips*.[12] In that case, Starke J described how the taxpayer carried on business, in partnership with his brother, as amusement managers and directors, and how, as part of that business, the taxpayer was employed as the governing director of a company that operated a theatre. Income under the employment contract was income of the business and, accordingly, agreed periodic compensation payments to the taxpayer for cancellation of the employment contract were income of the business; and

(4) the definition of business in s 995-1 ITAA97 (see above) does not state that a contract of employment cannot form part of a business. What the definition provides is that a person will not be taken to be conducting a business merely because the person earns income under a contract of employment. Something more than that would be required for there to be a business.

Most recently, in *Mould v CSR (Vic)*,[13] Warren CJ (Tate JA agreeing) said:

> "The ability of the word 'business' to assume different meanings in different contexts has been recognised by the High Court. In *Re Australian Industrial Relations Commission; Ex parte Australian Transport Officers Federation* [(1990) 191 CLR 216], Mason CJ, Gaudron and McHugh JJ observed that '[o]f all words, the word "business" is notorious for taking its colour and content from its surroundings'.
>
> In *NT Power Generation Pty Ltd v Power and Water Authority* [[2004] HCA 48], McHugh ACJ, Gummow, Callinan and Heydon JJ remarked:
>
>> 'While the word "business" in any particular context takes its meaning from that context, normally it is a "wide and general" word.'"

Capital asset ventured into business

The mere realisation of a capital asset, even if carried out in an enterprising way, will not amount to the carrying on of a business.[14] However, it is possible that a capital asset may be ventured into a business so that proceeds from sales or, depending on the facts, profits from sales will be proceeds from the carrying on of the business.

12 [1936] HCA 11.

13 [2015] VSCA 285.

14 *FCT v Williams* [1972] HCA 31.

This is illustrated by the decision of the Full High Court in *White v FCT*.[15] The court held that activities engaged in by the taxpayer to exploit timber on a pastoral property owned by him amounted to the carrying on of a business. The land became devoted exclusively and indefinitely to the sale of standing timber as it stood from time to time. The evidence indicated that the taxpayer had embarked on a particular form of trade; namely, the sale of standing timber. The land was being maintained exclusively in the interests of such trade.

Reference may also be made to the decision in *FCT v Whitfords Beach Pty Ltd*.[16]

Company or individual

The question of whether a business is being carried on in particular circumstances may be more readily answered affirmatively in the case of a company than in the case of an individual. In *American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue (Malaysia)*,[17] the Privy Council said:

> "In the case of a private individual it may well be that the mere receipt of rents from property that he owns raises no presumption that he is carrying on a business. In contrast, in their Lordships' view, in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business. Where the gainful use to which a company's property is put is letting it out for rent, their Lordships do not find it easy to envisage circumstances that are likely to arise in practice which would displace the prima facie inference that in doing so it was carrying on a business.
>
> The carrying on of 'business', no doubt, usually calls for some activity on the part of whoever carries it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between."

These observations have been referred to with approval in a number of Australian decisions.[18]

Partnership

For there to be a partnership according to the general law, a business must be carried on (the partnership could then also qualify as a small business entity). However, if there is a partnership only because of the extended definition of partnership that applies for income tax purposes (an association of persons in receipt of ordinary income or statutory income jointly), no business will be carried on and the partnership could not qualify as a small business entity. For example, if individuals – say, spouses – jointly own a rental property that they let out without the provision of any other services, there would be a partnership within the extended definition of that term, but no business would be carried on (see further below).

15 [1968] HCA 41.

16 [1982] HCA 8.

17 [1978] AC 676. See also *Mould v CSR (Vic)* [2015] VSCA 285.

18 See, for example, *Brookton Co-operative Society Ltd v FCT* (1981) 147 CLR 441 per Aickin J.

Rental property

The mere letting of a property by an individual or individuals without the provision of further services would not amount to the carrying on of a business.[19]

If, however, more is done than the mere letting of premises, a business may be carried on. In *Case* G10,[20] the taxpayer owned a block of holiday flats that he rented out on short-term lettings, and that he and his spouse maintained. The No. 1 Board of Review held that the taxpayer was carrying on a business. The evidence established that the money received by the taxpayer from the occupants of the flats was not solely a payment for the right to rent a flat for a certain period of time, but was also a payment for the hire or bailment of furniture, furnishings and chattels, and for the provision of services that would otherwise have to be supplied by letting agents, contractors and workmen.

There is a possible suggestion in the judgment of Hill J in *Kennedy Holdings & Property Management Pty Ltd v FCT*[21] that the mere renting out of premises by a company may not necessarily amount to the carrying on of a business by the company. The correctness of such a suggestion is doubtful (having regard to the observations of the Privy Council in the *American Leaf Blending Co* case (quoted above)).

In *Mould v CSR (Vic)*,[22] a land tax case, the question was whether the trustee of a deceased estate carried on a business of leasing residential properties. The Victorian Court of Appeal answered the question in the affirmative. Warren CJ (Tate JA agreeing) said:

> "The factual findings on which [the appellant] relied stand to benefit him much less once passivity in holding residential properties is not seen as a bar to a finding that their lease amounts to the conduct of a business.
>
> For example, while the appellant sought to demonstrate the passivity of the investment by pointing to the length of time the residential properties had been held and leased by his family and to the infrequent changes in tenants over that period, those matters in fact reinforce the systematic and repetitious nature of the rental activities conducted by the Estate, factors which point towards the rental activities having a business character. Moreover, as [*Havyn Pty Ltd v Webster* [2005] NSWSCA 182] makes clear, the fact that the properties were inherited by the appellant (in his trustee capacity) upon Mrs Mould's death is not relevant to the character of the Estate's activity in renting out the properties.
>
> …
>
> As I have also explained, counsel for the appellant ultimately conceded at the hearing that the management of the residential properties by an agent did not affect the character of the activities which the agent carried out on behalf of the appellant. This was plainly correct.
>
> I am not persuaded that the findings of fact relied upon by the appellant demonstrate error in the judge's conclusion that the Estate conducted a separate business of renting properties as at

19 *FCT v McDonald* 87 ATC 4541. See also IT 2423 and TR 93/32. The decision in the *McDonald* case was followed by the AAT in *Cripps v FCT* 99 ATC 2428, which involved a greater number of properties held by a husband and wife as joint tenants.

20 75 ATC 33.

21 92 ATC 4918.

22 [2015] VSCA 285.

31 December 2009. On the contrary, the evidence soundly supported his Honour's conclusion. In particular, this was due to the cumulative effect of the following factors:

(a) the residential properties were leased by the Estate at least in part for a profit-making purpose;

(b) the Estate leased 26 residential properties in the relevant year;

(c) the Estate generated substantial income from leasing the residential properties, in the order of $317,182 in 2009 and $353,188 in 2010;

(d) the residential properties had been leased in a regular and systematic way over a number of years; and

(e) the residential properties were leased in a businesslike manner, including with the assistance of an agent."

Reference may also be made to *Carson and FCT*,[23] which is considered at ¶8-135.

Winding up business

In *Northern Engineering Pty Ltd v FCT*,[24] Brennan J (then of the Federal Court) said:

> "When a company's business is closing down there comes a time when the activity of a trading or profit-making nature comes to an end. The business of the company is not carried on merely by managing or disposing of the company's assets otherwise than in a business."

This observation was applied by Dowsett J in *Coal Developments (German Creek) Pty Ltd ACN 009 974 896 v FCT*.[25]

The small business entity rules, however, apply to an entity as if the entity carried on a business in an income year if:

(1) in that income year, the entity was winding up a business that the entity previously carried on; and

(2) the entity was a small business entity for the income year in which the entity stopped carrying on the business.[26]

¶7-120 The immediately preceding income year test

An entity will be a small business entity for an income year (the "current year") if, in addition to carrying on a business in the current year, the entity also carried on a business in the immediately preceding income year, and the entity's aggregated turnover for that preceding income year was less than $2m.[27] This may be referred to as the immediately preceding income year test.

23 [2008] AATA 156.

24 [1979] FCA 79.

25 [2007] FCA 1324. The decision of Dowsett J was affirmed by the Full Federal Court on appeal ([2008] FCAFC 27). Reference may also be made to the decision of the Full Federal Court in *FCT v Ashwick (Qld) No. 127 Pty Ltd* [2011] FCAFC 49.

26 S 328-110(5) ITAA97.

27 S 328-110(1)(a) and (b)(i) ITAA97.

For what constitutes an entity's aggregated turnover for an income year, see ¶7-135.

It is not necessary for the business carried on in the current year to be the same business that was carried on in the immediately preceding income year.

¶7-125 The actual current year test

An entity will be a small business entity for an income year (the "current year") if, in addition to carrying on a business in the current year, the entity's aggregated turnover for the current year, worked out as at the end of that income year, is less than $2m.[28] This may be called the actual current year test.

For what constitutes an entity's aggregated turnover for an income year, see ¶7-135.

¶7-130 The likely current year test

Subject to an important qualification, an entity will be a small business entity for an income year (the "current year") if, in addition to carrying on a business in the current year, the entity's aggregated turnover for the current year is likely to be less than $2m.[29] This may be referred to as the likely current year test.

For what constitutes an entity's aggregated turnover for an income year, see ¶7-135.

The qualification is that an entity will not be a small business entity for the current year under the likely current year test if:

- the entity carried on a business in each of the two income years before the current year; and
- the entity's aggregated turnover for each of those income years was $2m or more.[30]

For the purposes of the likely current year test, an entity's likely aggregated turnover for the current year is worked out:

(1) as at the first day of the current year; or

(2) if the entity starts to carry on a business during the current year, as at the day when the entity started to carry on the business.[31] In this regard, s 328-120(5) ITAA97 provides for how the annual turnover of an entity is to be calculated where the entity does not carry on a business for the whole of an income year (see ¶7-160).

It is not clear how the likely aggregated turnover of an entity is calculated where the entity carried on a business at the commencement of the current year and commenced to carry on a new business during the current year. One possible view is that, in such a case, the calculation of the entity's annual turnover

28 S 328-110(4) ITAA97.

29 S 328-110(1)(a) and (b)(ii) ITAA97.

30 S 328-110(3) ITAA97.

31 S 328-110(2) ITAA97.

would include the likely annual turnover of the existing business and of the new business, both calculated as at the day when the new business commenced to be carried on.

The fact that (unless a business commenced during the current year) an entity's aggregated turnover is worked out as at the first day of the current income year means that the calculation needs to be based on the entity's state of affairs as at the first day of that income year. It does not mean that the assessment of the entity's situation must be performed on the first day of that income year.

Example (adapted from explanatory memorandum)

Brian is carrying on a business in the 2015-16 income year. He did not determine his small business entity status at the beginning of the income year, because he did not think he would need to use any of the concessions for which small business entity status was relevant.

However, in January 2016, Brian decides to sell one of his business assets and is, therefore, seeking to determine whether he is a small business entity in order to access the CGT small business reliefs.

If Brian does not satisfy the immediately preceding income year test (see ¶7-120), he would need to work out his aggregated turnover as at 1 July 2015. However, he may do this at any time in the income year (undertaking the calculation in January does not affect the result). Alternatively, Brian could, of course, satisfy the actual current year test (see ¶7-125).

Where it is possible that the likely current year test may need to be relied on to establish the status of an entity as a small business entity, the likely aggregated turnover of the entity for the current year should be calculated as soon as possible. To the extent that the current year has passed before this calculation is done, it may in some cases be difficult to displace an inference that the actual facts may possibly raise.

"Likely"

In *Tillmanns Butcheries Pty Ltd v Australasian Meat Industry Employees' Union & Ors*,[32] in the context of the *Trade Practices Act 1974*, Bowen CJ (Evatt J agreeing) said:

> "The word 'likely' is one which has various shades of meaning. It may mean 'probable' in the sense of 'more probable than not' – 'more than a 50 per cent chance'. It may mean 'material risk' as seen by a reasonable man 'such as might happen'. It may mean 'some possibility' – more than a remote or bare chance. Or, it may mean that the conduct engaged in is inherently of such a character that it would ordinarily cause the effect specified.
>
> In *Australian Telecommunications Commission v Kreig Enterprises Pty Ltd* (1976) 14 SASR 303, Bray CJ had to consider the meaning of the word 'likely' in s 139B of the *Post and Telegraph Act 1901-1973* (Cth). The context, of course, was different. However, Bray CJ concluded it meant 'more probable than not' in that context. His Honour expressed the view that that was the natural and ordinary meaning of 'likely', though he referred also to the rules of construction applicable where the statute being interpreted is a penal statute or one which, as in the case of s 139B, imposed an additional liability beyond the liability in tort."

32 (1979) 27 ALR 367.

Reference may also be made to *Australian Securities Commission v Nomura International Plc.*[33]

The explanatory memorandum to the amending Bill that became the *Tax Laws Amendment (Small Business) Act 2007* expresses a view of the meaning of the word "likely" that is consistent with the meaning adopted by Bray CJ in the *Kreig Enterprises* case. The explanatory memorandum states that the reference to "likely" means that, on the balance of probabilities, it is more likely than not that the entity's aggregated turnover will be under $2m.

Example (adapted from explanatory memorandum)

Denise carries on a business and had an aggregated turnover of $1.8m in the 2014-15 income year and $2.1m in the 2015-16 income year.

Denise is planning to retire in the 2016-17 income year and to gradually ease out of work by not taking on any new customers (rather than selling the business as a going concern). In the income year that Denise starts this process, her aggregated turnover will fall below $2m.

Denise does not satisfy the immediately preceding income year test (see ¶7-120) for the 2016-17 income year because her aggregated turnover in 2015-16 was greater than $2m. However, it is more likely than not that Denise will begin winding down her business in the 2016-17 income year, and her aggregated turnover is, therefore, likely to fall below $2m. Consequently, she satisfies the likely current year test. Also, the qualification to the likely current year test discussed above will not apply to Denise, given that her aggregated turnover in the 2014-15 income year was less than $2m.

Denise would, of course, be a small business entity for the 2016-17 income year if her actual aggregated turnover for that income year was less than $2m (see ¶7-125).

Whether an entity's aggregated turnover is likely to be less than $2m is an objective test. The explanatory memorandum states that some factors to consider when determining whether it is likely an entity's aggregated turnover for the current year would be under $2m include:

- the entity's aggregated turnover in previous income years;
- exceptional sales or particular product lines last year that will not occur in the current year;
- whether the entity is likely to have reduced staff in the current year;
- whether the operating hours of the business will decrease in the current year;
- whether aspects of the location of the business, or its industry, indicate a declining turnover in the current year (eg if a drought is declared in an area or if prices in the industry decline); or
- whether the business will face increased competition in the current year.

33 (1998) 160 ALR 246.

Example (adapted from explanatory memorandum)

During the 2015-16 income year, Topcoat Pty Ltd carried on a professional painting business. The company's aggregated turnover for that income year was $2.5m and it had 11 staff.

On 1 July 2016, the company received resignation letters from eight of its 11 employees. The company's sole director anticipates that it will be difficult to replace these workers during the current year.

For the 2016-17 income year, the company would fail the immediately preceding income year test (see ¶7-120) because its aggregated turnover in the previous income year was greater than $2m. However, given that the company's director anticipates difficulty with replacing staff, it is likely that the company's aggregated turnover will be under $2m for the 2016-17 income year.

Whether Topcoat Pty Ltd can rely on the likely current year test will depend on the company's aggregated turnover for the 2014-15 income year. Topcoat Pty Ltd could, of course, rely on the actual current year test (see ¶7-125) if this resulted in the company's aggregated turnover for the 2016-17 income year being less than $2m.

¶7-135 Aggregated turnover

The aggregated turnover for an income year (of an entity that is being tested for small business entity status (the "tested entity")) comprises the sum of the following amounts:

(1) the tested entity's annual turnover for the income year;

(2) the annual turnover for the income year of any entity (called a "relevant entity") that is connected with the tested entity at any time during the income year; and

(3) the annual turnover for the income year of any entity (also called a "relevant entity") that is an affiliate of the tested entity at any time during the income year.[34]

For what constitutes an entity's annual turnover, see ¶7-140. For the rules that apply to determine whether an entity is connected with another entity, see chapter 10 (see ¶10-100), and for the meaning of "affiliate", see ¶9-110 and ¶9-135.

When calculating the tested entity's aggregated turnover for an income year, the following are excluded:

(1) amounts derived in the income year by the tested entity or a relevant entity from dealings between the tested entity and the relevant entity while the relevant entity is connected with the tested entity or is the tested entity's affiliate;

(2) amounts derived in the income year by a relevant entity from dealings between the relevant entity and another relevant entity while each relevant entity is connected with the tested entity or is the tested entity's affiliate; and

(3) amounts derived in the income year by a relevant entity while the relevant entity is not connected with the tested entity and is not the tested entity's affiliate.[35]

34 S 328-115(1) and (2) ITAA97.

35 S 328-115(3) ITAA97.

Special rule: passively held assets

An entity (Entity X) that does not carry on a business (other than in partnership) may be eligible to claim the CGT small business reliefs for a capital gain that is made from the happening of a CGT event in relation to a CGT asset that Entity X owns, where (broadly) the active asset test is met and Entity X either satisfies:

(1) the maximum net asset value test; or

(2) one or other of the following tests:

  (a) the asset is used in (or is held ready for use in or is inherently connected with) a business carried on by an entity (Entity Z) that is a small business entity and is an affiliate of, or an entity connected with, Entity X;[36] or

  (b) Entity X is a partner in a partnership that is a small business entity and the asset is used in (or is held ready for use in or is inherently connected with) a business carried on by the partnership.[37]

In either case, the asset cannot be an interest in a partnership asset.

For the purpose of determining whether Entity Z or (in the case of (2)(b) above) the partnership is a small business entity, any other entity that is an affiliate of, or connected with, Entity X is taken to be an affiliate of or connected with Entity Z or (in the case of (2)(b) above) the partnership.[38]

The practical effect of this is that the annual turnover of any entity that is taken to be an affiliate of, or connected with, Entity X will be taken into account when determining the aggregated turnover of Entity Z or (in the case of (2) above) the partnership.

Example

Janelle owns a strata office unit that she leases to Better Plan Pty Ltd, which carries on an architectural practice from the premises. Janelle's spouse (Michael) is the sole shareholder and sole director of Better Plan Pty Ltd.

Janelle (who does not carry on business on her own account) is the sole shareholder and sole director of Comfort Fit Pty Ltd, a company that manufactures cardigans and other knitted garments.

Assuming that the strata office unit otherwise satisfies the active asset test, if Janelle were to dispose of the office unit, any capital gain could potentially be eligible for the CGT small business reliefs provided Janelle either satisfies the maximum net asset value test, or Better Plan Pty Ltd is a small business entity for the relevant income year. For the purposes of determining whether Better Plan Pty Ltd is a small business entity, the annual turnover of Comfort Fit Pty Ltd would be taken into account in calculating the aggregated turnover of Better Plan Pty Ltd, because Comfort Fit Pty Ltd is connected with Janelle.

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36 S 152-10(1)(d) and (1A) ITAA97 (see ¶4-105, ¶9-100 and ¶10-100).

37 S 152-10(1)(d) and (1B) ITAA97 (see ¶4-105).

38 S 152-48(1) and (2) ITAA97.

Further, if Entity X is a partner in two or more partnerships and the asset is used in (or held ready for use in or is inherently connected with) businesses that are carried on by at least two of those partnerships, then each such partnership that is not otherwise connected with the partnership being tested for small business entity status is taken to be connected with that partnership.[39]

¶7-140 Annual turnover

The basic rule is that an entity's annual turnover for an income year is the total ordinary income that the entity derives in the income year in the ordinary course of carrying on a business.[40]

The three elements that need to be considered are:

(1) ordinary income (see ¶7-150);

(2) derived (see ¶7-155); and

(3) in the ordinary course of carrying on a business (see ¶7-145).

It is important to keep in mind that these elements, which are relevant when determining an entity's annual turnover, are part of a composite expression – ordinary income derived in the income year in the ordinary course of carrying on a business. As such, the meaning of each element can only be determined by reference to the context of the composite expression. For example, the fact that an amount is ordinary income will not mean that it is included in the calculation of the entity's annual turnover; in addition, the amount must be able to be said to have been derived by the entity in the ordinary course of carrying on a business.

There is a special provision that applies if an entity does not carry on a business for the whole of an income year (see ¶7-160).

GST excluded

GST payable on a taxable supply is excluded from an entity's annual turnover, as is an increasing GST adjustment that relates to a supply.[41] An increasing adjustment that relates to an acquisition, and arises in circumstances that also give rise to a recoupment that is assessable, is also excluded.

Sales of retail fuel

Any amounts of ordinary income that an entity derives from sales of retail fuel (as defined) are also excluded from the calculation of an entity's annual turnover for an income year.[42] For a case in which a

39 S 152-48(3) ITAA97 (see ¶18-115).

40 S 328-120(1) ITAA97.

41 S 328-120(2) ITAA97.

42 S 328-120(3) ITAA97.

taxpayer's reliance on this exclusion was unsuccessful, see *PFGG and FCT*.[43] The evidence was that the fuel was purchased and paid for by the relevant entity, that it then used the fuel to run its own drilling rig in the course of it providing contracted drilling services, and that it subsequently recovered that cost from the client. There was no evidence of any intention to transfer property in the fuel to the clients.

Regulations

Regulations may be made to provide that an entity's annual turnover for an income year is to be calculated in a different way, but only if this would produce a lesser amount.[44] No regulations have been made for this purpose.

¶7-145 In ordinary course of carrying on a business

Whether an amount is received or otherwise derived in the ordinary course of carrying on a business will often be determinative of whether it is ordinary income or not.

In *FCT v The Myer Emporium Ltd*,[45] Mason ACJ, Wilson, Brennan, Deane and Dawson JJ, in a joint judgment, spoke of it as being "well settled" that a profit or gain made in the ordinary course of carrying on a business constitutes "income".

On the other hand, the fact that an amount (that is received or otherwise derived when carrying on a business) is ordinary income will not necessarily mean that it is derived in the ordinary course of carrying on the business. This is illustrated by the *Myer Emporium* case, in which it was held that a one-off commercial transaction entered into by the taxpayer company in the course of its business that was unusual or extraordinary judged by reference to the transactions in which the taxpayer company usually engaged, yielded ordinary income because the taxpayer company entered into the transaction for the purpose of making a relevant profit or gain from the transaction. It is unlikely that it could be said that a profit from such a transaction was derived in the ordinary course of carrying on a business.

Insurance proceeds or compensation received by an entity for a loss on revenue account would typically be ordinary income.[46] If the proceeds or compensation are for the occurrence of a natural or recognised incident of an entity's business, it would seem that the proceeds or compensation could be said to be derived in the ordinary course of carrying on a business.[47] Insurance proceeds or compensation for the loss or destruction of a capital asset would not usually be ordinary income.

43 [2015] AATA 972.

44 S 328-120(6) ITAA97.

45 [1987] HCA 18.

46 *Carapark Holdings Ltd v FCT* [1967] HCA 5.

47 Cf *Charles Moore & Co Pty Ltd v FCT* [1956] HCA 77.

The explanatory memorandum to the amending Bill that became the *Tax Laws Amendment (Small Business) Act 2007* states that, in general, income is derived in the ordinary course of carrying on a business if the income is of a kind that is regularly or customarily derived by the entity in the course of carrying on its business, arising out of no special circumstance or unusual event. Similarly, the income is derived in the ordinary course of carrying on a business if the income, although not regularly derived, is a direct result of the normal activities of the business.

The explanatory memorandum goes on to state that ordinary income may be derived in the ordinary course of carrying on a business, even if it is not the main type of ordinary income derived by the entity. Similarly, the income does not need to account for a significant part of the entity's overall receipts. It is sufficient that the ordinary income is of a kind derived regularly or customarily in the carrying on of a business.

For a decision of the Full Federal Court in which the concept of a transaction that is in the ordinary course of the carrying on of a taxpayer's business was considered in the context of the deduction of a bad debt, see *FCT v BHP Billiton Finance Ltd*.[48]

Winding up a business

As pointed out at ¶7-115, there is a special provision to the effect that, if an entity that was a small business entity is winding up a business, the small business entity rules apply as if the entity was carrying on a business.

This provision assumes that a business is not being carried on and, ex hypothesi, ordinary income derived from transactions entered into in the course of winding up the business would not be derived in the ordinary course of carrying on a business. However, the fact that the entity is treated as if it carried on a business possibly carries with it the implication that transactions that are entered into as a normal part of winding up the business are intended to be taken to be transactions in the ordinary course of carrying on the (assumed) business.

This, however, would not have the effect that the nature of an amount could be taken to change (from capital to ordinary income). For example, the disposal of trading stock on the sale of a business on a walk in/walk out basis would be a transaction on capital account, and the proceeds attributable to the trading stock would not be ordinary income[49] (even if they were statutory income under the trading stock provisions of the ITAA97).

Transactions with associated entities

Where a transaction is entered into with an associated entity, this may or may not be in the ordinary course of carrying on a business (see ¶7-165).

48 [2010] FCAFC 25 (appeal to High Court on another issue dismissed (*FCT v BHP Billiton Ltd* [2011] HCA 17)). See also *FCT v Ashwick (Qld) No. 127 Pty Ltd* [2011] FCAFC 49.

49 *Commissioner of Taxation (WA) v Newman* [1921] HCA 37.

¶7-150 Ordinary income

Ordinary income is defined for the purposes of the ITAA97 as income according to ordinary concepts.[50]

For the purposes of determining an entity's annual turnover, it would be irrelevant if the ordinary income is not assessable income (eg because it is exempt income). Also, the rule in s 6-25 ITAA97 (to the effect that, unless a contrary intention appears, if an amount of ordinary income is also the subject of a specific provision, the specific provision prevails) would not be relevant for the purpose of calculating the entity's annual turnover; that is, if an amount of ordinary income is derived in the ordinary course of carrying on a business, that amount will be included in the entity's annual turnover regardless of the effect of a specific provision (unless, and to the extent that, it falls within the specific exclusions noted at ¶7-140 relating to GST and sales of retail fuel).

In *FCT v Montgomery*,[51] Gaudron, Gummow, Kirby and Hayne JJ, in their joint reasons, said:

> "Nearly a century ago Lord Macnaghten begged pardon for reminding his listeners that '[i]ncome tax … is a tax on income. It is not meant to be a tax on anything' (*London County Council v AG* [1901] AC 26 at 35). But, as Jordan CJ said in *Scott v FCT* ((1935) SR (NSW) 215 at 219):
>
> 'The word "income" is not a term of art, and what forms of receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and usages of mankind, except in so far as the statute states or indicates an intention that receipts which are not income in ordinary parlance are to be treated as income, or that special rules are to be applied for arriving at the taxable amount of such receipts.'
>
> Because the distinction between income and capital has so often been considered by the courts, attempts to classify a particular receipt often proceed by seeking to draw analogies with decided cases. That approach is often helpful, but resort to analogy should not be permitted to obscure the essential nature of the inquiry which is to determine whether 'in ordinary parlance' the receipt in question is to be treated as income. As Jordan CJ made plain, the references to 'ordinary parlance' and to the 'ordinary concepts and usages of mankind' are no mere matters of ritual incantation; they identify the essential nature of the inquiry."

The last part of the sentence in the passage quoted above from the judgment of Jordan CJ in the *Scott* case (ie the part of the sentence that commences "except insofar as") is not particularly relevant in the context of the definition of annual turnover in s 328-120(1) ITAA97. Any amount that is assessable income and is not ordinary income is statutory income.[52]

As pointed out at ¶7-145, if a profit or gain is derived in the ordinary course of carrying on a business, this will usually mean that the profit or gain is ordinary income.

50 S 6-5(1) ITAA97.

51 [1999] HCA 34.

52 S 6-10 ITAA97.

¶7-155 Derived

The point in time when ordinary income is derived by an entity determines, for the purposes of the small business entity test, the income year in which the amount is taken into account in the calculation of the entity's annual turnover.

The only direct statutory guidance on the question of when ordinary income is derived is given by s 6-5(4) ITAA97, which provides that, when working out whether an entity has derived an amount of ordinary income and (if so) when the entity derived it, the entity is taken to have received the amount as soon as it is applied or dealt with in any way on the entity's behalf, or as the entity directs.

In *Brent v FCT*,[53] Gibbs J said:

> "The Act does not define the word 'derived' and does not establish a method to be adopted as a general rule to determine the amount of income derived by a taxpayer, although particular situations not relevant to the present case are dealt with. The word 'derived' is not necessarily equivalent in meaning to 'earned'. 'Derive' in its ordinary sense, according to the *Oxford English Dictionary*, means 'to draw, fetch, get, gain, obtain (a thing from a source)'. It has become well established that unless the Act makes some specific provision on the point the amount of income derived is to be determined by the application of ordinary business and commercial principles and that the method of accounting to be adopted is that which 'is calculated to give a substantially correct reflex of the taxpayer's true income'. (*The Commissioner of Taxes (South Australia) v The Executor, Trustee and Agency Company of South Australia Limited (Carden's case)* (1938) 63 CLR 108 at pp 152-4)."

As pointed out by Bowen CJ, Fisher and Lockhart JJ in *FCT v Australian Gas Light Co*,[54] many tests have been propounded and many expressions adopted by the courts when attempting to state when income is derived, and those tests have inevitably been conceived in different circumstances to determine different facts and issues. However, their Honours gave the following examples:

> "The fees of accountants are derived when they have matured into recoverable debts: *Henderson v FCT* 70 ATC 4016; (1970) 119 CLR 621. Fees paid in advance for provision of dancing lessons are not derived until they are earned: *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314 (1965) 14 ATD 98. The income of a trading business is derived when its stock is sold and a debt is created: *Rowe J & Son Pty Ltd v FCT* 71 ATC 4157; (1971) 124 CLR 421. Conversely, fees for the price of goods sold are not earned, and thus not derived, if a further step is required before the taxpayer is entitled to payment: *Rowe's* case. The passing of property in stock in trade does not necessarily signify the derivation of income if the consequence is merely the creation of a right to an account rather than entitlement to a debt: *Farnsworth v FCT* (1949) 78 CLR 504; (1949) 9 ATD 33. If a taxpayer accounts on the basis of cash receipts, the income is derived when the 'gains have during the period of account come home to the taxpayer in a realised or immediately realisable form': *C of T (SA) v Executor, Trustee & Agency Co of South Australia Ltd (Carden's case)* (1938) 63 CLR 108 at p 155; (1938) 5 ATD 98 at p 132 per Dixon J."

53 [1971] HCA 48.

54 83 ATC 4800.

In *FCT v Ashwick (Qld) No. 127 Pty Ltd*,[55] Edmonds J (Bennett and Middleton JJ agreeing) said that, generally speaking, the determination of whether income is to be recognised on a cash receipts or an accruals basis is done by applying ordinary business and commercial principles adopting a method of accounting that gives a true or substantially correct reflex of the income derived. The object of the ITAA36 and the ITAA97 is to discover those gains that have come home to the taxpayer in a realised or immediately realisable form during the relevant income year. It is not necessary for an amount to be received before it is derived, and the relevant gain can be a chose in action that has vested in the taxpayer (provided a distinct set of legal relations has come into existence during the income year). Edmonds J also said that the treatment of amounts in a taxpayer's financial statements and accounting records, even if not determinative, are both relevant and significant when determining whether its assessable interest income is to be recognised on receipt or on accrual of the entitlement and are evidence of the test that ought to be applied.

¶7-160 Business not carried on for whole income year

If an entity does not carry on a business for the whole of an income year, the entity's annual turnover for the income year is worked out using a reasonable estimate of what the entity's annual turnover for the income year would be if the entity had carried on a business for the whole of the income year.[56]

The explanatory memorandum to the amending Bill that became the *Tax Laws Amendment (Small Business) Act 2007* assumes that this provision applies not only where a business is commenced during an income year, but also where a business ceases to be carried on during an income year (eg because the business is sold).

In ID 2009/49, the view is expressed that s 328-120(5) ITAA97, when referring to a taxpayer who does not carry on a business for the whole of an income year, recognises that a taxpayer may carry on more than one business in an income year and may cease one of those businesses during the income year. Accordingly, the ATO view is that this provision can, for example, apply not only where a taxpayer ceases to carry on all of their businesses, but also where a taxpayer carries on two or more businesses and ceases to carry on one of those businesses during an income year, while still carrying on another business for the whole of the income year.

¶7-165 Dealings with associates

When working out an entity's annual turnover for an income year, the amount of ordinary income that the entity derives from any dealing with an associate of the entity is the amount of ordinary income that the entity would derive from the dealing if it were at arm's length.[57]

55 [2011] FCAFC 49.

56 S 328-120(5) ITAA97.

57 S 328-120(4) ITAA97.

"Associate" for this purpose takes the wide meaning given to it by s 318 ITAA36. For example, the associates of a natural person include a relative (as defined) or partner of the natural person. An individual or other entity who or which is a beneficiary of a trust would be an associate of the trust and, conversely, the trust would be an associate of the individual or other entity. Thus, for example, a discretionary object of a discretionary trust would be an associate of the trust and the trust would be an associate of the discretionary object.

It should be noted that amounts derived in an income year from any dealing between an entity and an associate that is a relevant entity (for the purposes of calculating the entity's aggregated turnover) are not included in the entity's aggregated turnover for that income year (see ¶7-135).

The operation of the dealing with associate provision[58] is not entirely clear. If decisions on other areas of the income tax law that use the expression "in the ordinary course of carrying on a business" are relevant, where an entity enters into a business transaction with an associate for other than an arm's length consideration, the transaction may or may not be in the ordinary course of carrying on a business.[59]

In *Pastoral & Development Pty Ltd v FCT*,[60] the taxpayer company operated a cattle run and sold cattle to an associated company for £12.10.0 per head, which then sold them on to an abattoir for £32.0.0 per head. Walsh J held that there was a disposal of trading stock that was not in the ordinary course of carrying on the taxpayer company's business for the purposes of the former s 36 ITAA36. His Honour said:

> "I do not assert as a general proposition that a sale by one company to an associated company upon terms that allow the latter to make a substantial profit and give the former less profit than otherwise it might be possible for it to make is never a sale in the ordinary course of the carrying on of the business of the former company. It is common enough that business is conducted in that fashion between associated companies, not by way of an exceptional and isolated transaction, but as a regular method of trading: cf *Cecil Bros Pty Ltd v FCT* (1964) 111 CLR 430. My conclusion is concerned with the particular facts and circumstances of this case. The conclusion to which those facts and circumstances lead, in my opinion, is that the price was an arbitrary one and was so low as to take the transaction outside the category of an ordinary business transaction."

¶7-170 Case studies

Case study 1

Multiphase Pty Ltd is a private company that carries on a business manufacturing electrical switchboards and other electrical components. Its issued shares (which are of one class) are held by Carl (50%), Mary (Carl's spouse) (38%) and Ampere Pty Ltd (12%). Carl and Mary beneficially own

58 S 328-120(4) ITAA97.

59 *Pastoral & Development Pty Ltd v FCT* [1971] HCA 41.

60 [1971] HCA 41.

their shares, and Ampere Pty Ltd, of which Carl is the sole director and shareholder, holds the shares as trustee of the Voltage Discretionary Trust. The Voltage Discretionary Trust acquires and wholesales the products manufactured by Multiphase Pty Ltd.

The beneficiaries of the Voltage Discretionary Trust include Carl and Mary, their lineal descendants (and spouses), and any company in which a beneficiary who is a natural person is a shareholder. Carl is the sole director/shareholder of the corporate trustee of the Voltage Discretionary Trust. It is assumed that no beneficiary controls the Voltage Discretionary Trust under the pattern of distributions control rule.

Multiphase Pty Ltd is considering selling a CGT asset in November 2016. The asset in question qualifies as an active asset and satisfies the active asset test. It is necessary to determine whether Multiphase Pty Ltd is a small business entity.

If it is assumed that, because Carl is the sole director of the corporate trustee of the Voltage Discretionary Trust, it could be said that the trustee acts, or could reasonably be expected to act, in accordance with Carl's directions or wishes, then Multiphase Pty Ltd and the Voltage Discretionary Trust would be connected entities. This would mean that, when calculating Multiphase Pty Ltd's aggregated turnover, the annual turnover of the Voltage Discretionary Trust would be included. However, as the Voltage Discretionary Trust would be connected with Multiphase Pty Ltd (because both are controlled by Carl), it would be a "relevant entity" for the purposes of calculating the aggregated turnover of Multiphase Pty Ltd and, therefore, any amounts derived by Multiphase Pty Ltd from its dealings with the Voltage Discretionary Trust would be excluded when calculating Multiphase Pty Ltd's aggregated turnover (see ¶7-135).

Case study 2

Assume the same facts as in case study 1 except that, in February 2017, Carl decides to give his son Frank a stake in the business by letting Frank take over the marketing and sales operations. To achieve this, Carl lets Frank take control of the Voltage Discretionary Trust. Carl, on 10 February 2017, transfers his shares in the trustee company to Frank and resigns as director. He also transfers his shares in Ampere Pty Ltd to Frank and resigns his directorship of Ampere Pty Ltd.

On these facts, the Voltage Discretionary Trust would cease to be a "relevant entity" in relation to Multiphase Pty Ltd from 10 February 2017 and, therefore, amounts derived in the ordinary course of business by Multiphase Pty Ltd from the Voltage Discretionary Trust from that date would be included in the calculation of Multiphase Pty Ltd's aggregated turnover.

However, Multiphase Pty Ltd and the Voltage Discretionary Trust would be associates. Provided all transactions entered into by Multiphase Pty Ltd with the Voltage Discretionary Trust are in the ordinary course of business, the arm's length amount of the transactions is to be taken into account for the purposes of calculating Multiphase Pty Ltd's aggregated turnover (see ¶7-165). What this amount would be will be a question of fact. It would not, it is submitted, simply be the market value of the products but, rather, would be the arm's length price if they were sold to an independent entity that marketed and distributed them.

Chapter 8

Active assets and the active asset test

¶8-100 Context

A capital gain can only qualify for the CGT small business reliefs if the relevant CGT asset satisfies the active asset test (see ¶4-100).

The relevant CGT asset will usually be the asset in relation to which the CGT event happens that results in the capital gain (see ¶5-100), but if the CGT event that happens is CGT event D1 (creating contractual or other rights), the relevant asset is the CGT asset with which the right created is inherently connected (see ¶5-110).

Active asset status of a CGT asset is also relevant for CGT small business roll-over relief – a "replacement asset" must be an active asset at the end of the replacement asset period (see ¶15-130) and, if a replacement asset subsequently ceases to be an active asset, this will trigger CGT event J2 (see ¶15-145).

For the purposes of applying the active asset test, the particular CGT asset must be tested for active asset status over a period of time.

There are some CGT assets that cannot be active assets (see ¶8-125 to ¶8-135), and special tests must be met for a share in a company or an interest in a trust to be an active asset (see ¶8-115 and ¶8-120).

The active asset test has been subject to quite significant legislative change over the years, but in its present form has operated in relation to CGT events that happen on or after 23 June 2009.

¶8-110 CGT asset that is not a share or trust interest as an active asset

Unless it is excluded from being an active asset, a CGT asset (other than a share or trust interest) will be an active asset of an entity (Q) at a particular time if, at that time, Q owns it and any of the following applies:

(1) Q uses the asset,[1] or holds it ready for use, in the course of carrying on a business (whether alone or in partnership);

(2) the asset[2] is used, or held ready for use, in the course of carrying on a business (whether alone or in partnership) by:

  (a) an affiliate of Q; or

  (b) another entity that is connected with Q; or

(3) the asset is an intangible asset that is inherently connected with a business that is carried on (whether alone or in partnership) by:

  (a) Q;

  (b) an affiliate of Q; or

  (c) another entity that is connected with Q.[3]

1 The asset may be tangible or intangible.

2 The asset may be tangible or intangible.

3 S 152-40(1) ITAA97.

For the CGT assets that are excluded from being active assets, see ¶8-125 to ¶8-135.

When applying the active asset test, the special provision under which a beneficiary of a trust that is carrying on a business of primary production can be taken to carry on the primary production business (for the purposes of the primary producer averaging scheme) is disregarded when determining whether an entity is carrying on a business.[4]

For a discussion of what constitutes the carrying on of a business, see ¶7-115. The leasing of a taxi licence does not constitute the carrying on of a business and, therefore, a taxi licence that is leased to an unrelated party cannot be an active asset.[5]

The express recognition in the definition of active asset that the business in which the asset is used (or is held ready for use or is inherently connected with) may be carried on by a relevant entity, either alone or in partnership, is intended to reflect the fact that a partner is considered to carry on the business of the partnership, but collectively with the other partners.

Passively held assets: winding-up rule

An entity that owns a CGT asset and does not carry on a business (other than in partnership) may access the CGT small business reliefs via the small business entity test if (broadly) at a time in the income year in which the CGT event happens, the asset is used in (or is held ready for use in or is inherently connected with) a business carried on by:

- an affiliate or a connected entity that is a small business entity for the income year; or
- a partnership that is a small business entity for the income year and in which the entity is a partner (see ¶4-105).

Where the relevant business ceases to be carried on and is being wound up in a later income year, there is a provision that has the effect that, for the purposes of the definition of active asset, the asset is treated as being used in (or as being held ready for use in or as being inherently connected with) the business in the later income year.[6]

Intangible assets

The very broad definition of a CGT asset provided by s 108-5 ITAA97 extends the term CGT asset to include a wide range of rights and other forms of intangible assets. The following are examples of intangible assets:

- the goodwill of a business;
- the benefit of a restrictive covenant;

4 S 152-40(2) ITAA97. Curiously, there is no reference to the provision that can operate to treat a beneficiary as carrying on a primary production business for the purposes of the farm management deposit provisions.

5 ID 2002/630. This interpretative decision has been withdrawn on the basis that it was a simple statement of the law and not an interpretative decision.

6 S 152-49 ITAA97.

- intellectual property rights;
- statutory rights; and
- a transferable poker machine entitlement granted to a hotelier under the *Gaming Machines Act 2001* (NSW) – the entitlement is inherently connected with the hotel business.[7]

Trade debtors of a business may qualify as active assets. Trade debtors are intangible assets inherently connected with the business. They are not financial instruments, but are a business facilitation mechanism that assists in the conduct of the business.[8] This is of particular relevance when applying the 80% look-through test to determine whether a share or trust interest is an active asset (see ¶8-115).

It will be noted that an intangible asset may also potentially qualify under the other categories of the active asset definition (ie (1) and (2) above). The specific inherently connected category of active asset is needed, because it may not be able to be said of some intangible CGT assets (eg goodwill or the benefit of a restrictive covenant) that they are used, or held ready for use, in the course of carrying on a business, but will be inherently connected with the business.

Held ready for use

The ATO applies the definition of active asset on the basis that the concept of "held ready for use" means that the CGT asset is in a state of preparedness for use in the business and is functionally operative at the relevant time.[9] For example, as pointed out in the ATO Guide, premises still under construction or land on which it is intended that business premises be constructed would not be held ready for use and, therefore, could not be an active asset.

Connected entities

Whether an entity is connected with another entity for the purposes of determining whether a CGT asset (owned by one of the entities and used (or held ready for use) by, or inherently connected with a business of, the other entity) is an active asset is determined by the application of the general small business connected entity rules in Subdiv 328-C ITAA97, supplemented by the special affiliate rule (noted below) under which an individual's spouse or child under 18 years of age may be his or her affiliate when determining affiliate or connected entity status for the purposes of CGT small business relief. For full discussion of the connected entity rules, see chapter 10 (see ¶10-100).

Note that, in the case of a discretionary trust that has a tax loss or a nil net tax income for an income year for which the trustee did not make a distribution of income or capital, provision is made in s 152-78 ITAA97 for the trustee to nominate up to four beneficiaries as controllers of the trust for the income year (and, therefore, each nominated beneficiary and the trust would be connected entities for that year). See further ¶10-185.

7 ID 2002/785. This interpretative decision was withdrawn on the basis that it did not contain an interpretative decision.

8 ATO Guide.

9 ID 2002/354.

Affiliate issues

It is important to note the circumstances in which a spouse or a child under 18 years of age of an individual will be the individual's affiliate for the purposes of the CGT small business reliefs. As a result of amendments made in 2009,[10] an individual's spouse or child under 18 years of age will be treated as the individual's affiliate for the purposes of determining (broadly) whether an entity that uses (or holds ready for use) in its business a CGT asset owned by another entity is an affiliate of, or is connected with, the other entity.[11] Where a spouse or child under 18 years of age is an affiliate of an individual under this rule, the spouse or child will be treated as an affiliate of the individual for the purposes of the CGT small business reliefs generally, including for the purposes of applying the small business entity provisions as they operate in the context of the CGT small business reliefs. For full discussion, see ¶9-135.

¶8-115 Share or trust interest in non-widely held entity as an active asset

A share in a company that is not widely held (see ¶8-120) or an interest in a trust that is not widely held (see ¶8-120) will be an active asset of an entity (R) at a particular time if R owns it at that time and:

(1) in the case of a share, the company is an Australian resident at that time or, in the case of an interest in a trust, the trust is a resident trust for CGT purposes for the income year in which that time occurs;[12] and

(2) the total of:

 (a) the market values of the active assets of the company or trust;

 (b) the market value of any financial instruments of the company or trust that are inherently connected with a business that the company or trust carries on; and

 (c) any cash of the company or trust that is inherently connected with such a business,

 is 80% or more of the market value of all of the assets of the company or trust.[13]

The requirement in (2) above is referred to, for convenience, as the 80% look-through test.

For the tests that apply in the case of a share in a widely held company or an interest in a widely held trust, see ¶8-120.

10 By the *Tax Laws Amendment (2009 Measures No. 2) Act 2009*. The amendments apply (subject to transitional provisions) to CGT events that happen in the 2007-08 and later income years.

11 S 152-47 ITAA97.

12 Note that, for the purposes of the statutory CGT rules relating to look-through earnout rights, interests in foreign entities may be active assets (s 118-570 ITAA97). For further details of the statutory CGT rules relating to look-through earnout rights, see ¶3-110.

13 S 152-40(3) ITAA97. Note that the statutory CGT rules relating to look-through earnout rights provide that an eligible share or an interest in a trust is treated as an active asset in the hands of an entity for the purpose of determining if a look-through earnout right exists (s 118-570 ITAA97). For further details of the statutory CGT rules relating to look-through earnout rights, see ¶3-110.

Relevant assets

The 80% look-through test (for determining whether a share or trust interest is an active asset) requires the market values of all of the assets of the company or trust to be taken into account in the denominator, and the market values of the active assets of the company or trust to be taken into account as a component of the numerator.

Active assets in this context will include any assets that qualify as active assets under the definition of that term, including assets that may not give rise to a capital gain (eg trading stock and depreciating assets) and pre-CGT assets. However, to be taken into account, the asset must be an active asset at the particular time.

For a discussion of the concept of "market value", see ¶6-110.

Financial instruments and cash

The expression "financial instruments" is not defined, but some indication of its meaning may be gleaned from the terms of s 152-40(4)(d) ITAA97. That provision precludes financial instruments from qualifying as active assets and gives loans, debentures, bonds, promissory notes, futures contracts, forward contracts, currency swap contracts, and a right or option in respect of a share, security, loan or contract as examples of financial instruments.

Continuing active asset status if reasonable to conclude

If a share in a company or an interest in a trust is an active asset at a particular time (because the 80% look-through test is met at that time), the share or trust interest will be an active asset at a later time if it is reasonable to conclude that the share or trust interest is still an active asset at the later time.[14] This recognises that applying the 80% look-through test on a continuous basis can impose an onerous compliance requirement on small businesses.

The relevant explanatory memorandum[15] gives, as an example of when it would be reasonable to conclude that a share or trust interest is still an active asset, the situation where there have been no significant changes to the assets or liabilities of the company or trust.

14 S 152-40(3A) ITAA97.

15 To the Tax Laws Amendment (2006 Measures No. 7) Bill 2006.

Temporary breaks

A share in a company or an interest in a trust that is an active asset will continue to be an active asset (despite a failure to meet the 80% look-through test) if the failure is of a temporary nature only.[16] The relevant explanatory memorandum[17] gives the following examples.

Example 1

John sells an active asset, meets the basic conditions for the CGT small business reliefs, and makes a capital gain of $500,000. He acquires shares in Fruit and Veg Company, which runs his family business, as replacement assets. The shares in Fruit and Veg Company meet the 80% look-through test and thus are active assets. Some time later, Fruit and Veg Company borrows money to pay a dividend, and fails the 80% look-through test. Two weeks later, the dividend is paid and the shares pass the 80% look-through test again. For the two weeks, the shares are treated as active assets, even though they do not pass the 80% look-through test.

Example 2

Georgina buys shares in a company that buys property in order to start a farm. The property makes up 50% of the asset value of the company. For the first year that she owns the shares, the company does not actively use the property. After that time, the company starts the farming business. The property is not active for the first year – therefore, the company does not pass the 80% look-through test. The shares are not treated as active because the company failed the 80% look-through test for an extended period of time (not just a temporary failure).

Active asset via a further entity

A share in a company or an interest in a trust can qualify as an active asset if the company or trust owns interests in another entity that satisfies the 80% look-through test. That test operates successively at each level in a chain of entities to determine the active asset status of the underlying interests.[18] If the company or trust is widely held, the CGT concession stakeholder test must be met (see ¶8-120).

The following example is adapted from an example given in the ATO Guide.

16 S 152-40(3B) ITAA97.

17 To the Tax Laws Amendment (2006 Measures No. 7) Bill 2006.

18 TD 2006/65.

Example

Ben owns all of the shares in Holding Company that, in turn, owns all of the shares in Operating Company (both are resident companies). The only assets of Holding Company are the shares in Operating Company, and all of Operating Company's assets are active assets.

As Operating Company satisfies the 80% look-through test, the shares owned by Holding Company in Operating Company are active assets. As those shares are the only assets owned by Holding Company, Holding Company also satisfies the 80% look-through test, and therefore the shares owned by Ben in Holding Company are also active assets.

If Ben sold the shares in Holding Company, all of the CGT small business reliefs may potentially apply to any capital gains made. Further, if Holding Company sold its shares in Operating Company, the CGT small business reliefs may potentially apply because Ben is a CGT concession stakeholder in Operating Company, as well as having a small business participation percentage in Holding Company of at least 90%.

If Operating Company sold its active assets, Operating Company may be entitled to the CGT small business concessions because Ben is a significant individual and CGT concessional stakeholder in Operating Company as a result of his direct and indirect small business participation percentage.

¶8-120 Share or trust interest in widely held entity

If a CGT asset is a share in a widely held company or an interest in what might be called a widely held trust, the share or trust interest will only be an active asset if:

- the requirements set out at ¶8-115 are met for the share or trust interest; and
- the shareholder or interest holder is a CGT concession stakeholder (see ¶11-115) of the company or trust (as the case may be).[19]

A widely held company is:

- a company, the shares in which (except shares which carry a right to a fixed rate dividend) are listed for quotation in the official list of an approved stock exchange; or
- a company with more than 50 members, other than a company that meets a 20 persons/75% interests test.[20]

A trust will be widely held in the relevant sense if:

- interests in the trust are listed for quotation in the official list of an approved stock exchange; or
- the trust has more than 50 members, is not a discretionary trust and does not meet a 20 persons/75% interests test.[21]

19 S 152-40(4)(b) and (c) ITAA97.

20 S 995-1 ITAA97.

21 S 152-40(5) ITAA97.

¶8-125 What cannot be an active asset?

Interests in an entity connected with the taxpayer can only be active assets if they are shares or trust interests that qualify under the tests set out at ¶8-115.[22] In addition, shares in a company or interests in a trust that do not satisfy the tests set out at ¶8-115 and ¶8-120 cannot be active assets.[23] For the circumstances in which entities will be connected, see ¶10-100.

¶8-130 Financial instruments

Financial instruments (such as loans, debentures, bonds, promissory notes, futures contracts, forward contracts, currency swap contracts, and a right or option in respect of a share, security, loan or contract) cannot be active assets.[24]

A Dairy Structural Adjustment Program is a financial instrument, as it has features that are characteristic of such instruments; for example, a face value, a discounted present value, an income stream and tradability.[25]

¶8-135 Assets producing passive income

A CGT asset, whose main use by the entity who or that owns it is to derive interest, an annuity, rent, royalties or foreign exchange gains, cannot be an active asset unless:

(1) the asset is an intangible asset and has been substantially developed, altered or improved by the entity that owns it so that its market value has been substantially enhanced; or

(2) its main use for deriving rent was only temporary.[26]

When determining the main use of an asset for this purpose:

(1) any personal use or enjoyment of the asset by the entity who or that owns it is disregarded; and

(2) any use of the asset by an affiliate of, or an entity connected with, the entity who or that owns the asset is treated as use by the entity that owns the asset.[27]

22 S 152-40(4)(a) ITAA97.

23 S 152-40(4)(b) and (c).

24 S 152-40(4)(d) ITAA97.

25 ID 2003/250. This interpretative decision was withdrawn because it contained a view in respect of particular transactions that occurred in the 2000-01 to 2008-09 income years. Despite its withdrawal, the interpretative decision continues to be a precedential view in respect of the particular transactions that occurred during those income years.

26 S 152-40(4)(e) ITAA97.

27 S 152-40(4A) ITAA97. For the definition of affiliate, see ¶9-100, and for the definition of connected entity, see ¶10-100.

This passive asset exclusion from the definition of active asset reflects amendments made by the *Tax Laws Amendment (2009 Measures No. 2) Act 2009* that apply to CGT events that happen on or after 23 June 2009 (the date on which the amending Act received royal assent). The amending Act amended s 152-40(4)(e) ITAA97 and inserted s 152-40(4A) ITAA97. The amendments were designed to ensure that all the uses of an asset (apart from the personal use of an asset by the taxpayer or an individual who is the taxpayer's affiliate) are considered when determining whether the asset is an active asset. This is intended to overcome the fact that, before the amendments, it was possible for an asset that had a predominant rental and a minor business use to qualify as an active asset. This could have been so where the minor business use was undertaken by an affiliate of, or an entity connected with, the taxpayer who or that owned the asset, but the rental use was by an entity that was neither an affiliate of, nor an entity connected with, the taxpayer. The amendments achieve their intended result by treating the use of an asset by an affiliate of, or an entity connected with, the taxpayer as though it were use by the taxpayer.

The following example (with some adaptations) is given in the explanatory memorandum to the relevant amending Bill[28] that became the *Tax Laws Amendment (2009 Measures No. 2) Act 2009* to illustrate how the present passive asset exclusion operates.

Example (adapted from explanatory memorandum)

Kiki owns a building and rents out 90% of the floor area to Lost Dog Pty Ltd, a company that is neither her affiliate nor connected with her. Kiki earns 90% of the revenue derived from owning the building from renting it to Lost Dog Pty Ltd.

Beaglehole Pty Ltd, which carries on a dog grooming business, uses the remaining 10% of the floor area of the property as its business premises, and pays Kiki rent for using it. The rent forms 10% of the revenue Kiki earns from owning the building. As Kiki beneficially owns 60% of the issued shares of Beaglehole Pty Ltd, Beaglehole Pty Ltd is, therefore, connected with Kiki.

The determination of the main use of Kiki's building would take into account the 90% rental use to Lost Dog Pty Ltd (which neither is Kiki's affiliate nor is connected with her).

Beaglehole Pty Ltd's use of that part of the building rented to it is treated as being Kiki's use, because Beaglehole Pty Ltd is connected with Kiki. Beaglehole Pty Ltd uses that part of the property as its business premises and Kiki is, therefore, treated as using that part as business premises. This means that the rent Beaglehole Pty Ltd pays to Kiki is not treated as rent for the purposes of determining Kiki's main use of the building.

Kiki's main use of the building is to derive rent, because 90% of the revenue she derives from the building is rent received from Lost Dog Pty Ltd. This means that Kiki's building is not an active asset.

For further examples, see case studies 10 and 11 at ¶8-160.

28 The Tax Laws Amendment (2009 Measures No. 2) Bill 2009.

Interest

"Interest" is not defined. As a matter of ordinary language, interest is the return or compensation for the use or retention by one person of a sum of money belonging or owed to another.[29]

Annuity

The term "annuity" is not relevantly defined. The fundamental distinction between an annuity transaction and a loan transaction is that, when moneys are lent, there is an obligation on the part of the borrower to repay the loan. If an annuity is purchased, there is no obligation on the part of the annuity provider to repay the price paid. The obligation is to pay the agreed annuity, and no relationship of debtor and creditor exists with respect to the price paid.[30]

Rent

There is no statutory definition of rent that is relevant for the purposes of the definition of active asset. The term "rent" in its ordinary, or at least its essential, meaning refers to a payment made for the possession of realty under a lease.[31] This makes it imperative, when considering the operation of the main use to derive rent exclusion from the definition of active asset, to identify whether what has been granted is a lease or a licence.

Where there is a real question of whether there is a lease or a licence, the problem may be solved by considering whether the right that is conferred is a right to the exclusive possession of the property in question. If such a right is conferred, there will be a lease, although exceptional cases may arise in which it will be seen that a right to exclusive occupation or possession has been given without the grant of a leasehold interest.[32]

The question of whether an occupation agreement amounts to a lease (conferring a proprietary interest) or merely to a contractual licence is a question that has, over the years, posed difficult problems for the courts in a variety of contexts. In *KJRR Pty Ltd v CSR (Vic)*,[33] Tadgell JA commented that a satisfactory statement of the criteria by which a grant of exclusive possession may inevitably be identified is elusive. It is clear that the particular description that the parties give to their agreement is not decisive.

The distinction between a lease and a licence for the purposes of the definition of active asset is an important one, because if a licence has been granted (so there is no rent), the CGT asset in relation to which the licence has been granted will not be precluded from being an active asset by that fact. The asset would, of course, need to satisfy the requirements of the definition of active asset (see ¶8-100).

29 *Adams v Paul's Properties Ltd* [1965] NZLR 161; *Vision Super Pty Ltd v Poulter* [2006] FCA 849.

30 *ANZ Savings Bank Ltd v FCT* 93 ATC 4370 per Davies J.

31 *C of SD (NSW) v JV (Crows Nest) Pty Ltd* 86 ATC 4740 per Mahoney JA.

32 *Radaich v Smith* [1959] HCA 45; 101 CLR 209 per Taylor J.

33 99 ATC 4335.

An important point is that, if a lease has been granted over the CGT asset (so rent is received), the CGT asset that is the subject of the lease may be an active asset if the asset is used in a business carried on by a connected entity or affiliate, provided any rent-producing use of the asset, by the connected entity or affiliate, is either not the main use of the asset or, if it is, that use is only temporary (see ¶8-140).

The distinction between a lease and a licence for the purposes of the definition of active asset is considered in TD 2006/78. The determination states:

> "A key factor therefore in determining whether an occupant of premises is a lessee is whether the occupier has a right to exclusive possession (*Radaich v Smith* (1959) 101 CLR 209). If, for example, premises are leased to a tenant under a lease agreement granting exclusive possession, the payments involved are likely to be rent and the premises not an active asset. On the other hand, if the arrangement allows the person only to enter and use the premises for certain purposes and does not amount to a lease granting exclusive possession, the payments involved are unlikely to be rent.
>
> If premises are operated as a boarding house, the issue arises as to whether an occupant of part of the premises is a tenant or alternatively only a lodger/boarder with a licence to occupy. Similarly, if residential units are operated as holiday apartments, the issue arises as to whether the occupants of the apartments are tenants/lessees or only have licences to occupy.
>
> Ultimately, these are questions of fact depending on all the circumstances involved. Relevant factors to consider in determining these questions (in addition to whether the occupier has a right to exclusive possession) include the degree of control retained by the owner and the extent of any services provided by the owner such as room cleaning, provision of meals, supply of linen and shared amenities (*Allen v Aller* (1966) 1 NSWR 572, *Appah v Parncliffe Investments Ltd* [1964] 1 All ER 838 and *Marchant v Charters* [1977] 3 All ER 918)."

The determination also states that many arrangements involving holiday apartments and the like will not satisfy the active asset test, such as where the activities do not amount to the carrying on of a business, or where the arrangement does, in fact, involve the derivation of rent.

AAT decision: Carson

The operation of the main use to derive rent exclusion was considered by the AAT in *Carson and FCT*,[34] a case that involved an objection against a private ruling. The AAT held that a holiday unit was not an active asset and was in any event not an asset of a business carried on by the taxpayers (husband and wife). The unit was acquired by the taxpayers in August 1999 for $500,000, and the taxpayers used the property to provide short-term tourist accommodation (usually for stays of about one to two weeks), and very occasionally for private purposes. The bookings for the unit were handled by a local real estate agent, who also attended to minor repairs. The taxpayers visited the property twice a year to carry out repairs, to refurbish and to replace crockery etc, and to clean the unit. A contract cleaner was used after each stay at the unit.

34 [2008] AATA 156.

The AAT had no doubt that the occupants regarded themselves as having rented the unit for the period of their stay and during that stay had exclusive possession. Not surprisingly, no formal lease agreement was signed, but this did not mean that there was no landlord/tenant relationship. On the facts provided, the main use of the subject property was to derive rent and, therefore, it was excluded from being an active asset (under s 152-40(4)(e) ITAA97). At the hearing, the Commissioner (presumably on the basis of the views expressed in TD 2006/78) accepted that, on the facts identified in the private ruling issued to the taxpayers, rent was not derived from the holiday unit.

It will be interesting to see whether the Commissioner revisits the "rent" issue dealt with in TD 2006/78. Practitioners who are seeking to rely on the determination will need to ensure that the facts with which they are involved fall within the terms of the determination.

No business

In any event, the AAT held that the taxpayers were not carrying on a business. Whether a business is being carried on is a question of fact and an objective consideration of the extent of the taxpayers' activities relating to the property. Here, the taxpayers invested approximately $500,000 in one property, appointed a real estate agent to arrange rentals and minor repairs, spent one week every six months servicing the property, and provided brochures relating to the property as required. These activities had all the earmarks of maintaining and deriving income from an investment, rather than the carrying on of a business. The activities such as financing the property, and dealing with rating authorities and the body corporate, were no more than any investor in real estate would do. Equally, the maintenance of accounting and tax records were relevant to any income-producing investment.

AAT decision: Tingari Village

In *Tingari Village North Pty Ltd and FCT*,[35] the AAT held that residents of mobile home sites situated on land owned by the taxpayer company and operated by it under the provisions of the *Residential Parks Act 1998* (NSW) were occupied by the residents under leases, so that the main use of the park by the taxpayer was to derive rent. The AAT referred to the judgment of Parker LJ in *Addiescombe Garden Estates v Crabbe*,[36] in which his Lordship, in relation to an agreement that was labelled a licence, said that almost all of its clauses were appropriate to a tenancy agreement. He referred particularly to clauses that he thought were "completely inconsistent" with the instrument being a licence. The first was a clause authorising the grantor to enter the premises and inspect; the second was the usual covenant for quiet enjoyment; and the third was the right, upon non-payment of rent, for the grantor to enter and determine the contract.

Examples

TD 2006/78 contains several examples, some of which are adapted in the case studies at ¶8-160.

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35 [2010] AATA 233. An appeal by the taxpayer from the decision of the AAT was discontinued.

36 [1958] Ch 513.

Royalties

The term "royalties" is defined in the dictionary in s 995-1 ITAA97 as having the meaning given to it in s 6(1) ITAA36. The word royalties is not asterisked in the definition of active asset, but there is no reason why the statutory definition would not be relevant.

"Royalty" or "royalties" is defined in s 6(1) ITAA36 to include any amount paid or credited, however described or computed, and whether the payment or credit is periodical or not, to the extent to which it is paid or credited, as the case may be, as consideration for (inter alia):

(1) the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trademark or other like property or right;

(2) the use of, or the right to use, any industrial, commercial or scientific equipment; and

(3) the supply of scientific, technical, industrial or commercial knowledge or information.

Main use

Where an asset is used partly for business and partly to derive interest, an annuity, rent, royalties or foreign exchange gains, it will be necessary to determine whether the derivation of the interest, rent etc is the "main use".

Dealing with rent, TD 2006/78 states that no single factor will necessarily determine whether the main use of the asset is to derive rent, and resolving the matter is likely to involve a consideration of a range of factors, such as:

- the comparative areas of use of the premises (between rent and other uses); and
- the comparative levels of income derived from the different uses of the asset.

For more information, see case study 5 at ¶8-160.

¶8-140 Asset rented to connected entity or affiliate

The fact that a CGT asset (for example, business premises) owned by an entity is leased by that entity to a connected entity or to an affiliate will not disqualify the asset from being an active asset.

As a result of amendments made by the *Tax Laws Amendment (2009 Measures No. 2) Act 2009* (and which apply where the relevant CGT event happens on or after 23 June 2009), an asset will only qualify as an active asset where (broadly) the main use of the asset by the taxpayer and/or an affiliate of, or an entity connected with, the taxpayer, is not to derive rent (otherwise than on a temporary basis). For a full discussion, see ¶8-135.

The position is the same in relation to intellectual property that has not been substantially developed, altered or improved, as contemplated by s 152-40(4)(e) ITAA97 (see ¶8-135).

¶8-145 Requirements to be met for active asset test

For CGT events that happen in the 2006-07 or a later income year, there is effectively only a period of time requirement that must be met for a CGT asset to be an active asset (see ¶8-150).

Previously, it was also necessary (if an asset were to satisfy the active asset test) for the asset to be an active asset at, broadly, the end of the period described in ¶8-150 that is relevant for now applying the active asset test.

¶8-150 The active asset test

A CGT asset will satisfy the active asset test if:

(1) the entity has owned the CGT asset for 15 years or less, and the asset was an active asset of the entity for a total of at least one-half of the period, beginning with the entity's acquisition of the asset and ending at the earlier of:

(a) the CGT event; and

(b) if the relevant business ceased to be carried on in the 12 months before the CGT event (or any longer period that the Commissioner allows), the cessation of the business; or

(2) the entity has owned the CGT asset for more than 15 years and the asset was an active asset of the entity for a total of at least 7½ years during the period specified in (1) above.[37]

Interest in asset acquired at different times

If a taxpayer acquires interests in a CGT asset at different times, the ATO view is that each interest acquired remains a separate CGT asset.[38] This means that the CGT small business active asset test is applied to each interest separately.[39]

Cessation of business

The notion of the cessation of a business (see (1)(b) above) includes the situation where the business is sold by the entity that carries it on.[40] For what the "relevant business" is in this context, see ¶8-110, ¶8-140 and ¶8-155. When a business is sold, usually the 12-month period would commence when the sale of the business is completed, not when the contract is entered into (which would typically be the time when the CGT event happened).

37 S 152-35 ITAA97.

38 TD 2000/31.

39 ID 2002/862.

40 TD 2006/64. This determination has been withdrawn because it was concerned with the former requirement of the active asset test that the asset be an active asset just before the earlier of the relevant CGT event and the cessation of the relevant business. The determination is still relevant for the purpose of determining the period by which active asset status must be measured (see (1) in text above).

Acquired

For the purposes of applying the period of time requirement in the active asset test definition that applied to CGT events that happened before the 2006-07 income year, the ATO view was that the time of the acquisition of a CGT asset (see (1) above) was the time when the asset was actually acquired and the time of acquisition rules that apply for CGT generally (eg the rules that apply in the case of a deceased estate) would not be determinative.[41]

The reason given in the interpretative decision for this view is that the meaning of the word "acquired" in the particular context was influenced by the reference to the word "owned" in the active asset test and the nature of the active asset test itself, which considers, in general, how an asset is used. This suggested that the period of actual ownership, rather than a period commencing at a deemed time of acquisition, was the relevant period. At the time when the interpretative decision was issued, the word "acquired" was not asterisked, and this was also referred to in the interpretative decision.

The present active asset test (that was enacted by the *Tax Laws Amendment (2006 Measures No. 7) Act 2007*) also refers to the CGT asset having been "owned" for 15 years or less (or for more than 15 years), but the word "acquired" is asterisked. It is pointed out in the withdrawal notice for ID 2004/531 that, subsequent to the issue of the interpretative decision, the word "acquired" was defined in the ITAA97 dictionary (s 995-1(1) ITAA97) with reference to Div 109 ITAA97. The withdrawal notice then states that, relevantly, s 109-5(1) ITAA97 defines acquired as:

> "In general, you acquire a *CGT asset when you become its owner. In this case the time when you *acquire the asset is when you become its owner."

The withdrawal notice then says that, on the facts postulated in ID 2004/531, the taxpayer "acquired" the asset when they attained legal ownership of the asset, when title to the asset was transferred. This is the same outcome as expressed in this interpretative decision under the previous legislation.

The withdrawal notice does not refer to the fact that "acquire" a CGT asset is defined in s 995-1 ITAA97 by reference to the provisions of Div 109 ITAA97 generally, including the provisions listed in Subdiv 109-B ITAA97. The table in s 109-5(2) ITAA97 broadly applies where there has been an acquisition as a result of the happening of a CGT event. For example, where a CGT asset has been acquired by an entity as a result of another entity disposing of the asset to the entity (so that CGT event A1 would happen for the other entity), the time of acquisition is when the disposal contract is entered into or, if none, when the other entity stops being the asset's owner (s 109-5(2) ITAA97, case 1).

Importantly, for the kind of case considered in ID 2004/531, items 1 and 2 in the table in s 109-55 ITAA97 (which is a provision in Subdiv 109-B ITAA97) apply (respectively) where a CGT asset devolves to an entity as legal personal representative of a deceased individual or a CGT asset passes to an entity as beneficiary in the estate of a deceased individual. The items provide that the deceased estate acquisition timing rules apply, with the consequence that the CGT asset would be acquired by the legal personal representative or beneficiary when the deceased died. This casts considerable doubt on the view expressed in the withdrawal notice as to the effect of the statutory definition of "acquire". The

41 ID 2004/531 (now withdrawn).

withdrawal notice does not attempt to justify the conclusion expressed in it by reference to any contrary context that would make the specific situations listed in Div 109 ITAA97 not relevant.

If the defined meaning of "acquired" applies for the purposes of determining the commencement of the period over which the active asset test is to be applied, substantial inequity may arise in some circumstances. For instance, if a taxpayer were to purchase, say, factory premises under a contract which had a long settlement period, the settlement period would form part of the period relevant for applying the active asset test in relation to the factory, as the acquisition would be taken to have occurred when the contract to purchase was entered into (s 109-5(2) ITAA97, case 1 in table).

It should be noted that, for the purposes of the active asset test, there are special provisions that effectively provide for a previous ownership period (and use) of a CGT asset to be taken into account where the compulsory acquisition, loss or destruction or financial services reform roll-over relief has applied.[42] If a taxpayer acquired a CGT asset in circumstances such that CGT marriage breakdown roll-over relief applied, the taxpayer can choose to have the transferor's period of ownership (and use) taken into account when applying the active asset test.[43]

¶8-155 Some issues with shares and trust interests

The end of the period by reference to which the active asset test operates is the earlier of:

(1) the CGT event happening; and

(2) if the relevant business ceased to be carried on in the 12 months before the CGT event happened (or a longer period allowed by the Commissioner), the cessation of the business.

In the case of a share in a company or an interest in a trust, the relevant business is the business carried on, or previously carried on, by the company or trust.[44]

The sale of all of the shares in a company would not constitute the cessation of the relevant business.

Time of CGT event happening

When applying the timing rule in (1) above in the case of a share in a company, it must be remembered that the 12 months is calculated from the time when the particular CGT event that gives rise to the capital gain happens.

Liquidation of company

If a company is liquidated, CGT event C2 or G1 will happen.

42 S 152-45 ITAA97.

43 S 152-45(2) ITAA97.

44 TD 2006/64 (withdrawn, but see the terms of the withdrawal notice); ID 2010/90.

If CGT event C2 (see ¶2-125) is the relevant CGT event, it will happen in relation to a share in a company that is liquidated when the company is finally treated under the corporations law as deregistered. In the ordinary case of a voluntary winding up, this is when the company is deregistered at the end of the three-month period after a return relating to the final meeting of members (or members and creditors) is lodged with ASIC by the liquidator.[45]

It will be CGT event G1 (see ¶2-125), and not CGT event C2, that applies to a liquidator's distribution if the company does not cease to exist within 18 months of the distribution. CGT event G1 happens when the distribution is made.

When a company sells its business or an active asset and the company is to be liquidated, care needs to be taken if the timing rule in (2) above is to be relied on.

Trust distribution

There is a trap in the timing rule in (2) above in the case of an interest in a trust where the relevant event that happens is CGT event E4 (see ¶17-115). That event happens immediately before the end of the income year in which the payment that triggers the happening of CGT event E4 is made by the trustee, unless some other intervening event other than CGT event E4 (eg CGT event A1) happens in relation to the trust interest.

If CGT event E4 happens immediately before the end of an income year and this is more than 12 months after the time of the cessation of the business, the timing rule in (2) above would not be met unless an extension of time were granted by the Commissioner.

¶8-160 Case studies

Case study 1

George owns a valuable trade mark, which he purchased on 18 March 2002. He grants an exclusive license for the exploitation of the trade mark to Exploiter Pty Ltd, a private company. The company has only one class of issued shares, of which George beneficially owns 60%. George does not develop, alter or improve the trade mark in any way.

Exploiter Pty Ltd uses the trade mark in the course of its manufacturing business.

The trade mark will be an active asset of George's while it is used by Exploiter Pty Ltd in its manufacturing business. This is because Exploiter Pty Ltd is an entity connected with George, and the company uses the trade mark in its business, and this use is not to derive royalty income.

45 See TD 2000/7. Note that CGT event G3 (s 104-145 ITAA97) may happen at an earlier time in respect of worthless shares in a company in liquidation or administration.

The fact that George derives royalty income under the licence agreement will not affect the status of the trade mark as an active asset. This is because Exploiter Pty Ltd's use would be attributed to George (see ¶8-110).

In addition, George's shares in Exploiter Pty Ltd would also qualify as active assets, provided the 80% look-through test described at ¶8-115 was met.

Case study 2

Exploiter Pty Ltd, the company in case study 1, decides to change its business operations and, as it is entitled to under the licence agreement with George, grants a sublicence to a public company, Manufacturers Ltd, to use the trade mark in relation to 70% of the product range. This part of the product range accounts for 60% of the turnover of the business. Exploiter Pty Ltd is paid royalties by Manufacturers Ltd, and George is entitled (under the licence agreement with Exploiter Pty Ltd) to 50% of the royalties paid by Manufacturers Ltd, as well as to royalties from Exploiter Pty Ltd for the continuing exploitation by Exploiter Pty Ltd of the trade mark for the remainder of the product range.

The trade mark would cease to be George's active asset when the sublicence was granted because the use of the trade mark by Exploiter Pty Ltd would be attributed to George (see ¶8-110).

Whether George's shares in Exploiter Pty Ltd can satisfy the active asset test will depend on the application of the 80% look-through test (see ¶8-115). When applying this test after Exploiter Pty Ltd grants the sublicence, the rights of Exploiter Pty Ltd under the licence agreement granted by George could not qualify as an active asset and, therefore, its market value would not be included in the numerator for the purposes of applying the 80% look-through test.

Case study 3

Lakeside Pty Ltd is the trustee of the Buy Easy Discretionary Trust. In its capacity as trustee of the trust, Lakeside Pty Ltd carried on a retail business and needed to acquire a warehouse.

The company, as trustee, purchased vacant land for this purpose under a contract that was entered into on 10 March 2012 and was settled on 21 June 2012. Due to financial constraints, construction of the warehouse did not commence until November 2013, and the warehouse was completed and ready for use on 19 March 2014.

Lakeside Pty Ltd sells the warehouse under a contract entered into on 15 February 2016 and vacates the warehouse several weeks later, before settlement of the contract.

Because the warehouse is not a deemed separate CGT asset, in order to satisfy the active asset test (see ¶8-150), the warehouse will need to have been an active asset for at least one-half of the period from the date of the contract for the acquisition of the land (10 March 2012) to the date when CGT event A1 happens (15 February 2016). The total period is 1,436 days and the period during which the warehouse was an active asset is 698 days. This means that the active asset test is not met. See also ¶8-150.

Case study 4

Optical Illusions Pty Ltd was incorporated in May 1990 and carries on a business of manufacturing specialised mirrors. It owns factory premises that need extensive refurbishment. Instead of undertaking the refurbishment, the decision is made to sell the premises, buy vacant land and construct new premises.

The existing premises are sold under a contract that is made on 19 October 2015 and settled on 3 December 2015.

The vacant land is acquired under a contract that is entered into on 10 November 2015 and settled on 29 January 2016. After vacating the existing premises when the contract is completed, Optical Illusions Pty Ltd leases temporary premises for 12 months while the new premises are under construction.

For the purposes of applying the 80% look-through test (see ¶8-115) to determine whether shares in Optical Illusions Pty Ltd are active assets:

- from 3 December 2015, any financial instruments of Optical Illusions Pty Ltd that reflect the sale proceeds of the existing premises will be included in the numerator of the formula (and also, of course, in the denominator) that applies for the purposes of the 80% look-through test; and
- the market value of the vacant land (and its progressive improvement) will be taken into account in the denominator, but not in the numerator, of the calculation that is relevant for the purposes of the 80% look-through test, as it would not be an active asset until it is held ready for use.

Case study 5

(adapted from TD 2006/78)

Mick owns land on which there are a number of industrial sheds. He uses one shed (45% of the land by area) to carry on a motorcycle repair business. He leases the other sheds (55% of the land by area) to unrelated third parties. The income derived from the motorcycle repair business is 80% of the total income (business plus rentals) derived from the use of the land and buildings.

When determining whether the main use of the land is to derive rent, it is appropriate to consider a range of factors. A substantial (although not a majority) proportion of the land by area is used for business purposes. In addition, the business proportion of the land derives the vast majority (80%) of the total income. In all of the circumstances, the main use of the land in this case is not to derive rent, and the land is not precluded from being an active asset by the main use to derive rent exclusion.

Case study 6

Harry and his spouse (Holly) jointly own a post-CGT factory as tenants in common in equal shares. They lease the factory to a partnership in which Harry has a 5% interest, but in which Holly has no interest. The partnership uses the whole of the factory in its manufacturing business.

Although Harry and Holly are a tax law partnership (they are in joint receipt of assessable income), there are two separate CGT assets involved; that is, Harry's interest in the factory premises and Holly's interest in the factory premises. Each of these separate CGT assets must be tested for active asset status.

As Harry is a partner in the partnership that carries on the manufacturing business, he is himself carrying on business and, therefore, his interest in the factory premises can qualify as an active asset (see ¶18-120).

Because Harry is Holly's affiliate by reason of the special spouse/child under 18 affiliate rule (see ¶8-110), her interest in the factory premises also qualifies as an active asset.

Case study 7

(adapted from TD 2006/78)

Christine carries on a business of providing commercial storage space. The storage facility comprises 50 storage sheds that are available for hire for periods of one week to two years or more. Christine provides office facilities and 24-hour on-site security. She also provides various items of equipment for sale or loan to clients, such as trolleys, cardboard boxes, brooms, tape, pens, locks, bolt cutters, torches and shelves. A cleaning service is also provided and charged for.

Christine enters into a storage agreement with each client. The agreements provide that, in certain circumstances, she can relocate the client to another space or enter the space without consent and that the client cannot assign the rights under the agreement.

The arrangements entered into in this situation indicate that the users of the storage sheds do not have the right to exclusive possession but, rather, only the right to enter and use the sheds for certain purposes. Some of the arrangements entered into were short-term and a range of services were provided to the users. There was also no intention by the parties to grant a lease.

Having regard to all of the circumstances, the ATO would consider that a landlord/tenant relationship does not exist between the parties and that, therefore, the amounts received are not rent. Accordingly, the storage facility is an active asset.

Case study 8

(adapted from TD 2006/78)

David owns an eight-bedroom property that he operates as a boarding house. He resides on the premises. Boarders enter into arrangements to occupy single rooms, with the average length of stay being four to six weeks. No notice is required to quit the rooms. There are rules requiring visitors to leave the premises by a certain time, and David retains the right to enter the rooms. David pays for all utilities (gas, electricity, water) and provides the following services and facilities to boarders:

- room cleaning and general maintenance;
- linen and towels; and
- common areas, such as a TV/lounge room, a kitchen, bathrooms, a laundry and a recreation area.

The services and facilities provided to boarders are relatively significant and the average length of stay is relatively short. David retains a significant degree of control over the premises as a result of being on the premises most of the time. The arrangements entered into indicate that those staying in the boarding house do not have the right to exclusive possession of a room but, rather, only a right to occupy the room.

These circumstances indicate that the relationship between David and those staying at the boarding house is not that of landlord/tenant under a lease agreement. Accordingly, the income derived is not "rent" and, if David's activities amount to the carrying on of a business, the boarding house will be an active asset.

Case study 9

Nathan is a partner in a partnership that carries on a business. The other partners are two companies, Donut Pty Ltd (of which Nathan is the sole director and shareholder) and Strudel Pty Ltd (of which Patrick, Nathan's adult son, is the sole director and shareholder). The partnership carries on its business in premises owned by the partners.

Tracey (Nathan's spouse) owns a vacant block of land that adjoins the land on which the partnership carries on its business. To provide more parking for its customers, the partnership leases the vacant land from Tracey. Because Nathan would be carrying on a business, the vacant land would, once it commences to be used by the partnership, be an active asset of Tracey (see ¶8-110 and ¶18-120).

If Nathan and Tracey were to divorce, the land owned by Tracey would cease to be an active asset, even if the partnership were to continue to use it. The active asset test may, however, be met when a CGT event happens in relation to the land, depending on the period of time when the land was an active asset.

If Tracey were to die, the land would, of course, cease to be an active asset. In this kind of case, the CGT event within two years of death rule may apply (see ¶19-105) or, failing that, the ordinary CGT small business relief rules may be met (depending on the facts) (see ¶19-115).

Case study 10

(adapted from explanatory memorandum to the Tax Laws Amendment (2009 Measures No. 2) Bill 2009)

John owns business premises. He rents 80% of the floor area to an affiliate (Peter) and uses the remaining 20% in his business. John earns 80% of the revenue derived from owning the premises from renting them to Peter.

Peter uses 60% of the floor area of that part of the premises rented to him in his business and rents the remaining 40% to an entity that is neither John's affiliate nor connected with John. Peter earns 40% of the revenue he derives from the premises from his on-renting to the third party.

Peter's use of the part of the premises rented to him will be treated as John's use (see ¶8-135). This means that John is treated as renting 40% of that part of the premises to an entity that is neither his affiliate nor is connected with him, and as using 60% in his (ie John's) business.

The main use of the premises by John is not to derive rent, because 32% (80% × 40%) of the premises is treated as being used to derive rent, and the remaining 68% is either actually used by John in his business (20%) or is treated as being used by him in a business he carries on (48%). Therefore, the premises are an active asset of John while these facts continue. (The premises would still have to satisfy the active asset test over the period that John owns them.)

Case study 11

(adapted from explanatory memorandum to the Tax Laws Amendment (2009 Measures No. 2) Bill 2009)

Neil owns a factory and rents 60% of the floor area to an affiliate (Andrea). Neil uses 15% of the floor area in his business and the remaining 25% for his own personal use.

Any personal use of an asset by the owner or an affiliate of the owner is ignored when determining the main use of an asset (see ¶8-135). This means that the proportions of 60% and 15% have to be adjusted so that they add up to 100% of the use of the factory. This adjustment is made by multiplying the 60% and 15% each by 100/75, as this factor adjusts the two percentages so that they add up to 100%, but maintains their current proportionality to each other, which is 4:1.

Following the adjustments, Neil rents 80% (60% × 100/75) of the non-personal use floor area of the factory to Andrea and uses 20% (15% × 100/75) of the non-personal use floor area in his business. Neil earns 80% of the revenue derived from owning the factory from renting it to Andrea.

Andrea uses 50% of that part of the factory rented to her in her business and rents the remaining 50% to an entity that is neither Neil's affiliate nor connected with him. Andrea earns 50% of the revenue she derives from the factory from her on-renting to the third party.

Andrea's use of that part of the factory rented to her is treated as Neil's use. Therefore, Neil is treated as renting 50% of that part of the factory to an entity that is neither his affiliate nor is connected with him, and as using 50% in a business he carries on.

The main use of the factory is not to derive rent. This is because 40% (80% × 50%) of Neil's factory is treated as being used to derive rent; and the remaining 60% is either actually used in Neil's business (20%) or is treated as being used in a business by Neil (40%).

Therefore, Neil's factory is an active asset in these circumstances while these facts continue.

Chapter 9

Affiliates

¶9-100 Context

Whether a person is an affiliate of another entity can be relevant for a number of reasons:

- to determine whether the other entity controls (and is, therefore, connected with) a company, trust or partnership (see ¶10-120);
- to determine what entities are relevant for the purpose of applying the maximum net asset value test to the other entity (see ¶6-105);
- to determine what entities are relevant when calculating the aggregated turnover of the other entity, and whether the other entity is a small business entity (see ¶7-135);
- to determine whether a CGT asset is an active asset (see ¶8-110); and
- to determine whether a personal use asset of an individual is excluded when applying the maximum net asset value test (see ¶6-120).

The present definition of "affiliate" (see ¶9-110) was enacted by the *Tax Laws Amendment (Small Business) Act 2007*. The definition forms part of the provisions that define the concept of a small business entity, and its relevance to those provisions is for the purpose of applying the rules that govern which entities are grouped with an entity to calculate that entity's aggregated turnover. These rules include provisions for determining when one entity is connected with another entity.

Subject to an important qualification, the definition of affiliate in the small business entity provisions applies for the purposes of the CGT small business reliefs generally. The qualification arises where a CGT asset that is owned by one entity is used in (or is held ready for use in, or is inherently connected with) a business carried on by another entity that is not otherwise an affiliate of, or connected with, the entity that owns the asset. In that situation, an individual's spouse or child under 18 years of age is taken to be the individual's affiliate for the purpose of determining whether the other entity is an affiliate of, or is connected with, the entity that owns the asset. This affiliate rule is referred to in this handbook as the special spouse/child under 18 affiliate rule. The rule is discussed fully at ¶9-135.

¶9-110 Definition of affiliate

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

It is provided that an individual or a company is not "your" affiliate merely because of the nature of the business relationship that "you" and the individual or company share.[2] See further ¶9-145.

If an individual or a company acts, or could reasonably be expected to act, in accordance with the directions or wishes of an entity (U), or in concert with U, in relation to the affairs of the business of

1 S 328-130(1) ITAA97. This definition was enacted by the *Tax Laws Amendment (Small Business) Act 2007* and first applied for the 2007-08 income year.

2 S 328-130(2) ITAA97.

the individual or company, this would mean that the individual or company would be the affiliate of U. However, it would not mean that U would be the affiliate of the individual or company.

The definition of "affiliate" is not expressed in terms that can be easily applied in some circumstances and, it is suggested, this is unsatisfactory. Some implications and aspects of the definition are discussed in ¶9-115 to ¶9-125, ¶9-140 and ¶9-145.

Spouse or child under 18

An individual's spouse or child under 18 years of age is not, because of that fact, an affiliate of the individual by virtue of the above definition. There are, however, circumstances in which an individual's spouse or child under 18 years of age may be treated as the individual's affiliate for the purposes of the CGT small business reliefs. The relevant provisions are discussed fully at ¶9-135.

¶9-115 Trustee cannot be an affiliate

It clearly follows from the definition of affiliate (see ¶9-110) that only a company or an individual can be an affiliate of another entity.

The reference to "a company" in the definition is a reference to a company in its capacity as such, and would not extend to a company acting in the capacity of a trustee.[3] Similarly, the reference to an individual would not include an individual acting in the capacity of a trustee. As such, a trustee cannot be an affiliate of another entity.[4]

On the other hand, the reference to "yours" in the definition of affiliate could, subject to a contrary intention, include any entity as defined in s 960-100 ITAA97, including an individual, a company, a trust or a trustee.[5]

¶9-120 "The affairs of the business"

An individual or a company will only be an affiliate of another entity if the individual or company acts, or could reasonably be expected to act, in accordance with the entity's directions or wishes, or in concert with the entity, in relation to "the affairs of the business of the individual or company" (see ¶9-110).

It follows that an individual or a company can only be an affiliate of another entity if the individual or company is carrying on a business. Accordingly, if an individual or a company is not carrying on a business, the individual or company could not be an affiliate of another entity.

3 S 960-100 ITAA97; *Di Lorenzo Ceramics Pty Ltd v FCT* [2007] FCA 1006.

4 This is the position taken in the explanatory memorandum to the Tax Laws Amendment (Small Business) Bill 2007.

5 S 4-5 ITAA97.

The definition of affiliate forms part of Subdiv 328-C ITAA97, which defines the concept of a small business entity and the expressions relevant to that concept. For an entity to be a small business entity for an income year, it is a prerequisite that the entity carry on a business (or be winding up a business formerly carried on) in the income year. This suggests that the reference to "the business" in the definition of affiliate should take the same meaning as it has in the definition of small business entity. This is discussed at ¶7-115.

Example

The issued shares in Crackle Pty Ltd (which are all of one class) are beneficially held in equal numbers by Ralph, his spouse (Betty), and their adult son (Nigel). Ralph, Betty and Nigel do not carry on any business on their own account or as a partner.

If these are the only relevant facts, Ralph, Betty and Nigel cannot be an affiliate of either of the others. As no shareholder has a control percentage of 40% or more in Crackle Pty Ltd, Crackle Pty Ltd would not be connected with Ralph, Betty or Nigel.

If there were other relevant facts, Ralph and Betty could be treated as affiliates for the purposes of the CGT small business reliefs under the special spouse/child under 18 affiliate rule (see ¶9-135).

In the case of a partner in a general law partnership, each partner would be carrying on a business, so it would seem that if a partner is an individual or a company, the reference to "the business" in the definition of affiliate would be to the business carried on by the individual or company as a partner in the partnership (see ¶18-110).

"Affairs"

There is no statutory guidance as to what is meant by the expression "the affairs of the business" in the definition of affiliate (see ¶9-110).

The *Macquarie Dictionary* relevantly defines "affair" as:

> "1. Anything done or to be done; that which requires action or effort; business; concern: … 2. (pl) matters of interest or concern; particular doings or interests: …"

"Affairs" has been said to be a word of "very wide import".[6] It is suggested that the affairs of a business refers to the conduct and operations of the business in all its relevant aspects, including the making of managerial and operational decisions.

It will be noted that the expression is "the affairs of the business", and there is a question of whether the reference is to the affairs of the business generally, or whether the fact that the individual or company acts (or could reasonably be expected to act) in the way described in relation to only some aspects of the affairs of the business could be relevant for the purposes of determining affiliate status. It is submitted that the expression "the affairs of the business" does not refer to the whole of the affairs of the business

6 *Johns v Connor* (1992) 107 ALR 465.

and that, depending on the facts, some aspect of the affairs of the business could be relevant. Minor or insignificant matters would presumably not be relevant.

¶9-125 Acting in defined manner

For an individual or a company to be an affiliate of another entity, it must be the case that the individual or company acts (or could reasonably be expected to act) in accordance with the directions or wishes of the other entity or in concert with the other entity, in relation to the affairs of the business of the individual or company (see ¶9-110). This means that, if it could reasonably be expected that the individual or company would act in the way described in the definition, the individual or company will be an affiliate; the fact that no relevant directions or wishes are in fact communicated will be irrelevant.

It needs to be kept in mind that it is specifically provided (in s 328-130(2) ITAA97) that an individual or a company is not "your" affiliate merely because of the nature of the business relationship that you and the individual or company share. This provision is discussed at ¶9-145.

The explanatory memorandum to the relevant amending Bill[7] states:

> "2.36 The following factors may have a bearing on whether an individual or company is an affiliate of an entity to the extent that they show that two or more entities are acting in concert:
>
> - family or close personal relationships;
> - financial relationships or dependencies;
> - relationships created through links such as common directors, partners, or shareholders;
> - the degree to which the entities consult with each other on business matters; or
> - whether one of the entities is under a formal or informal obligation to purchase goods or services or conduct aspects of their business with the other entity.
>
> 2.37 None of these factors are determinative in their own right.
>
> …
>
> 2.40 Only an individual or company can be an affiliate of another entity. Entities (for tax purposes) such as trusts, partnerships, and superannuation funds are not capable of being affiliates of entities."

The ATO Guide states that whether a person acts, or could reasonably be expected to act, in accordance with the taxpayer's directions or wishes, or in concert with the taxpayer, is a question of fact that is dependent on all of the circumstances of the particular case. No single factor will necessarily be determinative. The ATO Guide goes on to indicate that relevant factors that may support a finding that a person acts, or could reasonably be expected to act, in accordance with the taxpayer's directions or wishes, or in concert with the taxpayer, include:

- the existence of a close family relationship between the parties;

7 The Tax Laws Amendment (Small Business) Bill 2007.

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

The ATO Guide also states that, generally, another business would not be acting in concert with "you" if they:

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

Franchisees are not necessarily affiliates of the franchisor simply because of the franchise arrangement. Whether the franchisee acts in concert with the franchisor in respect of their franchise business depends on, among other things, the nature of the franchise agreement between them (ATO Guide).

For an entity to act "in accordance with" the instructions or wishes of another entity, there must be a causal connection between the instruction or wish of the other entity and the act taken by the first entity.[8]

AAT decisions

Stephens

In *Stephens and FCT*,[9] a solicitor's family trust failed in its attempt to establish that an incorporated legal practice was its small business CGT affiliate for the purposes of the CGT small business reliefs.

The family trust was one of several family trusts that owned post-CGT premises that were leased to the legal practice, and the solicitor was one of the shareholders and directors of the company carrying on the legal practice. The premises were sold during the 2002-03 income year, and the trust claimed the CGT small business 50% reduction in respect of the capital gain made by it. On the facts of the case, to be an active asset, the trust's interest in the premises had to be used in a business of a connected entity.

The AAT (constituted by Member Fice) said that it was a question of fact as to whether, at the relevant time, the company, in the conduct of its legal practice, acted, or could be reasonably expected to act, in accordance with the directions or wishes of the trust. It was also important to observe that (former) s 152-25(1) ITAA97 was not limited to the conduct of the small business CGT affiliate in the use of the CGT asset. Rather, the section was couched in broad terms, and included the relationship between the

8 *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* [2011] NSWCA 109.

9 [2008] AATA 176.

parties in the conduct of the affiliate's business generally. The question was whether the solicitor and his wife were in a position to direct the activities of the company in the course of that firm conducting its business at the leased premises. That must involve more than merely directing the company's use of the premises.

The AAT referred to decisions in other legislative contexts on the meaning of acting in concert, including the following observations of Finkelstein J in *Papua New Guinea Dockyard Ltd v Adams and Ors*:[10]

> "These cases show that a person, A, will be acting in concert with another person, B, if A engages in conduct (act or omission) in consequence of an agreement or understanding between A and B and the conduct is in pursuance of an objective or purpose which is common to both. It is not as is sometimes suggested necessary to show that the common objective or purpose has some pejorative element [such as] to circumvent the letter, or perhaps even the spirit, of some other statutory obligation or requirement …"

Although there was ample evidence of the solicitor's role in the company, there was no direct evidence that the company acted, or could be reasonably expected to act, in accordance with the directions or wishes of, or in concert with, the trustee of the trust in respect of the conduct of its business. There was nothing obvious from the evidence that the solicitor was the controlling partner of the practice. Furthermore, the legal practice had undergone substantial changes since it was first formed, including the departure of partners, the sale of one property interest, and the appointment of new directors of the company who did not hold a property interest. There was also no evidence that disclosed that the trustee and the company acted in concert in respect of the business of the company, in the context in which that expression appeared in the former s 152-25(1) ITAA97.

Although this decision was concerned with the concept of a small business CGT affiliate, it has relevance to the (narrower) concept of an affiliate. The approach to the concept of acting in concert is of continuing relevance. Also, as pointed out at ¶9-115, a company may be an affiliate of a trust.

It needs to be noted that this decision concerned an income year before the income year in which the provision that excludes certain business relationships from giving rise to an affiliate relationship came into force. This provision is discussed at ¶9-145.

[2010] AATA 455

In a subsequent case, *The Taxpayer and FCT*,[11] the AAT (constituted by Deputy President Hack SC) rejected an argument that a director (called "the son director") who was one of three directors of the taxpayer company was a "small business affiliate" of the taxpayer company which carried on a hotel/motel business. In addition to his capacity as a director of the taxpayer company, the son director was also the duty manager who had primary responsibility for the day-to-day management of the hotel

10 (2005) 215 ALR 742.

11 [2010] AATA 455. This case went on appeal to the Full Federal Court but the court did not find it necessary to deal with this issue (*FCT v Byrne Hotels Qld Pty Ltd* [2011] FCAFC 127).

side of the business, while his parents (the other directors) concentrated their endeavours on the motel side. The Commissioner's submissions highlighted:

- the son director's close involvement in the day-to-day operations of the hotel as its duty manager;
- the fact that he was the taxpayer company's nominee for the purpose of liquor licensing laws;
- the fact that he was the guarantor of the company's liabilities under the *Gaming Machine Act 1991* (Qld); and
- the evidence of one of the other directors that the son director generally acted in accordance with that director's directions, made on behalf of the company, in the carrying on of the business of the taxpayer company.

The Commissioner submitted that these matters gave rise to the inference "that [the son director] could reasonably be expected to act and acted in pursuance of a common objective with that of the [taxpayer company], namely in the interests of the company in the proper and lawful pursuit of the hotel business". The AAT, in rejecting the Commissioner's submission, said:

> "I do not regard the submission as sound. The acts of the son director, that is the first three matters, are explicable on the basis of the son director's position as a director or as an employee (or both) of the applicant. That is to say, it was his conduct *qua* director of the applicant, not conduct of his in his own right or in his capacity as director of other entities. Moreover, there is no objective or purpose common to both, the object or purpose that underlies the conduct is that of the applicant. The son director's conduct is directed to that objective or purpose but it is not his objective or purpose. Were the matter to be tested in the way that the Commissioner suggests, every employee would be regarded as a small business CGT affiliate of the employer. What is required to satisfy the test of affiliate, and what is absent from the Commissioner's formulation, is demonstrated by the test of 'in concert with' described by Finkelstein J in *Papua New Guinea Dockyard Ltd v Adams* …" [See above for the relevant passage from the judgment of Finkelstein J.]

It needs to be noted that this decision concerned an income year before the income year in which the provision that excludes certain business relationships from giving rise to an affiliate relationship came into force. This provision is discussed at ¶9-145.

Gutteridge

Reference may also be made to the decision of the AAT in *Gutteridge and FCT*[12] which considered the operation of the trustee reasonable to expect to act control rule in s 328-125(3) ITAA97. That control rule is similar in its terms to the first part of the definition of affiliate.

¶9-135 The special spouse/child under 18 affiliate rule

There is a provision which, in certain circumstances, treats an individual's spouse or child under 18 years of age as being an affiliate of the individual when determining whether one entity is an affiliate of, or connected with, another entity.

This affiliate rule is referred to in this handbook as the special spouse/child under 18 affiliate rule.

12 [2013] AATA 947.

Circumstances in which the special rule applies

The circumstances in which the special spouse/child under 18 affiliate rule can apply are where one entity (entity 1) owns a CGT asset (whether tangible or intangible) that is used in (or is held ready for use in or is inherently connected with) a business that is carried on in an income year by another entity (entity 2), and entity 2 is not otherwise an affiliate of, or connected with, entity 1 under the normal affiliate (see ¶9-110) or connected entity (see ¶10-100) rules.[13]

The explanatory memorandum for the relevant amending Bill[14] points out that the application of the special spouse/child under 18 affiliate rule is not limited to situations where an entity that owns a CGT asset and does not operate a business provides that asset to another entity for use in its business (the standard passively held asset). The rule also applies where an entity that operates a business owns a CGT asset that it provides to another entity for use in that other entity's business.

How the special rule operates

Where the circumstances are such that the special spouse/child under 18 affiliate rule can apply, the rule applies to treat an individual's spouse or child under 18 years of age as being the individual's affiliate when determining whether entity 2 (which carries on the business) is an affiliate of, or is connected with, entity 1 (which owns the CGT asset used in the business).[15]

It is expressly provided "to avoid doubt" that the special rule applies:

- for the purposes of reducing or disregarding, under the CGT small business relief provisions, any capital gain from any CGT asset; but
- only while a spouse remains a spouse or a child remains a child who is under 18 years of age.[16]

A clear example of where the special spouse/child under 18 affiliate rule could treat an individual's spouse as being an affiliate of the individual is where the individual owns a CGT asset that is used in a business that is carried on by his or her spouse. It would seem that, if there were no further relevant facts, the individual would not be treated as being an affiliate of his or her spouse. The ATO Guide, however, appears to take a contrary view in that it states that the affiliate rule works both ways so that the individual is also taken to be an affiliate of their spouse or child. It is suggested that, as a general proposition, this contrary view is not correct.

There may, however, be circumstances where each spouse is treated as being an affiliate of the other by virtue of the operation of the special spouse/child under 18 affiliate rule. This would be so, it is suggested, where it is immaterial (for the purposes of determining a relevant connected entity or affiliate status) whether one spouse is treated as being an affiliate of the other or vice versa.

13 S 152-47(1) ITAA97.

14 The Tax Laws Amendment (2009 Measures No. 2) Bill 2009.

15 S 152-47(2) ITAA97.

16 S 152-47(4) ITAA97.

If the above views are correct, the following table illustrates the operation of the special spouse/child under 18 affiliate rule. In the table:

- A is an individual;
- B is A's spouse;
- A Pty Ltd is a company of which A is the sole owner of all of the issued shares;
- B Pty Ltd is a company of which B is the sole owner of all of the issued shares; and
- Z Pty Ltd is a company with one class of shares on issue which are owned equally by A and B.

It is assumed that, apart from the operation of the special spouse/child under 18 affiliate rule, A would not be an affiliate of B and B would not be an affiliate of A. It is also assumed that there are no other relevant facts.

Where the CGT asset is		The special spouse/child under 18 affiliate rule has these consequences:
Owned by:	**Used in a business carried on by:**	
A	B	B will be treated as being A's affiliate. A will not be treated as being B's affiliate.
A	B Pty Ltd	B will be treated as being A's affiliate, which means that: ■ A controls B Pty Ltd; ■ B Pty Ltd is connected with A; and ■ A is connected with B Pty Ltd. A will not be treated as being B's affiliate.
B Pty Ltd	A	B will be treated as being A's affiliate, which means that: ■ A controls B Pty Ltd; ■ A is connected with B Pty Ltd; and ■ B Pty Ltd is connected with A. A will not be treated as being B's affiliate.
A Pty Ltd	B Pty Ltd	A will be treated as being B's affiliate and B will be treated as being A's affiliate. Treating A as B's affiliate means that A Pty Ltd and B Pty Ltd are each controlled by B and are, therefore, connected with each other. Treating B as A's affiliate means that A Pty Ltd and B Pty Ltd are each controlled by A and are, therefore, connected with each other.
Z Pty Ltd	A	The special rule has no operation because A is connected with Z Pty Ltd under the ordinary connected entity rules.
A	Z Pty Ltd	The special rule has no operation because A is connected with Z Pty Ltd under the ordinary connected entity rules.

Example 1

Trevor owns a CGT asset that is used by Trumper Pty Ltd in the course of carrying on its business. The issued shares (which are all of one class) in Trumper Pty Ltd are owned by Trevor (30%), Joanne (Trevor's spouse) (30%), and Graham (who is unrelated to either Trevor or Joanne) (40%). Assuming that Joanne is not otherwise Trevor's affiliate, under the special spouse/child under 18 affiliate rule, Trumper Pty Ltd will be connected with Trevor because Joanne will be taken to be his affiliate, and this will mean that Trevor and Joanne (his affiliate) have between them a control percentage in Trumper Pty Ltd of 60%.

The fact that Trumper Pty Ltd is controlled by Trevor will mean that, in addition to Trumper Pty Ltd being connected with Trevor, Trevor will be connected with Trumper Pty Ltd. On the view expressed above, and assuming that there are no other relevant facts, Trevor will not be taken to be Joanne's affiliate.

Example 2

Peter controls the Septimus Discretionary Trust under the pattern of distributions control rule (see ¶10-170). Peter and his spouse (Anne) own all of the issued shares (which are all of one class) in Time Warp Pty Ltd, Peter owing 65% and Anne 35% of the shares. The Septimus Discretionary Trust owns land which it lets Time Warp Pty Ltd use for the purposes of carrying on its business.

The special spouse/child under 18 affiliate rule would not operate to treat Anne as being Peter's affiliate. This is because Peter controls both the Septimus Discretionary Trust and Time Warp Pty Ltd in his own right, and the trust and the company are, for that reason, connected entities.

Example 3

Patrick and his spouse (Priscilla) beneficially hold all of the issued shares in two companies, Maximus Pty Ltd and Augustus Pty Ltd. The issued shares in each company are all of one class and are owned as follows:

	Patrick	Priscilla
Maximus Pty Ltd	70%	30%
Augustus Pty Ltd	20%	80%

Maximus Pty Ltd leases business premises that it owns to Augustus Pty Ltd.

Augustus Pty Ltd will be connected with Maximus Pty Ltd if Priscilla is Patrick's affiliate, or if Patrick is Priscilla's affiliate. It would seem that, in such a case, the special spouse/child under 18 affiliate rule would apply to treat Priscilla as being Patrick's affiliate, and to treat Patrick as being Priscilla's affiliate. (Note that if either Peter or Priscilla is an affiliate of the other under the ordinary definition of affiliate (see ¶9-110), the special spouse/child under 18 affiliate rule would have no application.)

Example 4

Ben and his spouse (Beryl) are discretionary beneficiaries of the Blanketty Discretionary Trust, which owns several property investments. For the 2014-15 income year, Ben has a 30% control interest and Beryl a 20% control interest in the Blanketty Discretionary Trust under the pattern of distributions control rule (because of distributions made during the 2013-14 income year). Neither Ben nor Beryl control the Blanketty Discretionary Trust under the trustee reasonable to expect to act control rule.

One of the properties owned by the Blanketty Discretionary Trust is leased to Top Travel Pty Ltd. That company uses the property to carry on a travel agency business. The issued shares in Top Travel Pty Ltd (which are all of one class) are owned as to 50% by Ben and 50% by Beryl. It is necessary to determine whether Top Travel Pty Ltd is connected with the Blanketty Discretionary Trust for the 2014-15 income year.

On the facts given, if the control interests of Ben and Beryl in the Blanketty Discretionary Trust are aggregated, Ben and Beryl will each control the trust, which would mean that the trust and Top Travel Pty Ltd would be connected entities. It will be immaterial whether Beryl is taken to be Ben's affiliate for this purpose, or whether Ben is taken to be Beryl's affiliate for this purpose. Thus, it would seem that the effect of the special spouse/child under 18 affiliate rule would be that Beryl would be taken to be an affiliate of Ben, and Ben would be taken to be an affiliate of Beryl.

It follows, of course, that the Blanketty Discretionary Trust is connected with Top Travel Pty Ltd.

Example 5

Assume the same facts as in example 4 above, except that Ben has a controlling interest of 45% and Beryl a controlling interest of 20% in the Blanketty Discretionary Trust. The special spouse/child under 18 affiliate rule would not have any scope of operation because Top Travel Pty Ltd and the Blanketty Discretionary Trust would be connected entities by the operation of the ordinary connected entity rules.

Further consequences

Where the special spouse/child under 18 affiliate rule applies for the purposes of determining whether an entity is taken to be an affiliate of, or connected with, another entity, the spouse or child under 18 years of age is also taken to be an affiliate of the individual for the purposes of the CGT small business relief provisions generally, and also for the purposes of the small business entity provisions as they operate in relation to the CGT small business relief provisions.[17] For the small business entity implications, see ¶7-135.

"Spouse" and "child"

"Spouse" (for the purposes of the special spouse/child under 18 affiliate rule) takes its ordinary meaning (that is, a person who at the time is legally married to another person, even if they are living separately and apart), but is extended by definition.[18]

17 S 152-47(3) ITAA97.

18 S 995-1 ITAA97.

The current definition of spouse (which has applied from and including the 2009-10 income year) includes:

(1) another individual (whether of the same sex or of a different sex) with whom the individual is in a relationship that is recognised under a State or Territory law prescribed for the purposes of s 22B of the *Acts Interpretation Act 1901* as a kind of relationship prescribed for the purposes of that section; and

(2) another individual who, although not legally married to the individual, lives with the individual on a genuine domestic basis in a relationship as a couple.[19]

For the 2009-10 and later income years (and without limiting who is a child of an individual), a child of an individual is defined as:

(1) the individual's adopted child (as defined), stepchild or ex-nuptial child;

(2) a child of the individual's spouse;

(3) someone who is a child of the individual within the meaning of the *Family Law Act 1975*.[20]

Some consequences of the rule

It is important to keep in mind that the operation of the special spouse/child under 18 affiliate rule can have a number of practical consequences for the purposes of the application of the CGT small business reliefs, including the following:

(1) the circumstances in which an asset may be an active asset are potentially extended;

(2) the entities that may be taken into account when applying the maximum net asset value test are also potentially extended;[21]

(3) even though an asset owner is not carrying on a business, the CGT small business reliefs may be able to be accessed by the asset owner where the entity that uses the asset in its business is an affiliate of, or is connected with, the asset owner and is a small business entity for the income year in which the CGT event happens (see ¶4-105);

(4) where a CGT asset is owned by an entity that does not carry on a business on his, her or its own account and eligibility for the CGT small business reliefs depends on another entity or a partnership being a small business entity, any entity that is an affiliate of, or is connected with, the entity that owns the asset is treated as being an affiliate of, or connected with, the other entity or the partnership for the purposes of calculating the aggregated turnover of the other entity or the partnership (see ¶7-135); and

(5) the operation of some of the exclusions from the maximum net asset value test (see ¶6-120) may possibly be extended.

19 S 995-1 ITAA97.

20 S 995-1 ITAA97.

21 However, the excluding rule for the purposes of applying the maximum net asset value test in s 152-30(3) and (4) ITAA97 must be kept in mind (see ¶6-135).

Scope of the special spouse/child under 18 affiliate rule

There are several important aspects of the special spouse/child under 18 affiliate rule that need to be noted.

Affiliate status applies generally

The special spouse/child under 18 affiliate rule applies where the capital gain being tested for CGT small business relief is made from the happening of a CGT event in relation to a CGT asset owned by an entity that is used in (or is held ready for use in or is inherently connected with) a business carried on by another entity. However, the rule can potentially have a far wider scope of operation. This is best illustrated by an example.

Example

Sarah owns a factory building that is used by Opportunity Plus Pty Ltd in the carrying on of a business of manufacturing promotional products. The issued shares of Opportunity Plus Pty Ltd are of one class and are owned as to 50% by Angus (Sarah's spouse) and 50% by Max (who is unrelated to both Sarah and Angus).

Sarah and Angus each have an interest in Storytime Pty Ltd, which owns a children's bookstore. The issued shares of Storytime Pty Ltd are all of one class, and are owned by Sarah (20%), Angus (30%) and Nathan (who is unrelated to Sarah and Angus) (50%).

Storytime Pty Ltd is contemplating disposing of its present business premises (a post-CGT asset) and acquiring new premises. The disposal of the present premises will give rise to a substantial capital gain.

By virtue of the special spouse/child under 18 affiliate rule, Angus will be taken to be an affiliate of Sarah because of the use by Opportunity Plus Pty Ltd of the factory building that she owns. This would, it is suggested, mean that Angus will be taken to be an affiliate of Sarah when determining whether Sarah controls Storytime Pty Ltd, with the consequence that Sarah would control Storytime Pty Ltd (she would have a 50% control interest). It would follow that each of Sarah and Opportunity Plus Pty Ltd would be connected with Storytime Pty Ltd.

The example in the explanatory memorandum to the relevant amending Bill[22] and on which case studies 2 and 3 at ¶9-150 are based, assumes that the special spouse/child under 18 affiliate rule would have the result suggested in the above example.

Capital gain made by affiliate

The explanatory memorandum to the relevant amending Bill[23] states that the special spouse/child under 18 affiliate rule applies in relation to any capital gain from any CGT asset owned by an individual, an affiliate of the individual, or an entity connected with the individual. This view is based on the provision noted above (under the heading "How the special rule operates") which is to the effect that,

22 The Tax Laws Amendment (2009 Measures No. 2) Bill 2009.

23 The Tax Laws Amendment (2009 Measures No. 2) Bill 2009.

to avoid doubt, the rule applies for the purposes of reducing or disregarding (under the CGT small business reliefs) any capital gain from any CGT event. The same point is made in the ATO Guide.

It is not clear what the explanatory memorandum and the ATO Guide mean. If they are intended to mean that the fact that an individual is taken to be an affiliate of his or her spouse (by virtue of the operation of the special spouse/child under 18 affiliate rule) has the consequence that the spouse is also an affiliate of the individual, it is submitted that this is not correct (see above).

It is true, as demonstrated above, that there are circumstances in which each spouse may be an affiliate of the other as a result of the operation of the special spouse/child under 18 affiliate rule. However, if the only consequence of the application of the rule is to treat a spouse of an individual as the affiliate of the individual, it is difficult to see how the special rule would have any further consequences so far as that spouse is concerned.

Does the rule only have a beneficial operation?

Subject to one possible qualification, the special spouse/child under 18 affiliate rule could operate to prevent the CGT small business reliefs from applying where they otherwise could apply. This could be so where the special rule has the effect of including extra entities for the purposes of applying the maximum net asset value test and, as a consequence, the test is not met. The explanatory memorandum to the relevant amending Bill[24] expressly recognises this possibility, as do the transitional provisions in the amending Act.

The possible qualification arises out of the terms of s 152-47(4) ITAA97. That subsection (which states that it is "to avoid doubt") provides (in para (a)) that the special spouse/child under 18 affiliate rule applies:

> "(a) for the purposes of reducing or disregarding under this Division [152] any capital gain from any CGT asset".

It may be arguable that, where the effect of the operation of the special spouse/child under 18 affiliate rule would be to prevent a taxpayer from claiming the CGT small business reliefs, the special rule would not apply because the rule, if it were applied, would not be applied "for the purposes of reducing or disregarding" a capital gain. On this view, the operation of the special spouse/child under 18 affiliate rule could only operate in a beneficial manner. It is very unlikely that the Commissioner would accept an argument along these lines, and, indeed, the enactment of the transitional provisions would support the rejection of the argument.

¶9-140 Whether an affiliate is an affiliate for all purposes

If an individual or a company is an affiliate of another entity under the small business entity definition of affiliate set out at ¶9-110 (that is because of a business carried on by the individual or company and not because of the special spouse/child under 18 affiliate rule) the question arises as to whether this means

24 The Tax Laws Amendment (2009 Measures No. 2) Bill 2009.

that the individual or company is to be treated as an affiliate of the other entity for all purposes (including when determining whether a company, partnership or trust is connected with the other entity).

Example

Assume the same facts in relation to Crackle Pty Ltd as in the example at ¶9-120, except that Betty also carries on, as a sole trader, a retail fabric business. Ralph, however, finances Betty's business, and makes all of the more significant business decisions for her. In these circumstances, Betty is likely to be an affiliate of Ralph.

If Betty is an affiliate of Ralph, the issue is whether this would mean that Ralph would control and, therefore, be connected with Crackle Pty Ltd. It is submitted that this would be the case. It would not, however, mean that Betty would control Crackle Pty Ltd (because Ralph is not Betty's affiliate).

Unless (as suggested) affiliate status applies generally, it is difficult to see how an individual or a company could be an affiliate of another entity for the purposes of determining whether a company, trust or partnership is connected with the other entity. This appears to be the assumption in the explanatory memorandum to the relevant amending Bill.[25]

Where an individual's spouse or child under 18 years of age is taken to be an affiliate of the individual under the special spouse/child under 18 affiliate rule, the spouse or child is treated as the individual's affiliate for the purposes of the CGT small business reliefs generally, and also for the purpose of determining whether an entity is a small business entity (see ¶9-135).

¶9-145 Business relationships

It is expressly provided in the definition of affiliate (see ¶9-110) that an individual or a company is not "your" affiliate merely because of the nature of the business relationship that "you" and the individual or company share.[26]

An example in s 328-130(2) ITAA97 states that a partner in a partnership would not be an affiliate of another partner merely because the first partner acts, or could reasonably be expected to act, in accordance with the directions or wishes of the second partner, or in concert with the second partner, in relation to the affairs of the partnership.

The example goes on to state that directors of the same company and trustees of the same trust, or the company and a director of the company, would be in a similar position.

The business relationship provision had its genesis in an amendment made to the former definition of small business CGT affiliate by the *Tax Laws Amendment (2006 Measures No. 7) Act 2007* (which effectively applies to CGT events that happen in the 2006-07 income year). The amendment replaced

25 The Tax Laws Amendment (Small Business) Bill 2007.

26 S 328-130(2) ITAA97.

a more limited provision in the former definition to the effect that another partner in a partnership in which "you" are a partner is not "your" small business CGT affiliate only because the partner acts, or could reasonably be expected to act, in concert with "you" in relation to the affairs of the partnership.

The statutory example, insofar as it refers to partners in a partnership or a company and a director, is understandable (because each partner or the company would be carrying on a business), but it is not clear whether the references in the example to directors of a company and trustees of a trust have any practical relevance. As noted above, the business relationship provision was introduced into the former definition of small business CGT affiliate by the *Tax Laws Amendment (2006 Measures No. 7) Act 2007*, and the references in the statutory example to that definition to directors of a company and trustees of a trust did make sense (because the former definition of small business CGT affiliate did not require (for an entity to be a small business CGT affiliate) the entity to be carrying on a business).

On the other hand, the definition of affiliate in s 328-130 ITAA97 requires that, to be an affiliate of an entity, it must be able to be said that the individual or company acts, or could reasonably be expected to act, in accordance with the entity's directions or wishes, etc, in relation to the affairs of "the business" of the individual or company. This, it is submitted, would make it impossible (without more) for the relationship between the directors of a company or the trustees of a trust to be that of affiliates. Indeed, an entity in its capacity as a trustee cannot be an affiliate of another entity (see ¶9-115).

Note that the ATO view was that, even without the *Tax Laws Amendment (2006 Measures No. 7) Act 2007* amendment, the former definition of small business CGT affiliate did not include the relationship between the "controller" of an entity and the entity itself.[27]

¶9-150 Case studies

Case studies 2 and 3 are adapted from examples in the explanatory memorandum to the amending Bill that became the *Tax Laws Amendment (2009 Measures No. 2) Act 2009*, and illustrate the operation of the special spouse/child under 18 affiliate rule (see ¶9-135) that was introduced by that amending Act.

Case study 1

Roger carries on a business on his own account as a dentist in a house that he acquired in 1992 and converted for use solely as a dental surgery. Roger does not carry on any other business but beneficially holds 20% of the shares in Magnetic Pty Ltd, which carries on a business of manufacturing magnets. Muriel, Roger's spouse, also beneficially holds 20% of the shares in Magnetic Pty Ltd. The remaining 60% of the shares in Magnetic Pty Ltd are beneficially held in equal numbers by three persons who are unrelated to each other or to Roger or Muriel. All of the issued shares in Magnetic Pty Ltd are of one class.

Magnetic Pty Ltd carries on its business in premises that were acquired by Muriel in 1995 and are leased by her to the company on an arm's length basis (acting on independent advice). This is the only

27 TD 2006/79 (withdrawn).

rental property that Muriel owns, and she does not carry on any other business activity. Muriel does not take part in the management of the company.

The definition of affiliate is unlikely to permit Muriel to be an affiliate of Roger on the facts given. Roger, however, will be treated as an affiliate of Muriel under the special spouse/child under 18 affiliate rule.

From Muriel's perspective, the premises that she leases to Magnetic Pty Ltd will be an active asset because Magnetic Pty Ltd is connected with her. As noted, the special spouse/child under 18 affiliate rule will operate to make Roger an affiliate of Muriel, which means that she will have a control percentage in Magnetic Pty Ltd of 40%.[28]

It would seem that the special spouse/child under 18 affiliate rule will not operate on the facts to treat Muriel as being an affiliate of Roger (see ¶9-135). Accordingly, Muriel will only be an affiliate of Roger if Muriel acts, or could reasonably be expected to act, in accordance with Roger's directions or wishes, or in concert with Roger, in relation to the affairs of the business of Muriel. There would be a basic question of whether there is any business carried on by Muriel, as the mere leasing of a single property by an individual would not ordinarily amount to carrying on a business (see ¶7-115). In any event, even if Muriel could be regarded as carrying on a business, because she conducts the leasing arrangements acting on independent advice, it would be very unlikely that Muriel would be an affiliate of Roger.

Accordingly, Magnetic Pty Ltd and Roger would not be connected entities and, therefore, the net assets of Magnetic Pty Ltd would not be taken into account when applying the maximum net asset value test to Roger. This would be so even if Magnetic Pty Ltd was an affiliate of Roger.[29]

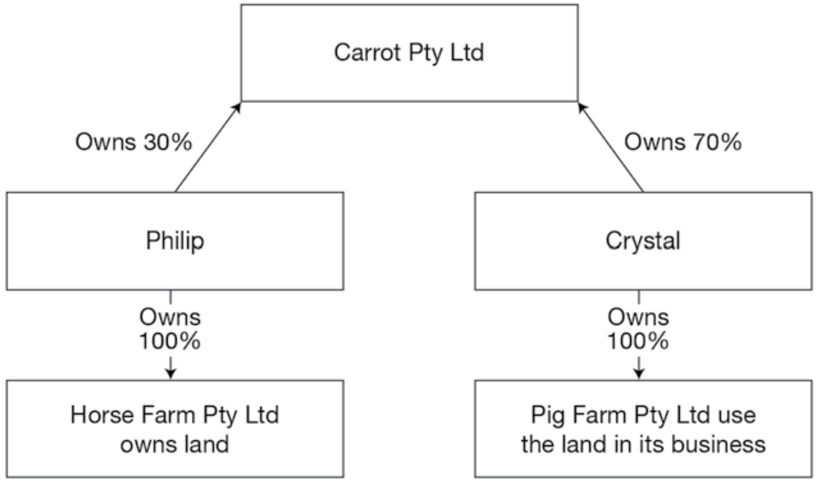
If Magnetic Pty Ltd is an affiliate of Roger, the annual turnover of Magnetic Pty Ltd would be taken into account when calculating Roger's aggregated turnover for the purposes of determining whether Roger is a small business entity (see ¶7-135).

Case study 2

Philip owns 100% of Horse Farm Pty Ltd, which owns land. Philip's spouse (Crystal) owns Pig Farm Pty Ltd, which uses the land in the course of carrying on a business. Philip owns 30% and Crystal 70% of Carrot Pty Ltd. It is assumed that Horse Farm Pty Ltd does not carry on a business.

28 S 328-125(2) ITAA97.

29 S 152-20(3) ITAA97; see ¶6-135.



Assuming Pig Farm Pty Ltd is not otherwise an affiliate of, or connected with, Horse Farm Pty Ltd, the special spouse/child under 18 affiliate rule would treat Crystal as Philip's affiliate when determining whether Pig Farm Pty Ltd (the entity that uses the land in its business) is connected with Horse Farm Pty Ltd (the entity that owns the land). Pig Farm Pty Ltd would be connected with Horse Farm Pty Ltd because Philip would control Horse Farm Pty Ltd, and because Philip and his affiliate (Crystal) would control Pig Farm Pty Ltd.

This would make the land that Horse Farm Pty Ltd owns an active asset. Horse Farm Pty Ltd could access the CGT small business reliefs if Pig Farm Pty Ltd's aggregated turnover is less than $2m (or if Horse Farm Pty Ltd meets the maximum net asset value test).

Because Crystal would be treated as Philip's affiliate when determining whether Pig Farm Pty Ltd is an affiliate of, or connected with, Horse Farm Pty Ltd, Crystal would also be treated as Philip's affiliate for testing whether Carrot Pty Ltd is connected with Horse Farm Pty Ltd. Carrot Pty Ltd would, therefore, be connected with Horse Farm Pty Ltd, because Philip would control Horse Farm Pty Ltd, and Philip and his affiliate, Crystal, would control Carrot Pty Ltd.

When seeking access to the CGT small business reliefs via the maximum net asset value test, Horse Farm Pty Ltd would need to include the net assets of Pig Farm Pty Ltd and of Carrot Pty Ltd.

When seeking access to the CGT small business reliefs via the small business entity test, Pig Farm Pty Ltd and Carrot Pty Ltd would be connected with Horse Farm Pty Ltd (and with each other) for the purposes of calculating Horse Farm Pty Ltd's aggregated turnover.

Case study 3

Assume the same facts as in case study 2, except that Horse Farm Pty Ltd carries on a business other than as a partner in a partnership.

Because the special spouse/child under 18 affiliate rule applies where an entity owns a CGT asset and carries on a business (other than as a partner in a partnership), Horse Farm Pty Ltd would be connected with Pig Farm Pty Ltd, and the land would be an active asset. Following the same reasoning as in case study 2, Carrot Pty Ltd would also be connected with Horse Farm Pty Ltd.

Depending on Horse Farm Pty Ltd's aggregated turnover, it may be able to access the CGT small business reliefs via the small business entity test. However, Horse Farm Pty Ltd would use the relevant small business entity provisions to test whether it is a small business entity. Alternatively, Horse Farm Pty Ltd could access the CGT small business reliefs if it satisfied the maximum net asset value test.

The explanatory memorandum states that the special spouse/child under 18 affiliate rule applies in relation to any capital gain from any CGT asset owned by the individual, an affiliate of the individual or an entity connected with the individual. As pointed out at ¶9-135, it is submitted that the rule does not operate in relation to a capital gain from a CGT asset owned by an affiliate of the individual. In this example, however, the rule would in fact operate to treat Philip as being an affiliate of Crystal. This means that if Crystal were to sell a CGT asset, the rule would treat Philip as Crystal's affiliate.

Case study 4

Amy leases a strata office unit to her spouse (Donald), which he uses in carrying on an accounting business.

Amy and Donald are the shareholders in Import Plus Pty Ltd, which carries on business as an import agent. The issued shares in this company are all of one class, and are beneficially held as to 20% by Amy and 80% by Donald.

Before the enactment of the special spouse/child under 18 affiliate rule (see ¶9-135), Amy would not control Import Plus Pty Ltd, but the office unit would qualify as an active asset because Donald would be treated as Amy's affiliate for the purposes of the definition of active asset. Because of the special spouse/child under 18 affiliate rule, Donald will be treated as Amy's affiliate generally and, so, she will control Import Plus Pty Ltd. The net value of its assets would be taken into account in determining whether Amy met the maximum net asset value test.

Chapter 10

Connected entities

¶10-100 Context

If an entity is connected with another entity, this has the following implications for CGT small business relief:

(1) when applying the maximum net asset value test (see ¶6-100) to one entity, the net value of the CGT assets of the other entity will be taken into account (unless the exclusion rule explained at ¶6-135 applies);

(2) when determining whether one entity is a small business entity for an income year, the annual turnover of the other entity will be taken into account when calculating the aggregated turnover of the first entity (see ¶7-100); and

(3) a CGT asset of one of the entities will be an active asset (see ¶8-100) if it is used (or held ready for use) by the other entity in the course of carrying on a business (unless the particular use precludes it from being an active asset (see ¶8-135)).

Connected entity status can be a two-edged sword – establishing connection and, therefore, active asset status for an asset will result in implications for the operation of the small business entity test (if the entities are connected at any time during the relevant income year) and for the maximum net asset value test (if the entities are connected just before the CGT event that triggers a capital gain).

Because it is no longer necessary, for the active asset test to be met, that an asset be an active asset just before the happening of the CGT event that triggers the capital gain that is being tested for CGT small business relief, it may in some cases be possible to sever connected entity status without jeopardising satisfaction of the active asset test by a CGT asset (see ¶8-145).

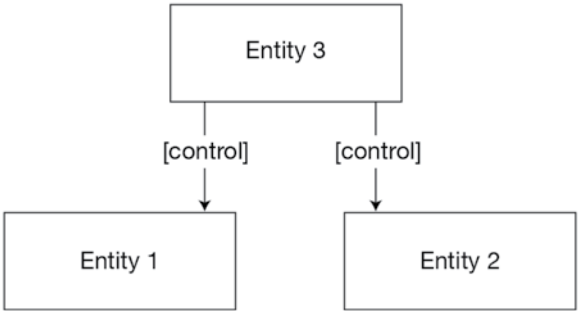
The basic connected entity rules that are relevant for the purposes of the CGT small business reliefs are contained in the small business entity provisions (s 328-125 ITAA97), supplemented by some modifications that are contained in the CGT small business relief provisions. These rules first applied in relation to CGT events that happened in the 2007-08 income year, but were amended in 2013 as noted in the text.

¶10-110 "Connected" depends on "control"

The basic rule is that an entity is connected with another entity if either entity "controls" the other, or both entities are "controlled" by a common third entity.[1]

1 S 328-125(1) ITAA97.

The following diagram illustrates this:



Each entity in the diagram is connected with the other two entities. For example, entity 1 is:

- connected with entity 3 because of the control of entity 1 by entity 3; and
- connected with entity 2 because both entity 1 and entity 2 are controlled by entity 3.

The ATO Guide gives the example of two individuals who conduct a professional practice in partnership. Each partner has a 50% interest in the partnership and therefore controls the partnership (see ¶10-140). Accordingly, the partnership is connected with each partner and the two partners are each connected with the partnership.

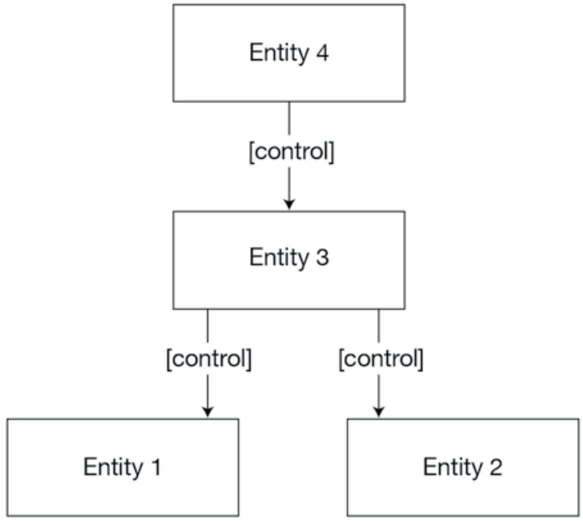
The fact that two entities (company X and company Y) are connected does not of itself mean that a third entity (R) that is connected with company X will be connected with company Y.

¶10-115 Indirect control rule

There is an indirect control rule to the effect that the "control" rules apply to an entity that directly controls a second entity as if it also controlled any other entity that is directly, or indirectly (by any other application or applications of the control rules), controlled by the second entity.[2]

2 S 328-125(7) ITAA97.

The indirect control rule may be illustrated by adding another tier to the diagram at ¶10-110, so that entity 3 is controlled by entity 4. The diagram would then be as follows:



The indirect control rule means that because entity 4 controls entity 3, entity 4 will be taken to also control both entity 1 and entity 2. Accordingly, each entity in this diagram is connected with each of the other three entities.

Example

Trainem Pty Ltd and Totem Pty Ltd carry on a business in partnership. The profits and losses are shared equally. Trainem Pty Ltd is the trustee of the Ballyhoo Discretionary Trust, and Totem Pty Ltd is not a trustee.

Totem Pty Ltd has only one class of shares on issue and these are beneficially held equally by David and Elvin.

For the 2014-15 income year, Linda (a beneficiary of the Ballyhoo Discretionary Trust) controls the trust under the pattern of distributions control rule (see ¶10-170).

Totem Pty Ltd controls the partnership under the right to distribution control rule (see ¶10-140). Because David and Elvin each control Totem Pty Ltd under either the right to distribution control rule or the voting power control rule (see ¶10-130), they would each control the partnership under the indirect control rule.

Even though Trainem Pty Ltd is acting as a trustee, it would control the partnership because it owns an interest in the partnership that carries the right to receive at least 40% of the net income of the partnership (see ¶10-140). That would mean that, because Linda controls the Ballyhoo Discretionary Trust, she would control the partnership.

No indirect control through certain public entities

There is a modification to the indirect control rule if an entity controls certain public entities as defined in s 328-125(8) ITAA97 (eg a listed company or a publicly traded unit trust). For the purposes of the CGT small business reliefs, the entity is not taken (by the indirect control rule) to control any entity that is controlled by the public entity.

¶10-120 Control by affiliates

Under the various control rules, an entity (entity 1) can control another entity (entity 2) because of:

- entity 1 satisfying the particular control rule;
- entity 1, in combination with one or more affiliates (see ¶9-100), satisfying the particular control rule; or
- one or more affiliates (see ¶9-100) of entity 1 satisfying the particular control rule.

However, if entity 1's control of entity 2 is "only because" of one or more affiliates, there are circumstances in which CGT assets of entity 2 are not taken into account when applying the maximum net asset value test to entity 1 (see ¶6-135).

It needs to be kept in mind that, while an individual's spouse or child under 18 years of age was formerly the individual's small business CGT affiliate merely by reason of the relationship (and, in the case of a child, his or her age), this has not been the case where a CGT event happens in the 2007-08 or a later income year. For a discussion of the circumstances in which an individual's spouse or child under 18 years of age may be treated as being the individual's affiliate when determining connected entity status for the purposes of the CGT small business relief provisions, see ¶9-135.

¶10-125 Relevant control rules

The various kinds of entity and the potentially relevant direct control rules are:

For this kind of entity:	the potential control rule(s) are:
Company	■ The right to distribution control rule (see ¶10-130). ■ The voting power control rule (see ¶10-130).
Non-discretionary trust	■ The right to distribution control rule (see ¶10-155).
Discretionary trust	■ The trustee reasonable to expect to act control rule (see ¶10-165). ■ The pattern of distributions control rule (see ¶10-170).
Partnership[3]	■ The right to distribution control rule (see ¶10-140).

3 A partnership may be a connected entity and a small business entity. For discussion of whether a partnership is an entity for the purposes of the CGT small business reliefs generally, see ¶18-110.

¶10-130 Control of company

There are two possible control rules that can apply to determine whether an entity directly controls a company. These may be called:

(1) the right to distribution control rule; and

(2) the voting power control rule.

The right to distribution control rule

Under the right to distribution control rule as it applies to a company, an entity (X) will control a company if X and/or X's affiliates own, or have the right to acquire the ownership of, interests in the company that carry between them the right to receive a percentage (the "control percentage") that is at least 40% of:

- any distribution of income by the company; or
- any distribution of capital by the company.[4]

For the definition of affiliate, see ¶9-110.

The right to distribution control rule can apply to determine control of any entity other than a discretionary trust, and this presumably explains why the word "interests" is used in the rule. In the case of a company with a share capital, interests in the company for this purpose would be represented by shares. (Note that the voting power control rule uses the defined term "equity interests".)

In certain circumstances, the Commissioner has a discretion to treat an entity with a control percentage in a company of at least 40% but less than 50% as not controlling the company (see ¶10-135).

Whether the right to distribution control rule is satisfied turns on the ownership of, or the right to acquire the ownership of, interests that carry the prescribed rights. It is not necessary (as it once was) that there be beneficial ownership of interests or the right to acquire beneficial ownership of interests. This change was made by the *Tax Laws Amendment (2013 Measures No. 1) Act 2013* and applies to CGT events that happen after 7.30 pm AEST on 10 May 2011.[5] Before the amendments, the better view, it is suggested, was that the right to distribution control rule could not be met where the interests in an entity were held on trust by the trustee of (say) a discretionary trust. The position could, however, have been otherwise where there was a bare trust.

It should be noted that, where an interest that would be relevant for the purposes of applying the right to distribution control rule or the voting power control rule is held by one entity on bare trust or as nominee for another entity, the other entity would satisfy the ownership requirement because the asset would be treated as being the other entity's and the bare trustee or nominee would be ignored

4 S 328-125(2)(a) ITAA97.

5 The *Tax Laws Amendment (2013 Measures No. 1) Act 2013* contains a provision to the effect that the amendments made to the right to distribution control rule do not affect by implication the interpretation of the ITAA97 before the amendments (Sch 1, Pt 2, s 10). Note also that amendments made by the *Tax Laws Amendment (2013 Measures No. 1) Act 2013* mean that, where an entity is absolutely entitled to an asset held on trust, the entity is to be treated as being the owner (s 106-50 ITAA97). The same is also broadly the case where an asset is vested in a trustee in bankruptcy or a liquidator or if security is provided over an asset (ss 106-30, 106-35 and 106-60 ITAA97).

(s 106-50 ITAA97). The right to distribution control rule can be satisfied either by reference to distributions of capital or by reference to distributions of income.

The fact that the issued shares of a company include shares on which discretionary dividends can be paid, or shares that carry preferential rights to dividends or distributions on a liquidation, will not necessarily mean that an entity cannot control the company under the right to distribution control rule. For example, an entity would control the company if the entity and/or the entity's affiliates own, or have the right to acquire the ownership of, at least 40% of the issued shares of each class. Depending on the particular share structure, however, an entity could control a company with different classes of shares by reference to shares of one or more (but not all) classes. The position will depend on the facts and is illustrated in case study 1 at ¶10-205.

The voting power control rule

An entity (Y) will control a company under the voting power control rule if Y and/or Y's affiliates own, or have the right to acquire the ownership of, equity interests in the company that carry between them the right to exercise, or control the exercise of, a percentage (the "control percentage") that is at least 40% of the voting power in the company.[6] For the definition of affiliate, see ¶9-110.

As with the right to distribution control rule, in certain circumstances the Commissioner has a discretion to treat an entity with a control percentage in a company of at least 40% but less than 50% as not controlling the company (see ¶10-135).

The voting power control rule was amended by the *Tax Laws Amendment (2013 Measures No. 1) Act 2013* in a similar way (and with similar application arrangements) to the amendments made by that amending Act to the right to distribution control rule discussed above.

Equity interests carrying right to exercise voting power

The voting power control rule fastens onto equity interests in the company that carry the right to exercise, or control the exercise of, the required percentage of the voting power in the company. An interest in a company is an equity interest if it is an equity interest for the purposes of the debt/equity rules.[7] Reference should be made to those rules, but, in the context of voting power, a relevant equity interest would usually be a share, and this is assumed to be the case in the following discussion.

In the case of voting power, it is possible that controlling voting power in a company may not be carried by any particular shares. This is illustrated by the decision of the High Court in *Kolotex Hosiery (Australia) Pty Ltd v FCT*.[8] In that case, under article 17 of the company's articles, a particular named individual had voting power that constituted a majority for the purposes of any ordinary or any special resolution. It was held that, although it was a condition to the exercise of the voting power conferred by

6 S 328-125(2)(b) ITAA97.

7 S 995-1; Subdiv 974-C ITAA97.

8 [1975] HCA 5.

article 17 that the particular individual hold a share in the company, the right conferred by article 17 was conferred in such a way that it was not attached to, or carried by, any share for the purposes of applying the continuity of beneficial ownership of shares test that then applied for the carry forward of company losses.

It is suggested that, on facts similar to those in the *Kolotex Hosiery* case, the particular individual would not control the company under the voting power control rule that applies for the purposes of the CGT small business reliefs. Nor, it is suggested, could any other shareholder control the company under the voting power control rule while the particular individual held a share in the company. This is because, even though other shares could carry the right to exercise at least 40% of the voting power in relation to an ordinary resolution, those other shares could not carry the right to exercise at least 40% of the voting power in respect of a special resolution. The reference in s 328-125(2)(b) ITAA97 to "at least 40% of the voting power" in the company would presumably refer to voting power at any kind of meeting.

Rights carried by shares relevant

If an entity owns shares or has a right to acquire the ownership of shares, the application of the right to distribution control rule to that entity (or an entity which is its affiliate) will turn on the rights carried by the shares as determined by reference to the terms of the company's constitution.[9] The position is similar in relation to the voting power control rule that refers to equity interests in the company that carry the requisite right or control; it would be immaterial whether or not it is possible to exercise the voting power. For example, if a company goes into liquidation, this does not affect the rights carried by the issued shares, but the capacity of the shareholder to exercise the rights carried by the shares may not be fully exercisable.[10]

Right to acquire

If an entity has the right to acquire the ownership of interests or equity interests in a company, these interests may be taken into account when determining whether the entity controls the company under the right to distribution control rule or the voting power control rule.

A right to acquire for this purpose would need to be an existing right that could be exercised immediately without restriction.[11] An example of such a right would be an unconditional call option over shares during the exercise period of the option. In these circumstances, it may be that there is a double counting of the particular shares for the purposes of determining whether a control rule is satisfied (subject to the Commissioner's discretion, explained at ¶10-135, to disregard control in some circumstances). A right of pre-emption in respect of shares would not constitute a right to acquire the shares.[12]

9 *FCT v Linter Textiles Pty Ltd (in liq)* [2005] HCA 20.

10 Ibid.

11 *WP Keighery Pty Ltd v FCT* [1957] HCA 2.

12 *Mackay v Wilson* (1947) 47 SR (NSW) 315.

¶10-135 Control percentage between 40% and 50%

If the control percentage of an entity (M) in another entity (Q) for the purposes of a control rule is at least 40% but less than 50%, the Commissioner may determine that M does not control the other entity (ie Q) if the Commissioner thinks that Q is controlled by an entity other than, or by entities that do not include, M or any of M's affiliates.[13] For the definition of affiliate, see ¶9-110 and ¶9-135.

This discretion can be exercised where the control percentage under any of the right to distribution control rule, the voting power control rule or the pattern of distributions control rule (that applies in relation to a discretionary trust) is within the tolerance of 40% to less than 50%. The discussion below considers the discretion, particularly in relation to the right to distribution control rule and the voting power control rule. For a discussion of the discretion in the context of the pattern of distributions control rule, see ¶10-175.

Official statements

The explanatory memorandum to the amending Bill which proposed the enactment of the discretionary disregarding of control power states:

> "2.59 Where an entity's interest in another entity is at least 40 per cent but *less* than 50 per cent the Commissioner may choose to ignore the interest of that entity in the other entity if the Commissioner determines that a third entity actually controls the other entity.
>
> 2.60 The Commissioner may think that another entity controls the entity either based on fact or on a reasonable assumption or inference. Whether or not the third entity has a 40 per cent interest may assist in determining whether the third entity controls the other entity, but it is not decisive.
>
> **Example**
>
> Chandra owns a restaurant with a turnover of less than $2 million and has inherited his father's 42 per cent interest in a software company. The other 58 per cent of the software company is owned by the manager of the company, and Chandra has had no dealings with the manager whatsoever. The turnover of Chandra's restaurant will not be aggregated with the turnover of the software company if the Commissioner thinks that the software company is actually controlled by the other person with the 58 per cent interest."

In a somewhat similar vein, the ATO Guide states:

> "If an entity's control percentage in another entity is at least 40% but less than 50%, the Commissioner may determine that the first entity does not control the other entity if he is satisfied that a third entity (not including any affiliates of the first entity) controls the other entity.
>
> Whether or not a third entity has a control percentage of at least 40% may assist in determining whether the third entity controls the other entity, but it is not decisive. For example, a third entity may control a discretionary trust because the trustee acts, or could reasonably be expected to act, in accordance with the directions or wishes of the third entity even if the third entity's

13 S 328-125(6) ITAA97.

control percentage is zero. In working out the third entity's control percentage, the interests of any affiliates of the third entity are taken into account.

Alternatively, it is possible that both of the entities with a control percentage of at least 40%, or both an entity with a control percentage of at least 40% and an entity that controls the other entity in another way, may control the other entity if responsibilities are shared.

Example

Lachlan owns 48% of the shares in Ayoubi Art Supplies. He plays no part in the day-to-day or strategic decision making of the business. Daniel owns 42% of the shares in the company. The remaining 10% of shares are beneficially owned by a third shareholder who does not take part in the management of the business. All shares carry the same voting rights and Daniel makes all day-to-day and strategic decisions for the company. Even though Lachlan owns 48% of the shares in Ayoubi Art Supplies, he would not be taken to control the company if the Commissioner was satisfied that the company is controlled by Daniel."

Two discretions

For the discretionary disregarding of control power to apply in a particular case, there are two separate discretionary evaluations that the Commissioner is required to make. First, he must "think" that the particular entity "is controlled" by some entity other than the entity whose less than 50% control percentage is to be potentially disregarded. Second, if he so thinks, the Commissioner "may determine" that the control of the entity with the less than 50% control percentage is to be disregarded.

It is submitted that these are distinct discretionary evaluations and, if the Commissioner were to approach the exercise of the disregarding of control power in any other way, this would involve an error of law.

Discretion can only have a negating effect

A fundamental and important point is that what the discretionary disregarding of control power confers on the Commissioner is confined to determining that an entity that would otherwise control another entity because of a control percentage in the range of 40% to less than 50% "does not control the other entity".

What the discretionary disregarding of control power does not do is to confer on the Commissioner the power to determine that, for the purposes of s 328-125 ITAA97, an entity (and, in particular, the entity that the Commissioner thinks controls), controls an entity; the fact that, for the purposes of applying the discretionary disregarding of control power, the Commissioner thinks an entity is controlled by another entity does not mean that the other entity "controls" the first entity within the meaning of s 328-125 ITAA97.

This means, for example, that, if the Commissioner were to determine that Entity K does not control Company V because Company V "is controlled" by Entity G, the exercise of the discretion would not of itself mean that Entity G would control Company V for the purposes of s 328-125 ITAA97.

"Is controlled"

The logical consequence of the above is that the expression "is controlled" in s 328-125(6) ITAA97 must refer to control in a manner provided for in s 328-125 ITAA97. The comments quoted above (from the explanatory memorandum and the ATO publication) that whether or not the third entity has a 40% interest "may assist" in determining whether the third entity controls may possibly suggest that the Commissioner could exercise the discretion even if the third entity did not have a control percentage of at least 40%. Such a suggestion, it is thought, is not correct.

Discretionary trust: nominated controllers

It seems to be clear that, where the trustee of a discretionary trust has nominated one or more beneficiaries as controllers for an income year in which the trust had a tax loss or a nil tax income, there would be no basis on which the Commissioner could exercise the discretion conferred by s 328-125(6) ITAA97 to disregard the statutory control which is conferred on the nominated beneficiaries.

Discretionary trust: distribution control rule

It is thought that the Commissioner's discretionary disregarding of control power may be particularly relevant where there is a direct control of a discretionary trust as a result of the application of the distribution control rule. As seen at ¶10-170, a 40% or more distribution to a beneficiary of a discretionary trust in year 1 will mean that the beneficiary (without any further distribution) will control the discretionary trust for years 2 to 5 (both inclusive). It is not difficult to imagine circumstances that would mean that it would be inappropriate for beneficiaries who received distributions in year 1 should not be taken to control the trust in (say) year 5.

Some further points

There will be circumstances in which the exercise by the Commissioner of the discretionary disregarding of control power conferred by s 328-125(6) ITAA97 in a particular way would be beneficial to a taxpayer (for example, for the purposes of applying the maximum net asset value test) or may be detrimental (for example, so as to preclude a CGT asset from being an active asset). This raises the possibility that there may be an argument that the exercise of the discretion is dependent on the result being favourable to the taxpayer. Otherwise there would be great uncertainty which, of course, is to be avoided if at all possible.

As a final point, it may be arguable that the Commissioner could in fact exercise the discretion differently when applying the CGT provisions to different taxpayers involved in the one transaction. On its face, this proposition appears to be of somewhat doubtful validity.

Indirect control

The discretion conferred on the Commissioner by s 328-125(6) ITAA97 to disregard an entity as controlling another entity could not be exercised to disregard the control that an entity has in respect of another entity because of the indirect control rule (see ¶10-115). This is because an entity that has control by virtue of the indirect control rule does not have a "control percentage" in the other entity.

Of course, if the Commissioner, in the exercise of the discretion, disregarded the direct control of an entity in another entity, no entity could have indirect control of the other entity through the entity that would otherwise have had direct control.

Overriding discretion

Even if the Commissioner thinks that there is control by another entity or other entities, this will not mean that the entity that would otherwise be a controller is not to be taken to control. This is because the Commissioner has an overriding discretion; that is, he "may" determine that the entity does not control if he thinks that there is control by another relevant entity or relevant entities. The word "may" is usually permissive.[14]

It is submitted that s 328-125(6) ITAA97 is not one of those provisions in which there are relevant conditions precedent to the exercise of a discretion, which would mean that, once those conditions were met, the Commissioner would be obliged to exercise the discretion.[15] Rather, the discretion is analogous to the kind of discretion considered in *Corlette v Mackenzie*.[16]

No application for exercise of discretion needed

The exercise by the Commissioner of the discretion to disregard the right to distribution control rule, the voting power control rule or the pattern of distributions control rule where the control percentage is 40% or more but less than 50% is not subject to any application being made for the exercise of the discretion by any entity and, *prima facie*, the Commissioner could exercise the discretion on his own initiative.[17]

Review of exercise of discretion

The exercise by the Commissioner of, or his refusal to exercise, the discretion under consideration (like the exercise of other discretions conferred by the ITAA36 or ITAA97) could be reviewed on its merits by the AAT. However, the jurisdiction of the Federal Court to intervene in relation to the Commissioner's (or AAT's) exercise, or refusal to exercise, the discretion would be limited to the grounds set out by Dixon J in *Avon Downs Pty Ltd v FCT*.[18]

There have been many cases in which the Commissioner's exercise of a discretion has been challenged on appeal to a court, and reference may be made, for example, to *FCT v Brian Hatch Timber Co (Sales) Pty Ltd*[19] and *Kolotex Hosiery (Australia) Pty Ltd v FCT*.[20]

14 S 33(2A) of the *Acts Interpretation Act 1901*.

15 *Finance Facilities Pty Ltd v FCT* [1971] HCA 12; cf *Cummins v FCT* [2007] FCAFC 21.

16 95 ATC 4578.

17 Cf *FCT v Linter Textiles Australia Ltd (in liq)* [2005] HCA 20.

18 [1949] HCA 26.

19 [1972] HCA 73.

20 [1975] HCA 5.

Potential effect on active asset status

If an entity's 40% control percentage in another entity is being relied on to make an asset used in the other entity's business an active asset (see ¶8-110), and there are grounds on which the Commissioner could exercise the discretion conferred by s 328-125(6) ITAA97, the asset would lose its active asset status for any period of time that the Commissioner exercised the discretion.

¶10-140 Control of partnership

The only direct control rule relevant to the control of a partnership for CGT small business relief purposes is the right to distribution control rule. For a discussion of the concept of "entity" as it applies to a partnership in the context of the CGT small business reliefs, see ¶18-110.

Under the right to distribution control rule, an entity (Y) controls another entity (A) if Y and/or Y's affiliates own, or have the right to acquire the ownership of, interests in A that carry between them the right to receive a percentage (the "control percentage") that is at least 40% of:

(1) any distribution of income by A;

(2) if A is a partnership – the net income of the partnership; or

(3) any distribution of capital by A.[21]

It will be noted that there is a specific circumstance in which an entity will control a partnership (see (2) above). It seems from the explanatory memorandum to the amending Bill that became the *Tax Laws Amendment (Small Business) Act 2007*, that it is intended that (1) and (3) above also apply to a partnership. The explanatory memorandum states that, if an entity is a partner in a partnership, the entity's interest in the partnership is a type of interest that gives the partner the right to receive a distribution of income or capital by the partnership (see (1) and (3) above). See further ¶18-110.

For the definition of affiliate, see ¶9-110, and for further discussion of the right to distribution control rule, see ¶10-130.

In certain circumstances, the Commissioner has a discretion to treat an entity with a control percentage in another entity of at least 40% but less than 50% as not controlling the other entity. This discretion is considered at ¶10-135 in the context of the rules that apply to determine whether an entity controls a company. In the case of a partnership, if there is a managing partner, or managing partners, there may be circumstances in which the Commissioner's exercise of this discretion would be a distinct possibility.

The expression "net income" of the partnership used in (2) above is not asterisked. There is, however, a definition of net income in the Dictionary (s 995-1 ITAA97) which, in the case of a partnership, defines the expression by reference to the definition of "net income" in the partnership provisions of the ITAA36 (see s 90 ITAA36). Unless there is a contrary context, that will be the definition relevant for the purposes of (2) above.

21 S 328-125(2)(a) ITAA97.

Particular issues that the CGT small business reliefs raise in the context of a partnership, the assets of a partnership and the partners in a partnership are considered in chapter 18 (see ¶18-100).

¶10-145 Control of trust

The CGT small business relief control rules draw a distinction between two kinds of trust:

- discretionary trusts; and
- other trusts.

If the trust is a discretionary trust, there are at present two potential direct control rules (see ¶10-160). However, if the trust is not a discretionary trust, the only direct control rule that is relevant is the right to distribution control rule (see ¶10-155).

¶10-150 What is a discretionary trust?

The legislation gives no direct guidance as to what the term "discretionary trust" means in the context of the connected entity control rules.

Clearly, of course, a trust of a kind that has come to be commonly known as a discretionary trust would be a discretionary trust for the purposes of these control rules. However, there are other kinds of trusts that, although structured differently to a conventional discretionary trust, in the ultimate analysis, bear some fundamental resemblance to a conventional discretionary trust. Into this category fall hybrid unit trusts, under which income or capital and, possibly, both can effectively be distributed among unit holders on a discretionary basis or, in the case of income and depending on the terms of the trust deed, accumulated.

In *Australian Securities and Investments Commission; In the matter of Richstar Enterprises Pty Ltd v Carey (No. 6)*,[22] French J (as he then was) said:

> "The term 'discretionary trust' has been said in the High Court to bear a meaning 'disclosed by a consideration of usage rather than doctrine' and to be used in a way that is 'descriptive rather than normative'. It has 'no fixed meaning and is used to describe particular features of certain express trusts' – *Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226 at [8]. In *FCT v Vegners* (1989) 90 ALR 547 at 552, Gummow J said that the expression 'discretionary trust' is used to identify a species of express trusts in which, unlike a fixed trust, the entitlement of the beneficiaries to income, or to corpus, or both, is not immediately ascertainable (at 552):
>
> '… the beneficiaries are selected from a nominated class by the trustee or some other person and this power may be exercisable once or from time to time'."

Hybrid unit trusts of the kind referred to above have features that fall within the above statement, as the entitlement of the beneficiaries (unitholders) to income, or to corpus, or both, will not be immediately ascertainable. However, hybrid unit trusts also bear a similarity to companies with dividend access

22 [2006] FCA 814. See also *Kennan v Spry* [2008] HCA 56 and *Cypjayne Pty Ltd v Sverre Rodskog* [2009] NSWSC 301.

shares on issue. A dividend access share is a CGT asset in its own right, and a unit in a hybrid unit trust is also a CGT asset in its own right.

A significant point is that if the expression "discretionary trust" is intended to only cover trusts that are discretionary trusts in the conventional sense (ie not including hybrid unit trusts), it would not have been necessary to expressly exclude a "discretionary trust" from the right to distribution control rule.

Under the CGT small business relief direct control rules that apply in the case of a trust, a trust is either a discretionary trust or not a discretionary trust. This is because, if the trust is a discretionary trust, the right to distribution control rule (see ¶10-155) simply does not apply; it is the trustee reasonable to expect to act control rule and/or the pattern of distributions control rule (see ¶10-160) that are relevant.

It is of interest to refer to the trust considered by the Full Federal Court in *Forrest v FCT*.[23] Under the deed which established that trust, the beneficial interest from time to time in the fund was divided into the unit component, held on trust for the unitholders from time to time, and the discretionary component, held on the terms of a typical discretionary trust for the discretionary beneficiaries. It was provided that:

- "income" meant income produced from the investment, management or realisation of the fund (or any part of the fund) and included any accretion, gain (whether or not realised), payment or receipt determined by the trustee to be income;
- "discretionary component" meant all income which represented realised and unrealised capital gains derived from the holding or realisation of any investment;
- "fixed income" meant such of all income other than income comprising the discretionary component; and
- "unit component" meant (so far as is relevant) any and all fixed income.

Each unit conferred an equal interest in the unit component.

The trust was, therefore, essentially a fixed trust with regard to income (held for the unitholders pro rata) and a non-fixed trust with regard to capital (held for the discretionary beneficiaries). Accordingly, the trust could meet the right to distribution control rule if it were looked at solely from the unitholders' perspective but not if regard were had to the beneficiaries for whom the capital (other than the subscription price of the units) was held. As pointed out, a trust must be either a discretionary trust or not a discretionary trust for the purposes of the connected entity rules, and it would seem to follow that a trust of the kind considered in the *Forrest* case should be regarded as a discretionary trust for the purposes of the connected entity rules. The practical consequence of this would be that a unitholder could only control the trust if distributions of income were paid or applied which would occur if income were derived because of the fixed nature of the units. If there were no income for an income year, the provisions discussed at ¶10-185 may also be relevant.

23 [2010] FCAFC 6.

¶10-155 Non-discretionary trusts

In the case of a trust that is not a discretionary trust (see ¶10-150), the only relevant direct control rule is the right to distribution control rule. Under that rule, when applied to a trust, an entity (Z) controls a trust if Z and/or Z's affiliates own, or have the right to acquire the ownership of, interests in the trust that carry between them the right to receive a percentage (the "control percentage") that is at least 40% of:

(1) any distribution of income by the trust; or

(2) any distribution of capital by the trust.[24]

It may be noted that the right to distribution control rule was amended by the *Tax Laws Amendment (2013 Measures No. 1) Act 2013* to make it operate by reference to "ownership" rather than "beneficial ownership" (see ¶10-130).

For the definition of affiliate, see ¶9-110 and ¶9-135. For a discussion of what is meant by the right to acquire the ownership of interests, see ¶10-130.

It is explained at ¶10-130 that the right to distribution control rule in s 328-125(2)(a) ITAA97 (which applies to CGT events that happen in the 2007-08 or a later income year) is drafted somewhat differently to the former right to distribution control rule. Under the present right to distribution control rule it is clear, for example, in the case of a fixed trust (typically, a unit trust with no discretionary elements as to income or capital) that if there are two classes of units on issue (one class carrying the right to distributions of income and the other class carrying the right to distributions of capital), an entity may control the trust by reference to one class of units. This is illustrated in case study 4 at ¶10-205.

It is thought that the decision of the High Court in *CPT Custodian Pty Ltd v CSR* (*Vic*)[25] would not mean that the right to distribution control rule could not apply to, say, a fixed unit trust. The right to distribution control rule (in its application to a trust) refers to entitlements to receive distributions of income or capital by the trust, which would refer to distributions to beneficiaries and would not include the entitlement of a trustee to be indemnified out of the trust fund. See also *Cajkusic v FCT*.[26]

The Commissioner's view is that two unadministered deceased estates with the same executor and common beneficiaries are not connected entities.[27] Neither the executor nor any beneficiary of an unadministered deceased estate owns, or has the right to acquire ownership of, interests in the unadministered estate which carry rights to receive any distributions of income or capital. Accordingly, on the Commissioner's view, there is no entity that controls an unadministered deceased estate under the right to distribution control rule. It should be noted that, in a case such as that considered in the interpretative decision, the executor in his/her capacity as executor of one of the deceased estates would control the partnership and, so, the whole of the partnership assets and liabilities would be taken into

24 S 328-125(2)(a) ITAA97.

25 [2005] HCA 53.

26 [2006] FCAFC 164.

27 ID 2010/106.

account when determining whether the estate of that deceased satisfied the maximum net asset value test.[28]

In certain circumstances, the Commissioner has a discretion to treat an entity with a control percentage in a trust of at least 40% but less than 50% as not controlling the trust. This discretion is considered at ¶10-135 in the context of the control of a company.

¶10-160 Discretionary trusts

In the case of a discretionary trust (see ¶10-150), there are two potential direct control rules that apply. These control rules may be called:

(1) the trustee reasonable to expect to act control rule (see ¶10-165); and

(2) the pattern of distributions control rule (see ¶10-170).

¶10-165 The trustee reasonable to expect to act control rule

An entity (R) controls a discretionary trust (see ¶10-150) under the trustee reasonable to expect to act control rule if a trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of R and/or R's affiliates.[29] This is one of the two direct control rules that may determine whether an entity directly controls a discretionary trust. The other direct control rule is the pattern of distribution's control rule, which is considered at ¶10-170.

The trustee reasonable to expect to act control rule in its terms bears some resemblance to the definition of "affiliate" (see ¶9-110). However, there are differences. For example, unlike the definition of affiliate, the trustee reasonable to expect to act control rule does not, in its terms, limit the matters in respect of which the trustee acts or could reasonably be expected to act. It is thought, however, that the matters would be confined to matters relating to the operation and administration of the trust or matters incidental thereto.

Another difference between the reasonable to expect to act control rule and the definition of affiliate is that, unlike the definition of affiliate, there is no express exclusion relating to business relationships. This opens up the possibility, for example, that if a company that is a trustee of a discretionary trust has a sole director/shareholder, the director/shareholder could control the trust under the trustee reasonable to expect to act control rule. The ATO expressed the view in the NTLG Losses & CGT Subcommittee minutes of the meeting of 11 November 2009 that the sole director/shareholder would control the trust.[30]

28 *Commissioner of Stamp Duties (Qld) v Livingston* [1964] UKPC 2.

29 S 325-125(3) ITAA97.

30 There may be an argument that the director would act as the company and, therefore, decisions made by him or her would be made by the company (*Tesco Supermarkets Ltd v Nattrass* [1972] AC 153 per Lord Reid) and the director would be exercising the powers of the company (s 198E of the *Corporations Act* 2001).

The explanatory memorandum to the relevant amending Bill[31] states that whether a trustee might reasonably be expected to act in accordance with the directions or wishes of another is determined having regard to all of the circumstances of the case. For example, the mere presence in the trust deed of a requirement that the trustee should have no regard to particular directions or wishes would not prevent examination of the actual circumstances to determine whether an entity controls the trust.

Among the factors that might be considered, the explanatory memorandum lists the following:

- the way in which the trustee has acted in the past;
- the relationship between the entity and the trustee;
- the amount of any property or services transferred to the trust by the entity; and
- any arrangement or understanding between the entity and a person or persons who have benefited under the trust in the past.

As noted above, the trustee reasonable to expect to act control rule does not limit the particular matters or aspects of the trust's operations or the trustee's duties and powers that are relevant. This possibly indicates that the way the trustee acts, or could reasonably be expected to act, in relation to any aspect of the trust's operations or the exercise of any powers or discretions could be relevant. Aspects of the trust's operations and the trustee's duties and powers that could be relevant would presumably include the way the trustee exercises any discretion with regard to the distribution of income or capital of the trust, and the way the trustee exercises the powers and discretions that are relevant to the carrying on of the trust's business or other income-producing activities.

While the fact that the provisions of a discretionary trust deed preclude the trustee from having regard to the directions or wishes of an entity will not necessarily mean that the entity does not control the trust under the trustee reasonable to expect to act control rule (see above), there may well be provisions in the trust deed that indicate that a particular entity would "control" a trustee of the trust in the relevant sense.

In ID 2008/139, the Commissioner took the view that an appointor who has the power to remove a trustee of a discretionary trust and appoint a new trustee would control the discretionary trust under the trustee reasonable to expect to act control rule. The Commissioner withdrew ID 2008/139 in October 2014 and in the notice of withdrawal stated (correctly) that the ability of an appointor of a discretionary trust to remove a trustee and to appoint a trustee does not of itself mean that the appointor controls the trust under the trustee reasonable to expect to act control rule.

AAT decision

The operation of the trustee reasonable to expect to act control rule was considered by the AAT in *Gutteridge and FCT*.[32] In that case, the issue was whether the director (a Ms McKenzie) of a corporate trustee controlled the trust under the trustee reasonable to expect to act control rule. The AAT held that

31 The Tax Law Amendment (Small Business) Bill 2007.

32 [2013] AATA 947.

the director did not in fact control the trust under that rule. Rather, another individual (Mr Gutteridge, her father) did. The appointor (a Mr Coffey) was similarly under Mr Gutteridge's control and so did not control the trust. The tribunal said:

> "The circumstances of the present case call for conclusions that the Trust was not accustomed to act in accordance with Ms McKenzie's wishes independently of her father's wishes in circumstances where her wishes and directions were her father's. She was acting as the director of the trustee in circumstances where the trustee could be removed at the will of Mr Coffee [sic] and Mr Coffee [sic] regarded himself bound by the wishes and directions of Mr Gutteridge. Further, if it were necessary to find that Ms McKenzie was a puppet director, or that Mr Gutteridge was a shadow or de facto director, there is ample material on which to rest such a finding.
>
> The facts as found above require a finding that Mr Gutteridge alone was the person who controlled the Trust within the meaning of s 328-125(3) of the 1997 Assessment Act."

It may be noted that, in the course of its decision, the AAT, in discussing the operation of the trustee reasonable to expect to act rule, stated:

> "The controller test s 328-125(3) has parallels with the definition of *director* in the *Corporations Act 2001* (C'th). That text was effectively considered in *Buzzle Operations Pty Ltd (In Liq) v Apple Computer Australia Pty Ltd* [(2011) 81 NSWLR 47]. The following principles can be derived from the discussion of the scope of the words *accustomed to act in accordance with wishes limb* in that definition:
>
> (a) treating another person's instructions or wishes as a sufficient reason so to act, rather than making personal decisions where those wishes or instructions are merely a factor considered, meets the test of being accustomed so to act;
>
> (b) it is not necessary that the behaviour be universal, at least some decisions, one or more important decisions, would be enough, some or all decision making is the focus;
>
> (c) decisions made in pursuit of one's own business goals even, if consistent with the wishes of another party, do not necessarily render the decision maker accustomed to acting in accordance with the other party's wishes. The other party may have superior bargaining power;
>
> (d) while not significantly different, acting in accordance with a person's wishes covers a wider field than acting in accordance with a person's instructions; and
>
> (e) it is necessary to undertake a critical assessment of the way in which the trustee is managed.
>
> These principles can be applied in the present context as a reasonable expectation to act in the prescribed way can be formed if a person is accustomed to act in that way.
>
> The statutory test calls for an examination of all of the circumstances of a case. Formal occupation of offices, such as a director of a company that is a trustee, and documented terms of instruments, such as limitations on trustees' ability to have regard to an entity's wishes or directions, do not prevent an examination of the actual circumstances when addressing the question posed by s 328-125(3). If the actual circumstances are that a formal office holder does not control a trust, or that the terms of an instrument are not observed, the conclusion that the controller is found in the person occupying the office or the person identified by the terms

> of the instrument does not necessarily follow. As noted by Gordon J in a parallel context, it is necessary to undertake a critical assessment of the way in which the Trust is managed. This is an enquiry into activities and decision making, and the circumstances in which they occur, not an enquiry into occupation of offices or terms of instruments per se."

It is submitted that, on the facts disclosed, the decision of the AAT that Mr Coffey, the appointor, did not control the trust in the relevant sense is correct and that the decision that Mr Gutteridge did control the trust is also correct.

No argument appears to have been put to the AAT by the Commissioner that the reference in s 328-125(3) ITAA97 to a trustee acting in accordance with "the directions" of the first entity is in fact wide enough to cover the position where formal directions are given by (taking the facts of the *Gutteridge* case) the sole director of a corporate trustee, even if these directions are effectively dictated by another entity. The directions of the sole director could, it is suggested, fall within the words "a trustee of the trust acts … in accordance with the directions … of the first entity".

On this construction, in the context of the facts of the *Gutteridge* case, each of Ms McKenzie (because she, as the sole director of the trustee company, would in fact direct the company's acts by her formal decisions) and Mr Gutteridge (because of his de facto control over the decision-making of the trustee) could be regarded as controlling the trust.

In a decision impact statement on the AAT's decision in the *Gutteridge* case, the Commissioner stated that he accepted that the decision of the AAT was open to it in view of the findings of fact made by the tribunal. However, while the circumstances in the case allowed for a finding that a person could reasonably be expected to act in a certain way because they were "accustomed to act" in that way, the Commissioner does not accept that the "reasonable expectation" test could be substituted with an "accustomed to act" test in all cases. It depends, as the AAT said, on an examination of all of the circumstances of a case. For example, if there is no history at all of a trustee having acted on the directions of another, there may nonetheless be an expectation (reasonably founded) that they would act on the directions of a particular person, were such directions to be given.

A further point about the reasonable to expect to act control rule is that, if there is more than one trustee of a discretionary trust, an entity may control the trust under the rule by reference to one of the trustees.

¶10-170 The pattern of distributions control rule

An entity (M) will control a discretionary trust (see ¶10-150) under the pattern of distributions control rule for an income year if, for any of the four income years before that income year:

(1) the trustee paid to, or applied for the benefit of, M and/or any of M's affiliates (see ¶9-110), any of the income or capital of the trust; and

(2) the percentage (the "control percentage") of the income or capital paid or applied is at least 40% of the total amount of income or capital paid or applied by the trustee for that income year.[33]

33 S 328-125(4) ITAA97.

This is one of the two direct control rules that may determine whether an entity directly controls a discretionary trust. The other direct control rule is the trustee reasonable to expect to control rule, which is considered at ¶10-165.

There can be no control of a discretionary trust under the pattern of distributions control rule for the income year in which the trust is created, and control can only commence for the income year following the income year for which a relevant control percentage distribution is first made to (broadly) a beneficiary (and/or the beneficiary's affiliates). Control by the beneficiary (and each affiliate of the beneficiary) will then exist for a further three income years, even if there is no distribution to the beneficiary (and/or the beneficiary's affiliates) for those income years.

Under the pattern of distributions control rule, there is no requirement for the income or capital that is paid to, or applied for the benefit of, an entity to be for the entity's individual benefit, for example, it could be in the entity's capacity as the trustee of another trust.

Exempt entity or deductible gift recipient

An exempt entity or a deductible gift recipient cannot control a discretionary trust under the pattern of distributions control rule.[34] However, distributions of income or capital to exempt entities or to deductible gift recipients are taken into account when applying the pattern of distributions control rule as part of the total amount of income or capital paid or applied by the trustee for the income year.

¶10-175 Pattern of distributions: control percentage between 40% and 50%

If the control percentage of an entity (P) under the pattern of distributions control rule (see ¶10-170) is at least 40% but less than 50%, the Commissioner may determine that P does not control the discretionary trust if the Commissioner thinks that the discretionary trust is controlled by an entity other than, or by entities that do not include, P or any of P's affiliates.[35]

Neither the relevant explanatory memorandum nor the ATO Guide give any indication of the circumstances in which the Commissioner would envisage that the discretion could be exercised in the context of the pattern of distributions control rule.

Presumably, it is intended that the Commissioner could disregard a beneficiary who would otherwise control the discretionary trust under the pattern of distributions control rule, in favour of another entity that controlled the trust under the pattern of distributions control rule or in favour of an entity that controlled the trust under the trustee reasonable to expect to act control rule (see ¶10-165). However, because an entity that controls a discretionary trust under the trustee reasonable to expect to act control rule does not have a control percentage, the Commissioner could not disregard such an entity's control.

For further discussion of this discretionary power of the Commissioner, see ¶10-135.

34 S 328-125(5) ITAA97.

35 S 328-125(6) ITAA97.

¶10-180 Example of operation of pattern of distributions control rule

The following example illustrates the operation of the pattern of distributions control rule (see ¶10-170).

The Snap Discretionary Trust was established by a deed dated 18 August 2006. For each of the 2008-09 to 2014-15 income years, the trustee only makes distributions of income, and the distributions in these years to Peter and Amy (Peter's spouse) are as follows:

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Peter	40%	10%	5%	–	25%	20%	–
Amy	–	10%	30%	–	12%	20%	–

No other distributions of income are made to any other entity that would be relevant to the operation of the pattern of distributions control rule.

Whether Peter or Amy controls the Snap Discretionary Trust will depend on the income year in which the CGT event that gives rise to the capital gain being tested for CGT small business relief happens.

If the CGT event happened in:

- the 2011-12 or 2012-13 income years – Peter would control the Snap Discretionary Trust under the pattern of distributions control rule and Amy would control the trust only if Peter was her affiliate;
- the 2013-14 income year – neither Peter nor Amy would control the Snap Discretionary Trust under the pattern of distributions control rule; and
- the 2014-15 income year – neither Peter nor Amy would control the Snap Discretionary Trust by virtue of the pattern of distributions control rule unless one was the affiliate of the other.

For a beneficiary of a discretionary trust to continuously control the trust under the pattern of distributions control rule, a control percentage distribution of 40% or more would need to be made for at least the fourth income year after the income year for which the first controlling distribution was made, and then for the fourth income year after that income year, and so on. This means, for example, that if a controlling distribution of 40% or more is first made to a beneficiary in income year 1, the minimum frequency that a controlling distribution would need to be made to the beneficiary and/or the beneficiary's affiliates (in order to ensure that the beneficiary continuously controls the trust from and including income year 2) would be for income years 5, 9, 13, and so on.

For a discussion of the question of whether income and capital distributions are to be considered separately when applying the pattern of distributions control rule, see ¶10-195.

¶10-185 Loss year controllers

If a discretionary trust has a tax loss or no net tax income for an income year and the trustee did not make a distribution of income or capital of the trust for that income year, the trustee may nominate no more than four beneficiaries as being controllers of the trust for the income year for the purpose of applying the provisions governing the tests for an entity to be a small business entity and applying the CGT small business relief provisions (including the active asset test and the maximum net asset value test).[36]

This provision was enacted by the *Tax Laws Amendment (2011 Measures No. 2) Act 2011* and replaced a provision that applied solely for the purpose of determining whether a CGT asset is an active asset.[37] The amendment made by the amending Act applies (subject to transitional provisions) in relation to CGT events that happen on or after 27 June 2011.

Each nominated beneficiary is taken to control the trust during the relevant income year (ie the income year in which the trust had the tax loss or nil net tax income) in a way described in s 328-125 ITAA97.[38]

The effect of nominating a beneficiary of a discretionary trust to be a controller would be to make the beneficiary and the discretionary trust connected entities for the income year. Also, of course, any other entity that is controlled by a nominated beneficiary would be connected with the trust. A beneficiary does not have to be an individual to be nominated and, for example, a company that is a beneficiary could be nominated.

In addition to the trust having a nil net tax income or a tax loss for the particular income year, a nomination can only be made if the trustee does not make a distribution of income or capital of the trust for the income year. The fact that a trust has a nil net tax income or a tax loss will not, of course, necessarily mean that the trust does not have distributable income for the purposes of trust law and the trust deed. In such a case, a default distribution clause may be activated. The words "the trustee did not make a distribution" suggest some active step taken by the trustee, rather than a mere passive operation of the trust deed. The position, however, is not clear, particularly as some default income clauses operate to treat the trustee as having made a distribution resolution in favour of the default beneficiaries.

It is important to note, however, that the nomination by a trustee of a beneficiary as a controller of a discretionary trust for an income year under former s 152-42 ITAA97 was only for the purpose of applying the definition of active asset (see ¶8-100). If a beneficiary was a controller of a discretionary trust only as a result of being nominated by the trustee of the trust, this would not have made the beneficiary and the trust connected entities for the purpose of applying the maximum net asset value test or the small business entity test. The operation of s 152-78 ITAA97 is not limited in this way.

The fact that a beneficiary is nominated by the trustee to control a discretionary trust for an income year would not, of course, prevent another beneficiary (or other beneficiaries) from controlling the trust for that income year under the pattern of distributions control rule for the purpose of applying the CGT small business relief provisions.

36 S 152-78 ITAA97. "Tax loss" is defined in s 995-1 ITAA97.

37 Former s 152-42(2) ITAA97.

38 S 152-78(3) ITAA97.

Example

Example

The Icarus Discretionary Trust was created by a deed made on 16 March 2009. It has a net tax income for each income year from 2008-09 to 2014-15, save for the 2013-14 income year (for which it made a tax loss). Assume that the trustee's only distributions are of income, and that distributions are made for each income year other than for the 2013-14 income year.

Assume further that control percentage distributions (40% or more) are made as follows:

- 2008-09 – to Mary;
- 2009-10 – to Murray;
- 2010-11 – to Frank;
- 2011-12 – to Frank;
- 2012-13 – to Ivan;
- 2013-14 – none (tax loss); and
- 2014-15 – to Priscilla.

Putting to one side the effect of any nomination that the trustee may make in relation to the 2013-14 income year, the beneficiaries who control the Icarus Discretionary Trust for the various income years under the pattern of distributions control rule are:

- 2008-09 – none;
- 2009-10 – Mary;
- 2010-11 – Mary and Murray;
- 2011-12 – Mary, Murray and Frank;
- 2012-13 – Mary, Murray and Frank;
- 2013-14 – Murray, Frank and Ivan; and
- 2014-15 – Frank and Ivan.

What, then, would be the effect of the trustee nominating Archie, Bluey and Simone "as being controllers of the trust" for the 2013-14 income year (under s 152-78 ITAA97)? The nominated beneficiaries would be taken (under s 152-78(3) ITAA97) to have "controlled" the trust during that income year for the purpose of determining connected entity or small business entity status. This would be in addition to Murray, Frank and Ivan. Because the nominated beneficiaries would be taken to each control the trust for the 2013-14 income year and no payment to them (or application for their benefit) is taken to occur, they would not control the Icarus Discretionary Trust for any later income year (as a result of the nomination) for the purpose of applying the connected entity and small business entity rules. However, if it was essential for Mary to control the trust for the 2013-14 income year for the purpose of (for example) the active asset test (eg a CGT asset of hers may be used by the trust in the carrying on of its business), the nomination of Mary by the trustee would mean that she would control the trust for that income year, despite no distribution having been made to her since the 2008-09 income year.

Nomination

A nomination of a beneficiary (or beneficiaries) must be in writing, and signed by the trustee and each nominated beneficiary.[39]

The time by which the trustee must make a nomination of controllers under s 152-78 ITAA97 is not specified. However, in relation to an earlier provision (former s 152-30(6C) ITAA97), the Commissioner stated in ID 2004/970 that it would generally be expected that the nomination should be made by the time the CGT small business reliefs were chosen for the particular capital gain. This interpretative decision was withdrawn following the enactment of former s 152-42 ITAA97. The ATO Guide does not contain any indication of the Commissioner's current view. Arguably, the making of a nomination under s 152-78 ITAA97 could be regarded as the making of a choice to which the CGT choice making rules apply (see ¶2-135). The effect of these rules would be consistent with the view that was expressed by the Commissioner in ID 2004/970.

Precedent

 # Trust

Nomination of Controllers

Pty Ltd, as trustee of the # Trust ("the Trust"), hereby nominates pursuant to section 152-78 of the *Income Tax Assessment Act 1997* the following beneficiaries whose signatures appear below to be controllers of the Trust for the income year ended 30 June 201#:

[full name];

[full name];

etc.

Dated the day of 201#

....

[full name and capacity, eg sole director of # Pty Ltd]

Signatures of nominated beneficiaries:

....

[full name]

....

[full name]

etc.

39 S 152-78(4) ITAA97.

¶10-190 Distributions after close of income year

The pattern of distributions control rule (see ¶10-170) refers to payments or applications of income or capital made by the trustee of a discretionary trust "for" any of the four relevant income years.

It is thought that the pattern of distributions control rule, by using the expression "for" in relation to the payment or application of income or capital, suggests that a distribution after the close of the income year could be relevant (providing, of course, the trust deed permitted this). This is the position taken in the explanatory memorandum to the amending Bill that became the *Tax Laws Amendment (2004 Measures No. 1) Act 2004*, and which introduced the pattern of distributions control rule. The explanatory memorandum states:

> "Frequently distributions from trusts for an income year are made after the end of that income year. Consistent with the Commissioner's long standing administrative practices, for the purpose of applying the new control test, distributions that are paid to or applied for the benefit of the entity within two months following the end of an income year will generally be taken to be paid or applied for that preceding income year."

This statement from the explanatory memorandum is, however, somewhat ambiguous.

The Commissioner's "long standing" administrative practices referred to related to distributions of income (see IT 328 (now withdrawn)). For the purposes of the pattern of distributions control rule, however, both distributions of income and distributions of capital for an income year are required to be taken into account. The statement from the explanatory memorandum does not draw any distinction between capital and income distributions.

It is not clear, however, why the Commissioner's (former) practice in relation to the operation of Div 6 ITAA36 could have been of any relevance. The question (in the context of Div 6 ITAA36) is whether a beneficiary is presently entitled to a share of the income of the trust estate. The question that is relevant to the pattern of distributions control rule is whether there has been a payment or application of income or capital for an income year – which, it would seem, is a different inquiry.

The concept of a distribution of capital being made "for" an income year is not a clear one. It could refer to a distribution during the income year, regardless of when the capital was received or otherwise derived. It is possible, however, that the concept could be interpreted so that a distribution of capital "for" an income year is a distribution of capital that is sourced to an income year in which the capital amount was received or otherwise derived. The capital gains "streaming" provisions require a beneficiary to be made "specifically entitled" to an amount of a capital gain made by a trust during an income year and for this to be recorded in the accounts or records of the trust no later than two months after the end of the income year (s 115-228 ITAA97). If, however, the capital gain is, by virtue of the provisions of the trust deed or the exercise by the trustee of powers under the trust deed, "income", then the distribution in respect of the capital gain would need to be effected by 30 June of the income year or, if it is earlier, the time dictated by the trust deed for the distribution of income.

The present pattern of distributions control rule was enacted by the *Tax Laws Amendment (Small Business) Act 2007* and applies to CGT events that happen in the 2007-08 or a later income year.
The explanatory memorandum to the amending Bill that became the *Tax Laws Amendment (Small Business) Act 2007* muddies the waters somewhat. The explanatory memorandum gives an example of the operation of the pattern of distributions control rule that compares the amount of a distribution of income to a beneficiary "in" the 2007-08 income year with the total amount of income distributed "in" the income year. No mention is made of the possibility of a distribution of income for an income year being made after the end of that income year.

It is submitted that clarification of the issues raised above is required. Preferably, this should be by way of legislative amendment but, at the very least, a binding ruling should be issued by the Commissioner.

¶10-195 Income and capital distributions to be considered separately

The pattern of distributions control rule refers to the trustee having paid to, or applied for the benefit of, a beneficiary (and/or any of a beneficiary's affiliates) "any of the income or capital of the trust" for an income year, and requires the amount paid or applied to be compared with "the total amount of income or capital paid or applied" by the trustee for that income year (see ¶10-170). There is no statutory definition relevant to the meaning of the expressions "income" and "capital".

There is an issue of whether, when determining whether the 40% threshold is reached, distributions of income and distributions of capital are counted separately, or whether it is the aggregate of income and capital paid to, or applied for the benefit of, an entity and/or the entity's affiliates that is taken into account. It is submitted that the wording of the pattern of distributions control rule is not clear in this respect. The different constructions, of course, can produce significantly different results.

The view stated in the ATO Guide is that payments and applications of income and capital to the same beneficiary are considered separately (ie not added together) to determine whether the beneficiary reaches the 40% threshold.

Example (adapted from ATO Guide)

The Flintlock Discretionary Trust sold a business asset during the year ended 30 June 2015 and made a capital gain. The trust made the following percentage distributions of income and capital for the previous year (there were no distributions of any kind for any of the earlier years, and the trust did not have a tax loss in any previous year):

	2013-14	
	Income	Capital
David	50%	
Denise (David's spouse)	50%	
Lester		30%
Leanne (Lester's spouse)		70%

As David and Denise each received at least 40% of the total distributions of income from the trust, they each control the trust. As Leanne received at least 40% of the total distributions of capital from the trust, she also controls the trust. However, as Lester received less than 40% (and Leanne is not his affiliate), he does not control the trust.

Distinction between income and capital

The view adopted in the ATO Guide on the way in which the pattern of distributions control rule operates means that a distribution by the trustee of a discretionary trust must be categorised as either income or capital, or partly income and partly capital. In the latter case, it would be necessary to determine the extent to which the distribution is income, and the extent to which the distribution is capital.

A failure to draw this distinction correctly in relation to a distribution made for an income year may result in a beneficiary, who it is assumed controls the trust, not in fact controlling the trust and another beneficiary, who it is assumed does not control the trust, in fact controlling the trust.

Also, a failure to correctly characterise a distribution as being "income" or "capital" could potentially have significant implications for the purpose of determining whether an entity has a direct small business participation percentage in a trust, and what that percentage is (see ¶11-130 and ¶11-135).

There is no statutory guidance as to what is meant by the expressions "the income of the trust" and "the … capital of the trust" in these statutory contexts.

The ordinary trust provisions of Div 6 ITAA36 also use the expression "the income of the trust estate". These provisions turn, in part, on whether a beneficiary of a trust is presently entitled to a share of the income of the trust estate and, if that is the case, provide (broadly) for an assessment of the beneficiary (or of the trustee on behalf of the beneficiary) on that share of the net tax income of the trust estate.[40]

40 See, for example, s 97(1) ITAA36.

For some years, there was a controversy as to what meaning should be given to the expression "the income of the trust estate" in the provisions of Div 6 ITAA36. While it was accepted that "the income" in s 97 ITAA36 referred to the distributable trust income, the particular point of controversy was whether the terms of the trust deed could operate to define, or vary, what is income in this context. This question was authoritatively dealt with by the High court in *FCT v Bamford*.[41] The court held that the words "the income of the trust estate" in Div 6 ITAA36 refer to distributable income ascertained by the trustee according to appropriate accounting principles and the trust instrument. It is submitted that the expression "the income of the trust" in the pattern of distributions control rule should be similarly interpreted. This is the view taken by the Commissioner in ID 2012/99.[42]

Following the High Court's decision in *Bamford*, the Commissioner issued TR 2012/D1 which considers the meaning of the term "income of the trust" as used in s 97 ITAA36. The draft ruling takes the view that the expression the "income of the trust", given its statutory context, must be:

- measured in respect of distinct years of income;
- a product "of the trust estate"; and
- an amount in respect of which a beneficiary can be made presently entitled.

Consequently, capital gains that are attributable to notional amounts will not be "income" of the trust, such as:

(1) so much of a net capital gain that is attributable to an increase of what would have otherwise been a relevant amount of capital proceeds for a CGT event as a result of the market value substitution rule in s 116-30 ITAA97; and

(2) so much of a net capital gain that is attributable to a reduction of what would have otherwise been a relevant cost base or reduced cost base of a CGT asset as a result of the market value substitution rule in s 112-20 ITAA97.

¶10-200 Some practical aspects of the pattern of distributions control rule

There are a number of practical aspects of the pattern of distributions control rule (see ¶10-170) that may be noted.

Any kind of entity

Subject to one qualification, any kind of entity may control a discretionary trust under the pattern of distributions control rule. The qualification is that an exempt or tax deductible entity cannot control a discretionary trust under the pattern of distributions control rule (see ¶10-170).

41 [2010] HCA 10. The decision of the High Court affirmed the view that had been expressed in decisions of the Full Federal Court, including *Cajkusic v FCT* [2006] FCAFC 164 and *Richardson v FCT* [2001] FCA 1354.

42 This interpretative decision relates to the interpretation of s 152-70 ITAA97 which defines what constitutes a direct small business participation percentage but states that the reasoning in the ruling would also broadly apply to the interpretation of the pattern of distributions control rule.

Reasons for utilising the rule

It may, for example, be desired that a particular beneficiary control a discretionary trust under the pattern of distributions control rule so as to make the trust and the beneficiary connected (eg to make a CGT asset an active asset).

Control in what income years?

The pattern of distributions control rule cannot operate to make a beneficiary control a discretionary trust for the income year in which the trust is created. But once a beneficiary has received a control percentage distribution (of 40% or more) for an income year, the beneficiary will control the discretionary trust under the pattern of distributions control rule for the next four income years (without any further income or capital distribution to the beneficiary), even if the particular beneficiary in fact ceases to be a beneficiary of the trust (eg because of divorce, the person ceases to be within the beneficiary class).

If a distribution by the trustee of a discretionary trust to a beneficiary for an income year (year 1) is such that the beneficiary controls the trust under the pattern of distributions control rule (so the beneficiary would control the trust for the four succeeding income years (ie years 2, 3, 4 and 5)), for the beneficiary to control the trust under the pattern of distributions control rule for the fifth succeeding income year (ie year 6), a relevant distribution would need to be made to the beneficiary at the latest for the fourth succeeding income year (ie year 5).

Example

(For simplicity, it is assumed in this example that Pamela does not have any affiliates.)

Pamela is a beneficiary of the Angora Discretionary Trust, which was formed in July 2008. For each of the 2008-09 and the 2009-10 income years, Pamela has 42% of the distributions of income and capital of the trust distributed to her.

Pamela will not control the Angora Discretionary Trust for the 2008-09 income year under the pattern of distributions control rule, but will control the trust for the 2009-10 income year because of the distribution to her in the 2008-09 income year.

Because of the distribution to her for the 2009-10 income year, Pamela will control the Angora Discretionary Trust under the pattern of distributions control rule for each of the income years up to and including the 2013-14 income year.

For Pamela to control the Angora Discretionary Trust under the pattern of distributions control rule for the 2014-15 income year, she will need to have a controlling distribution (of 40% or more) made to her at the latest for the 2013-14 income year.

If no controlling distribution is made by the Angora Discretionary Trust to Pamela for any of the income years 2010-11 to 2013-14 (inclusive), Pamela could at the earliest control the Angora Discretionary Trust under the pattern of distributions control rule for the 2015-16 income year (if a controlling distribution (of 40% or more) is made to her for the 2014-15 income year).

Relevant distribution

What is relevant to the operation of the pattern of distributions control rule is an amount paid to, or applied for the benefit of, a beneficiary. This is a similar form of expression to that used in s 101 ITAA36, so that (subject to the terms of the trust deed) a resolution of the trustee that has the effect of making a beneficiary entitled to a specific amount or portion of the income of the discretionary trust for an income year will suffice, even if the income of the trust for the income year has not been quantified when the resolution is made.[43]

For a payment or an application of income or capital to be relevant for the purposes of applying the pattern of distributions control rule, the payment or application would need to be made to or for the benefit of the recipient in the capacity of a beneficiary. The ATO Guide points out that, where a discretionary trust makes a contribution to a superannuation (or similar) fund for an employee who is also a beneficiary of the trust, the payment could not be considered to be a relevant payment or application of income or capital because the payment would be made for the person in their capacity as employee and not in their capacity as beneficiary.

Distribution resolution

Care will need to be taken when drafting any distribution resolutions. For example, if it is essential for a beneficiary (R) to control a discretionary trust under the pattern of distributions control rule and only income is to be distributed, a resolution along the following lines (subject to the terms of the trust deed) should suffice:

> **RESOLVE THAT** [at least 40]%* of the income [or whatever term is used in the trust deed] of the trust for the year ended 30 June # be distributed to R by [details of how distribution is to be effected].
>
> **RESOLVE THAT** [appropriate provisions to deal with balance of the income].
>
> **RESOLVE FURTHER THAT** no distribution of capital be made for that year.
>
> * This would need to be 50% or more if there is any likelihood the Commissioner could exercise the discretion under s 328-125(6) ITAA97 (see ¶10-175).

To overcome the problems that the “income” and “capital” distinction could otherwise give rise to, where it is essential for a particular beneficiary to control a discretionary trust under the pattern of distributions control rule, the trustee should (if possible) ensure that what is distributed for an income year is sourced solely to a global amount. For example, the trust deed may include a net capital gain in the “income” of the trust, so if a distribution of 40% of the “income” is distributed to the beneficiary (and no distributions from any other source were made to beneficiaries for the income year), this should satisfy the pattern of distributions control rule (subject to the Commissioner’s discretion under s 328-125(6) ITAA97 to treat a beneficiary as not controlling a discretionary trust where the control percentage is less than 50% (see ¶10-175)). There may be cases where the trustee would need

43 *Harmer v FCT* [1991] HCA 51.

to consider exercising powers under the trust deed that are relevant to characterising an amount as income or capital.

¶10-205 Case studies

Case study 1

Nelly Pty Ltd has two classes of issued shares. These are 1,000 ordinary shares and 10 dividend access shares, which must be treated equally in relation to any dividend declared on the shares. All of the shares are paid up to $1. On a winding up of the company, the ordinary shares and the dividend access shares rate equally in relation to a return of paid-up capital, but only the ordinary shares are entitled to participate in any surplus.

An entity could control Nelly Pty Ltd under the right to distribution control rule by reference to ordinary shares only. Provided an entity owns (or has the right to acquire the ownership of) at least 404 ordinary shares, the entity would control Nelly Pty Ltd under the right to distribution control rule (see ¶10-130) (assuming the Commissioner cannot disregard the entity's control under s 328-125(6) ITAA97 (see ¶10-135)). This is because on any distribution of capital (say on a winding up), the entity would be entitled to 40% of the distribution.

The position would be otherwise if it were assumed that Nelly Pty Ltd had a third class of issued shares comprising 10 redeemable preference shares, which were entitled to a preferential dividend and a preferential repayment of capital on a winding up. In that situation, for an entity to control Nelly Pty Ltd under the right to distribution control rule, the entity would need to own (or have the right to acquire the ownership of) either 40% of each class of share, or 404 ordinary shares and four redeemable preference shares.

Of course, if the ordinary shares carried all of the voting power (one vote per share), an entity would control Nelly Pty Ltd under the voting power control rule (see ¶10-130) if the entity owned (or had the right to acquire the ownership of) 400 ordinary shares. (This is subject to the Commissioner not being able to exercise the discretion explained at ¶10-135.)

Case study 2

The trustee of the Lollipop Discretionary Trust distributes the following amounts of income of the trust for the year ended 30 June 2015:

- to Murray – 20% of the income;
- to Marion (Murray's spouse) – 30% of the income;
- to Hilite Pty Ltd (a company controlled by Peter, an adult child of Murray and Marion) – 35% of the income; and
- to Terry (an adult child of Murray and Marion) – 15% of the income.

The trustee also distributes capital amounts for the income year totalling $40,000 as follows:

- to Hilite Pty Ltd – $25,000, ie 62.5% of the capital; and
- to Lester (Murray's father) – $15,000, ie 37.5% of the capital.

On these facts, if the view in the ATO Guide is adopted (see ¶10-195), Hilite Pty Ltd would control the trust for the 2015-16 income year under the pattern of distributions control rule. In addition, because Peter would control Hilite Pty Ltd by virtue of the control tests that apply in relation to companies, Peter would also control the trust as a result of the application of the indirect control rule (see ¶10-115).

Case study 3

Assume the same facts in case study 2, except that Marion owns a CGT asset that she leases to the Lollipop Discretionary Trust for use in its business. The special spouse/child under 18 affiliate rule would apply so that, for the purposes of determining whether the Lollipop Discretionary Trust is connected with Marion, Murray would be treated as being Marion's affiliate (see ¶9-135). This would mean that Marion has a control percentage in relation to the Lollipop Discretionary Trust of 50% and, accordingly, she would control the trust for the 2015-16 income year. However, there is a question whether the special spouse/child under 18 affiliate rule could operate to treat Murray as being Marion's affiliate. If the special rule did so operate, Murray would control the Lollipop Discretionary Trust. For a discussion of this question see ¶9-135.

Case study 4

The Dingle Unit Trust has two classes of units: "A" class units that carry ratably all of the rights to income, and "B" class units that carry ratably all of the rights to capital. An entity will control the Dingle Unit Trust under the right to distribution control rule (see ¶10-130 and ¶10-155) if the entity owns (or has the right to acquire the ownership of) at least 40% of the A class units or at least 40% of the B class units.

Chapter 11

Significant individuals and CGT concession stakeholders

¶11-100 Context

The significant individual concept is relevant for the following purposes:

(1) determining whether a company or trust satisfies the significant individual test (see ¶11-105), which must be met by a company or trust to be able to choose the CGT small business retirement exemption;

(2) determining whether a company or trust is eligible for the CGT 15-year small business exemption (see ¶12-115) and whether a capital gain from a share or trust interest is eligible for the CGT 15-year small business exemption (see ¶12-110); and

(3) determining whether a shareholder or beneficiary is a CGT concession stakeholder (see ¶11-115), which is relevant:

   (a) for determining whether the basic conditions are met for the CGT small business reliefs to apply to a capital gain made from a CGT event happening in relation to a share or trust interest (see ¶4-110);

   (b) to the operation of the flow-through concession that applies where the CGT small business 15-year exemption has operated to disregard a capital gain of a company or trust (see ¶12-150); and

   (c) when applying the CGT small business retirement exemption (see ¶14-160) to a company or trust.

The significant individual test was introduced by the *Tax Laws Amendment (2006 Measures No. 7) Act 2007* and replaced the controlling individual test for CGT events that happen in the 2006-07 or a later income year. In very broad terms, the controlling individual test required a 50% direct interest in a company or trust. The significant individual test requires a 20% direct or indirect interest.

¶11-105 The significant individual test

An entity will satisfy the significant individual test if the entity had at least one "significant individual" just before the CGT event.[1]

For the meaning of "significant individual", see ¶11-110.

¶11-110 Significant individual

An individual is a significant individual in a company or trust at a particular time if, at that time, the individual has a "small business participation percentage" in the company or trust of at least 20%.[2]

For the meaning of "small business participation percentage", see ¶11-120.

1 S 152-50 ITAA97.

2 S 152-55 ITAA97.

¶11-115 CGT concession stakeholder

An individual is a CGT concession stakeholder of a company or trust at a particular time if, at that time, the individual is:

- a significant individual in the company or trust (see ¶11-110); or
- a spouse of a significant individual in the company or trust, provided the spouse has a small business participation percentage (see ¶11-120) in the company or trust at that time that is greater than zero.[3]

For this purpose, the "spouse" of an individual is now defined to extend beyond the ordinary meaning of spouse so as to *include*:

(1) another individual (whether of the same sex or a different sex) with whom the individual is in a relationship that is registered under a State law or Territory law prescribed for the purposes of s 2E of the *Acts Interpretation Act 1901* as a kind of relationship prescribed for the purposes of that section; and

(2) another individual who, although not legally married to the individual, lives with the individual on a genuine domestic basis in a relationship as a couple.[4]

The small business participation percentage that a spouse has (to qualify the spouse as a CGT concession stakeholder) is irrelevant for the purposes of specifying a CGT concession stakeholder's percentage of a CGT-exempt amount under the CGT small business retirement exemption (see ¶14-170). However, in the case of the CGT 15-year small business exemption, it is a "stakeholder's participation percentage" in a company or fixed trust that is relevant to the flow-through concession, and this is determined by reference to the actual interests in the company or fixed trust held by a CGT concession stakeholder (see ¶12-160).

¶11-120 Small business participation percentage

An individual may have a small business participation percentage in an entity that is either "direct" or "indirect".

If the individual has both a direct small business participation percentage and an indirect small business participation percentage in an entity, the individual's small business participation percentage in the entity is the total of the direct and indirect small business participation percentages.[5]

3 S 152-60 ITAA97.

4 S 995-1 ITAA97. This is an inclusive definition which extends the ordinary meaning of the word spouse. Accordingly, individuals who are legally married will be spouses. Note that although the maximum number of CGT concession stakeholders in a company or trust will usually be eight, there may be circumstances in which there may be a greater number. This is because individuals while they remain legally married are spouses even if they are separated and a legally married spouse who is separated may also have a spouse within the extended definition of "spouse".

5 S 152-65 ITAA97.

What constitutes a direct small business participation percentage is defined in relation to:

- a company (see ¶11-125);
- two mutually exclusive categories of trust that may, for convenience, be referred to as:
  - fixed trusts (see ¶11-130); and
  - non-fixed trusts, which includes discretionary trusts (see ¶11-135).

The calculation of an indirect small business participation percentage is explained at ¶11-140.

¶11-125 Direct small business participation percentage: company

For an entity to hold a direct small business participation percentage in a company at a particular time, the entity must (because of holding the legal and equitable interests in non-redeemable shares in the company) have:

(1) (unless the shares are held jointly with another entity) voting power in the company;

(2) an entitlement in respect of any dividend that the company may pay; and

(3) an entitlement in respect of any distribution of capital that the company may make.[6]

It is necessary to determine the entity's percentages of the voting power, dividend entitlements and capital distribution entitlements because, if these percentages are different, the entity's direct small business participation percentage is the lowest percentage. This means that an entity must hold the legal and equitable interests in shares that carry voting power (see further below), dividend entitlements and capital distribution entitlements to have a direct small business participation percentage in a company.

All classes of shares in a company (other than redeemable shares – see below) are taken into account for the purposes of applying the direct small business participation percentage definition.[7]

6 S 152-70(1) ITAA97, item 1 in table.

7 TD 2006/77.

Example 1

Mirage Mirrors Pty Ltd has the following shares on issue:

- 100 "A" class shares that carry all of the voting power on a pro rata basis; and
- 100 "B" class shares that carry all of the dividend and capital distribution entitlements on a pro rata basis.

The shares in the company are beneficially held as follows:

Share class	Charles	Amy	Brian	Mitchell	Peter	Tricia
A	20%	10%	30%	15%	25%	Nil
B	25%	10%	35%	20%	5%	5%

The shareholders have the following direct small business participation percentages in the company:

- Charles – 20%;
- Amy – 10%;
- Brian – 30%;
- Mitchell – 15%;
- Peter – 5%; and
- Tricia – nil.

Example 2

If, in example 1, all of the "A" class shares in Mirage Mirrors Pty Ltd were beneficially held by shareholders who did not beneficially hold any of the "B" class shares in the company, there would be no direct small business participation percentage held in Mirage Mirrors Pty Ltd.

Redeemable shares

When applying the definition of direct small business participation percentage in the case of a company, redeemable shares are ignored.[8] Redeemable shares are defined to mean shares that are liable to be redeemed or shares that, at the option of the company that issued them, are liable to be redeemed.[9]

It is not clear how this exclusion of redeemable shares is to be applied, given that such shares may carry, for example, a right to a preferential dividend and the definition of direct small business participation

8 S 152-70(2) ITAA97.

9 S 995-1 ITAA97. What constitutes a redeemable preference share was considered by the High Court in *Beck v Weinstock* [2013] HCA 15.

percentage refers to “the voting power” in the company, “any” dividend that the company may pay, and “any” distribution of capital that the company may make.

One possible construction of the definition of direct small business participation percentage is that the references to “the voting power”, “any” dividend and “any” distribution of capital are references to voting power, dividend entitlements and capital entitlements carried by shares other than redeemable shares. This appears to be the view taken in TD 2006/77. The following is an example given in the determination.

Example

XYZ Co has 100 ordinary shares and one redeemable preference share on issue. Michelle and ABC Co each own 20 ordinary shares. Catherine owns the redeemable preference share.

The redeemable preference share has voting rights that are equal to the ordinary shares, preferential dividend rights and a return of capital right, but no right to participate in surplus capital on winding up. The ordinary shares have voting rights, dividend rights and rights to participate in surplus capital on winding up.

In this situation, the redeemable preference share is ignored for the purpose of determining whether XYZ Co has a significant individual. Accordingly, as Michelle has the right to exercise at least 20% of the voting power in the company and receive at least 20% of any distribution that the company may make (excluding redeemable shares), she is a significant individual of XYZ Co.

It should be noted that redeemable shares are relevant for the purpose of applying the connected entity rules (see ¶10-130).

Voting power

Where an entity holds the legal and equitable interests in shares in a company jointly with another entity, the voting power test does not apply.[10] Instead, only the dividend and capital distribution tests apply.

It is important to note that the voting power that is taken into account when applying the direct small business participation percentage definition is the voting power that an entity has because of holding the legal and equitable interests in shares in the company. The way that this voting power test applies can be illustrated by comparing it with the way in which the controlling individual test (which applied to CGT events that happened before the 2006-07 income year) was expressed. The controlling individual test referred to shares that carry the right to exercise voting power in the company.

On facts similar to those considered by the High Court in *Kolotex Hosiery (Australia) Pty Ltd v FCT*[11] (and that are considered at ¶9-120), if the particular individual owned the legal and equitable interests in a share that, by virtue of the constitution, would mean that the individual could exercise majority

10 S 152-70(3) ITAA97.

11 [1975] HCA 5.

voting power at any general or any special meeting, the individual could have a direct small business participation percentage (but could not have been a controlling individual).

The definition of direct small business participation percentage in the case of a company refers to the percentage of the voting power in the company. In the *Kolotex Hosiery* case, the percentage of the particular individual's voting power depended on the nature of the resolution (ie whether it was an ordinary or special resolution). Presumably, however, what would be likely to be relevant to the definition of direct small business participation percentage would be the lesser percentage.

Any dividend, any distribution

The direct small business participation percentage definition in the case of a dividend refers to "any dividend that the company may pay" and, in the case of a capital distribution, refers to "any distribution of capital that the company may make". This can make the test impossible to satisfy in some cases where there are non-redeemable shares on issue that have discretionary or preferential dividend features or that carry preferential rights to a distribution on a winding up. Redeemable shares are ignored – see above.

Nevertheless, if there are different classes of shares on issue that either carry some preferential rights to distribution or in respect of which there is a discretionary power in the directors or the company in general meeting as to the payment of dividends, an entity would have a direct small business participation percentage in the company if the entity holds the legal and equitable interests in shares of each class of share on issue. Generally (but not always), the direct small business participation percentage of the entity would be the lowest percentage of the shares of a particular class so held by the entity.[12]

TD 2006/77 deals with the operation of the definition of significant individual. The following examples are given in the determination.

Example 1

A company has two different classes of shares, A and B, which have equal voting and distribution rights. Isaac holds 20% of the shares of each class. The directors can decide to make a distribution of income or capital to either class of shares to the exclusion of the other class of shares.

In this situation, the company does have a significant individual. Isaac holds 20% of the voting power and, regardless of how the directors' discretion is exercised, Isaac will always receive 20% of any distribution made by the company.

12 TD 2006/77.

Example 2

A company has A class shares and one D class share issued to a key employee. Gus holds 20% of the A class shares, which have full voting and distribution rights. The D class share has dividend rights only, payable at the discretion of the directors.

The company does not have a significant individual. Gus may receive 20% of a distribution if the directors do not exercise their discretion to make a distribution to the D class shareholder, but he will receive less than 20% of the distribution if the discretion is exercised. That is, Gus does not have the right to receive at least 20% of any distribution made. His "notional" 20% interest is reduced to below 20% because of the directors' ability to make distributions to the D class shareholder.

Company in liquidation

The decision of the High Court in *FCT v Linter Textiles Australia Ltd (in liq)*[13] established that a company that beneficially owns shares in another company does not cease to beneficially own the shares on the other going into liquidation. This would, it is thought, mean that a company that holds the legal and equitable interests in shares in another company would not cease to hold those interests if the other company were to go into liquidation.

The High Court also held that the reference (in the continuity of beneficial ownership of shares test that applies to the carry forward of company losses) to the beneficial ownership of shares carrying the right to exercise voting power in the company is a reference to voting power as determined by the company's constitution and the fact that the company goes into liquidation could not affect such voting power.

On the other hand, for the purposes of the indirect control provisions of the company loss carry forward tests, the High Court held that, on the making of the winding-up order, the voting power in the taxpayer company ceased to be controlled, or be capable of being controlled, by those persons who, before the making of the winding-up order, had been in that position.

In the context of the definition of direct small business participation percentage, it is a question of whether, as a consequence of a company going into liquidation, it can be said that a shareholder in the company "has" the voting power in the company attached to the shares because of the holding of the legal and equitable interests in shares in the company. It may be arguable that a shareholder would not have such voting power if it could not in fact be exercised by the shareholder. However, it is submitted that it is open to construe the relevant words (and that they should be construed) to refer to the voting power carried by the shares by virtue of the terms of the company's constitution. If this construction is not adopted, it would mean that there could not be any CGT concession stakeholders of a company once the company went into liquidation (which would have the consequence that CGT small business relief would not be available for a capital gain that is made from the happening of CGT event C2 or G1 in the liquidation of a company).

13 [2005] HCA 20.

Holding legal and equitable interests

For an entity to hold a direct small business participation percentage in a company, the entity must "hold" "the legal and equitable" interests in shares in the company. These expressions are not defined.

"Holding"

The reference to an entity "holding" the legal and equitable interests in shares means, it is submitted, that the entity would need to "hold" the shares in the sense that has been given to that word in a number of cases involving income tax. It is difficult to see how an entity could hold the legal interest in shares in any other way. It has been consistently held in those cases that, for shares in a company to be "held" by an entity, the entity would need to be a shareholder.[14] In *FCT v Patcorp Investments Ltd*,[15] it was held that the general principle is that entry on the register is necessary to constitute membership of a company, and that the beneficial ownership of shares, without registration, does not make a person a shareholder. However, if a person ought to be on the register on a certain day, and is subsequently registered as from that day, generally speaking the registration (if a proper registration) will operate retrospectively and the person will be regarded as a shareholder from that day.

"Legal and equitable interests"

The concept of holding "the legal and equitable interests" in shares is somewhat awkward. In *DKLR Holding Co (No. 2) Pty Ltd v Commissioner of Stamp Duties (NSW)*,[16] Hope JA (Glass JA agreeing), with reference to real property, said:

> "… an absolute owner in fee simple does not hold two estates, a legal estate and an equitable estate. He holds only the legal estate, with all the rights and incidents that attach to that estate. If he were to execute a declaration that he held the land in trust for himself absolutely, the declaration would be of no effect; it would give him no separate equitable rights; he would remain the legal owner with all the rights that a legal owner has."

And in *Commissioner of Stamp Duties (Qld) v Livingston*,[17] Lord Radcliffe said:

> "When the whole right of property is in a person … there is no need to distinguish between the legal and equitable interest in that property, any more than there is for the property of a full beneficial owner."

It is submitted that the scope of the expression "the legal and equitable interests" in shares in the definition of direct small business participation percentage in the case of a company lacks clarity. However, at face value, the expression is apt to convey the notion that the entity is the absolute owner of the shares, because it would not be satisfied if any other entity had any interest in the shares at all.

14 See, for example, *Dalgety Downs Pastoral Co Pty Ltd v FCT* [1952] HCA 54; and *FCT v Linter Textiles Australia Ltd (in liq)* [2005] HCA 20.

15 [1976] HCA 67.

16 80 ATC 4279.

17 [1964] UKPC 2.

Because an entity can only have a direct small business participation percentage in a company if the entity holds the equitable interest in shares in the company (in addition to the legal interest in the shares), the question arises as to whether a trustee could have a direct small business participation percentage in a company, even if the trustee was registered as the holder of the shares. If not correct, this would, of course, mean that an indirect small business participation percentage in a company could never be obtained by tracing through a shareholder that is a trustee.

Some light is, however, thrown on this issue by observations of Griffith CJ in *Glenn v Federal Commissioner of Land Tax*,[18] a land tax case that was referred to with approval by the High Court in *CPT Custodian Pty Ltd v CSR (Vic)*.[19] Griffith CJ said that an argument for the Commissioner was:

> "based on the assumption that whenever the legal estate in land is vested in a trustee there must be some person other than the trustee entitled to it in equity for an estate of freehold in possession, so that the only question to be answered is who is the owner of that equitable estate. In my opinion, there is a prior inquiry, namely, whether there is any such person. If there is not, the trustee is entitled to the whole estate in possession, both legal and equitable."

In a joint judgment, the High Court in the *CPT Custodian* case said that that statement was a prescient rejection of a "dogma" that, where ownership is vested in a trustee, equitable ownership must necessarily be vested in someone else because it is an essential attribute of a trust that it confers on individuals a complex of beneficial legal relations that may be called ownership. Their Honours said that the current state of authority, exemplified by *FCT v Linter Textiles Australia Ltd (in liq)*,[20] bore out what was said by Griffith CJ.

Therefore, it is arguable that, where shares are held on trust and no equitable owner can be identified (as would usually be the case, for example, where the trust is a typical discretionary trust), the trustee may be said to hold the legal and equitable interests in the shares.[21] However, while this may provide a solution in the case of such a trust to the determination of a direct small business participation percentage in a company, it would not provide a solution in other cases, including where shares are held on a bare trust. This produces the rather strange consequence that, technically, the trustee of a discretionary trust that holds shares in a company could have a direct small business participation percentage in the company, but the trustee of a bare trust could not. In the case of a bare trust, the beneficiary would hold the equitable interest in the shares, but could not be said to hold the legal interest in the shares.

It would seem to be clear from an example in s 152-75 ITAA97, and also from examples in the explanatory memorandum, that it is assumed there could be a tracing of an indirect small business participation percentage through a trust (including a discretionary trust), and presumably this will be the basis on which the provisions will be administered. It is submitted that a clarifying amendment

18 [1915] HCA 57.

19 [2005] HCA 53.

20 [2005] HCA 20.

21 For a decision in which the position of the beneficiaries of a discretionary trust was considered, see *CSR (WA) v Serana Pty Ltd* [2008] WASCA 82.

should be made or that, at least, the Commissioner should issue a binding ruling. The relevant examples from the explanatory memorandum are adapted at ¶11-145.

¶11-130 Direct small business participation percentage: fixed trust

An entity's direct small business participation percentage in a trust (where entities have entitlements to all of the income and capital of the trust) depends on the entity being "beneficially entitled" to a percentage of any distribution of income and any distribution of capital that the trustee may make.

The entity's direct small business participation percentage is the percentage of any distribution of income or capital that the trustee may make, to which the entity would be beneficially entitled. However, if the percentages in relation to income and capital are different, the direct small business participation percentage is the lesser percentage.[22]

For this direct small business percentage rule to apply, the trust must be one where entities have entitlements to all of the income and capital of the trust. It is submitted that this would refer to the income and capital of the trust that are properly available to be distributed to beneficiaries.

The definition of direct small business participation percentage is applied to determine whether an entity has a direct small business percentage in an entity at a particular time (called the relevant time). In the case of a fixed trust, the definition operates by reference to what percentage of a distribution of income or capital the trustee "may make". This would seem to require that a hypothetical assumption be made that (at the relevant time) the trustee made a distribution of income and also a distribution of capital. Two practical consequences flow from this.

The first consequence is that the fact that there may be a mechanism provided for by the trust instrument, whereby the right of a unitholder or other beneficiary can be altered by a process which could not be immediately effected, would not be relevant when determining whether the trust is a fixed trust.

The second consequence is that, if the trust deed does not permit the trustee to make a distribution of, say, capital at the relevant time, this arguably would mean that there could be no entity that had a direct small business participation percentage in the trust at the relevant time. For example, if the trust deed for a unit trust provides that the trustee may only distribute capital at a particular time or times, there could be no direct small business participation percentage held by any entity in the unit trust at any other time, even if the trustee could distribute income of the trust at the particular time or times.

It may be noted that, in the case of a non-fixed trust, the definition of direct small business participation percentage operates by reference to what percentage of distributions of capital and income were made during the income year that the entity had a beneficial entitlement to. If no distributions of either capital or income were made during the income year, no entity could have a direct small business participation percentage in the discretionary trust. However, if there are distributions of either capital

22 S 152-70(1) ITAA97, item 2 in table.

or income during the income year, an entity may have a small business participation percentage during the whole of the income year (see ¶11-135).

The expression "beneficially entitled" is not defined. The expression was considered by the Victorian Court of Appeal in *CSR (Vic) v Landrow Properties Pty Ltd*,[23] a case involving the land rich provisions of the *Duties Act 2000* (Vic). The court agreed with the trial judge that a person who takes property on trust does not acquire a beneficial entitlement to the trust property. The expression "beneficially held" in former provisions of the ITAA36 governing the carry forward of company losses was considered by the High Court in *Dalgety Downs Pastoral Co Pty Ltd v FCT*.[24] The court considered that the word "beneficially" more naturally served the purpose of excluding the case of a holding for the benefit of others than the purpose of broadening the meaning of the word "held".

Adoption of this approach would mean that a trust could not have a direct small business participation percentage in another trust. However, it would seem (from an example in s 152-75 ITAA97) that this is not intended and, it submitted, if that is so, the provision should be amended. If an interest in a fixed trust were to be held by a trustee under the terms of a bare trust, it could be said that the beneficiary of the bare trust would be beneficially entitled to relevant distributions of income or capital that the trustee of the first trust may (or did in fact) make.

The distinction between the "income" and the "capital" of a trust is considered at ¶10-195.

If a fixed trust has different capital and income beneficiaries, no beneficiary could have a direct small business participation percentage in the trust.[25]

If there are discretionary elements in the entitlement of beneficiaries under a trust (eg as would be the position if a unit trust has units on issue in respect of which the trustee has discretionary distribution powers), it seems that such a trust would not be a fixed trust in the relevant sense because it could not be said that the beneficiaries had entitlements to all of the income and capital of the trust.

The reasoning in the decision of the High Court in *CPT Custodian Pty Ltd v Commissioner of State Revenue (Vic)*[26] raises issues as to when it may be said that a beneficiary of a trust (even a unitholder in what might be regarded as a fixed trust) has an entitlement to income and capital of the trust. It is submitted that the references to a distribution of income and a distribution of capital in s 152-70 ITAA97 are references to distributions to an entity as a beneficiary and, accordingly, the decision may have no practical significance when determining whether a trust is a fixed trust in the relevant sense. The Commissioner has not given any indication of his views regarding the implications of the High Court's decision.

23 [2010] VSCA 197.

24 [1952] HCA 54.

25 Cf ID 2003/1114 (withdrawn because the legislation was repealed).

26 [2005] HCA 53.

Further and notwithstanding the current view that most unit trusts are not fixed trusts for the purposes of Sch 2F ITAA36 as a consequence of the decision in *Colonial First State Investments Ltd v FCT*,[27] the preferred view for the purposes of s 152-70 ITAA97 is that, if the units carry only non-discretionary entitlements to income and capital distributions, the unit trust will be treated as a fixed trust to determine an entity's small business participation percentage.

¶11-135 Direct small business participation percentage: other trusts

An entity's direct small business participation percentage in a trust (where entities do not have entitlements to all of the income and capital of the trust) at a particular time depends on the trustee having made distributions of income and/or distributions of capital during the income year ("the relevant income year") in which the particular time occurs. The entity's direct small business participation percentage is determined by reference to the percentage of the distributions to which the entity was beneficially entitled.[28]

If the trustee only made distributions of income during the relevant income year or only made distributions of capital during the relevant income year, the entity's direct small business participation percentage is the percentage of the distributions to which the entity was beneficially entitled.

If, however, the trustee made distributions of both capital and income during the relevant income year, an entity can only have a direct small business participation percentage in the trust if a distribution of income and a distribution of capital were made by the trustee to that entity. The entity's direct small business participation percentage is the lesser of the percentage of the distributions of income and the percentage of the distributions of capital to which the entity was beneficially entitled.

The distinction between the "income" and "capital" of a trust is, therefore, of critical importance. For a discussion of the distinction, see ¶10-195.

The use of the expression "beneficially entitled" for the purposes of determining whether a beneficiary of a non-fixed trust has a direct small business participation percentage in the trust raises the same problems as are discussed in relation to fixed trusts at ¶11-130.

No distribution of either income or capital

Provision is made to deal with the situation where a trustee does not make a distribution of either income or capital in a relevant income year.[29]

27 [2011] FCA 16.

28 S 152-70(1) ITAA97, item 3 in table.

29 S 152-70(4) to (6) ITAA97.

Where that is the case, an entity's direct small business participation percentage is determined by reference to:

- if the trustee made a distribution of income or capital during the CGT event year (that is, the income year in which the CGT event happened) — the CGT event year; or
- otherwise — the last income year before the CGT event year in which the trustee did make a distribution of income or capital (s 152-70(5) ITAA97).

However, an entity will hold a direct small business participation percentage of 0% in the trust at the relevant time if the trust:

- had a net income for the relevant income year; and
- did not have a tax loss for the relevant income year (s 152-70(6)(a) ITAA97).

An entity will also hold a direct small business participation percentage of 0% in the trust at the particular time if the trustee did not make a distribution of income or capital at any time before the end of the CGT event year (s 152-70(6)(b) ITAA97).

The following is adapted from an example provided by the relevant explanatory memorandum.

Example

XYZ Trust is a trust where entities do not have entitlements to all of the income and capital of the trust. XYZ Trust operates a business and owns land that it has used in the course of carrying on its business for the last 20 years. Evan, Mario, Denise and Katrina are all objects of XYZ Trust and have been so for the last 20 years.

After suffering a bad trading year, XYZ Trust decides to sell the land. XYZ Trust's aggregated turnover for the income year in which it sells the land (the CGT event year) is less than $2m. XYZ Trust wants to exempt the capital gain under the small business 15-year exemption and pay out the exempt amount to Evan, Mario, Denise and Katrina.

In order for XYZ Trust to meet the conditions of the small business 15-year exemption, Evan, Mario, Denise and Katrina have to work out a small business participation percentage in XYZ Trust.

The trustee of XYZ Trust did not make a distribution in the CGT event year and the trust had a tax loss for that year. The trustee made a distribution of income in the year prior to the CGT event year, with Evan being beneficially entitled to 40% of the income and Mario, Denis and Katrina each being beneficially entitled to 20% of the income. The trustee did not make a distribution of capital in that year.

In all the other income years except the income year 14 years before the CGT event year, the trustee of XYZ Trust made a distribution and XYZ Trust had a significant individual. In the income year 14 years before the CGT event year, the trustee did not make a distribution and the trust had a tax loss for that year.

Under the provisions discussed above, a direct small business participation percentage can be calculated for Evan, Mario, Denise and Katrina for the CGT event year and for the income year 14 years before the CGT event year. As there is no distribution in the CGT event year, the focus shifts to the last income year before the CGT event year in which there was a distribution, that is, the income year prior to the CGT event year. Therefore, in the CGT event year and in the income year 14 years before the CGT event year, the direct small business participation percentages are as follows: 40% for Evan; and 20% for each of Mario, Denise and Katrina.

Example (cont)
In the circumstances of this example, the XYZ Trust will have a significant individual in the two tax-loss years. As Mario was 60 years of age just before the land was sold, XYZ Trust would be able use the small business 15-year exemption to exempt the capital gain on the sale of the land so long as the other relevant conditions of the small business 15-year exemption are met.

Distributions "during" income year

It will be noted that, when determining whether an entity has a direct small business participation percentage in a non-fixed trust, the distributions of income or capital that are relevant are distributions of income or capital that are in fact made during the income year in which the relevant time occurs, that is, distributions made on or after the first day and on or before the last day of the income year.[30] "During" is defined in the *Macquarie Dictionary* as "1. throughout the continuance of. 2. in the course of". It would be immaterial what the trust deed provided and also that a specific entitlement to a capital gain could be created after the end of the income year and be effective under the streaming of the capital gains provisions of the ITAA97.

It is immaterial at what point during the income year a distribution takes place. For example, in the income year in which the CGT event happens that triggers the capital gain, it is immaterial whether a distribution takes place before or after the happening of the CGT event.

What is a distribution?

The expression "distribution" is not defined for the purposes of the definition of direct small business participation percentage. In relation to the former controlling individual definition, the ATO view was that, based on a provision in the trust loss provisions, a distribution in the relevant sense was a distribution to an entity in the entity's capacity of a beneficiary of the trust.[31] There seems to be no reason why the ATO would not take a similar view in relation to the definition of direct small business participation percentage.

The particular trust loss provision[32] provides (in very broad terms) that a trust distributes income or capital of the trust to a person if it pays, credits or transfers the income or capital in the form of money or property to the person or applies the income or capital for the benefit of the person, in the person's capacity as a beneficiary of the trust.

It is thought that a resolution of the trustee that has the effect of making a beneficiary presently entitled to an amount, or specifically entitled to an amount of a dividend or capital gain, should be sufficient to constitute a distribution.

30 Note that the words used in the pattern of distributions control rule for discretionary trusts are different (see ¶10-190).

31 TD 2006/66 (withdrawn).

32 S 272-45, Sch 2F ITAA36.

Operation of a default income provision

If the trustee of a discretionary trust does not make an effective distribution resolution in respect of the whole of the income of the trust for an income year, and a default income clause operates, the question arises as to whether the entitlement of the default income beneficiaries would be a relevant distribution of income.

For the purposes of determining an entity's direct small business participation percentage in a discretionary trust, what is relevant is "if the trustee makes distributions" of income or capital. This form of expression conceivably requires the trustee to take some positive action by way of distribution.[33] Under some discretionary trust deeds, the default income provision operates by attributing a deemed exercise by the trustee of its power to make a distribution of income. This may be sufficient for it to be said that the trustee makes the distribution.

Of course, if the operation of a default income clause in a discretionary trust deed is relevant for the purposes of applying the definition of direct small business participation percentage, any distribution caused by the operation of the clause would be made during the income year in which the clause in fact operated.[34]

Some practical points

The following practical points should be noted with regard to the operation of the definition of direct small business participation percentage in the case of a discretionary trust:

(1) For a beneficiary to have a direct small business participation percentage in a discretionary trust at a particular time, there must be a distribution of income or capital to the beneficiary during the income year. If the trustee has made distributions of both income and capital during the income year, a beneficiary will only have a direct small business participation percentage in the trust if a distribution of income and a distribution of capital have been made to the beneficiary during the income year. If the percentages of the distributions of income and capital made to the beneficiary are different, the beneficiary's direct small business participation percentage will be the lesser percentage.

(2) It will be important for a trustee to determine whether an amount distributed to a beneficiary is income or capital for the purposes of the trust (see ¶10-195). It may be necessary for the trustee to consider the exercise of some power under the trust deed to ensure that an amount is treated appropriately as income or capital, but care needs to be taken.

(3) If it is desired that a particular individual be a significant individual or that two or more particular individuals each be a significant individual in a discretionary trust for an income year, and only distributions of income are made (ie no distribution of capital is made), the income should be distributed before the end of the income year and preferably to him, her or them by percentages. For example, if it is desired that X, Y and Z be significant individuals of a discretionary trust and

33 Cf GSTR 2006/9.

34 Cf *BRK (Bris) Pty Ltd v FCT* [2001] FCA 164.

only one distribution of income is made during the income year, the distribution of the income could be as follows:

"(1) to each of X, Y and Z – 20%; and

(2) the balance as follows: (#)"

(4) If in (3) above it is also desired that X's spouse (M) be a CGT concession stakeholder, (2) could read:

"(2) the balance as follows:

(a) $# to M;

(b) etc.

…"

It is only necessary that some distribution of income be made to M, for M to be a CGT concession stakeholder (see ¶11-115).

(5) Alternatively, if specified amounts are distributed, it should be ensured that the desired beneficiary or beneficiaries get at least 20% in any circumstances. For example, if it is calculated that the income of the trust for an income year is $110,000, only one distribution of income (and no distribution of capital) is made and it is desired that X, Y and Z each be a significant individual, the distribution could be along the following lines:

"(1) to each of X, Y and Z – $22,000;

(2) to A – $14,000;

(3) to B – $10,000; and

(4) to the LMN Charitable Foundation – $20,000,

provided that, if the income* of the Trust for the income year* is greater or less than $110,000, the distribution to each beneficiary shall be increased or reduced on a pro rata basis."

* The term used should reflect that used in the trust instrument.

¶11-140 Indirect small business participation percentage

An entity may have an indirect small business participation percentage in a company or trust through one or more interposed entities.

For the purposes of explaining the way in which an indirect small business participation percentage is calculated, the following terminology is used for convenience:

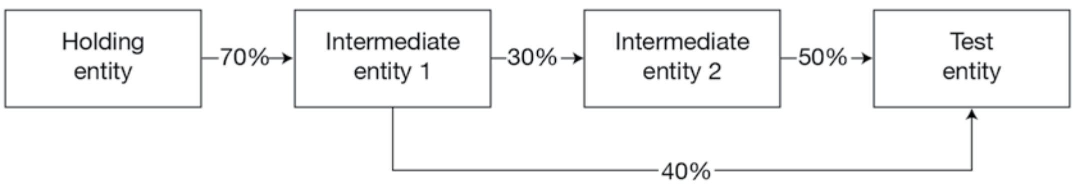
- the holding entity – this is the entity whose indirect small business participation percentage is being calculated;
- the test entity – this is the entity (company or trust) in which the holding entity's indirect small business participation percentage is being calculated; and
- the intermediate entity – this is any entity that is interposed between the holding entity and the test entity.

If there is only one intermediate entity between the holding entity and the test entity, the indirect small business participation percentage of the holding entity in the test entity is calculated as follows:[35]

Direct small business participation percentage of holding entity in intermediate entity × Total of direct and indirect small business participation percentages of intermediate entity in the test entity

If there is more than one intermediate entity, the holding entity's indirect small business participation percentage is the sum of the percentages worked out as above in relation to each of the intermediate entities.[36]

The effect of these rules may be illustrated as follows:



(All percentages in the diagram represent direct small business participation percentages.)

Holding entity's indirect small business participation percentage in test entity is calculated as:

$(70\% \times (30\% \times 50\%)) + (70\% \times 40\%)$

$= 10.5\% + 28\%$

$= 38.5\%.$

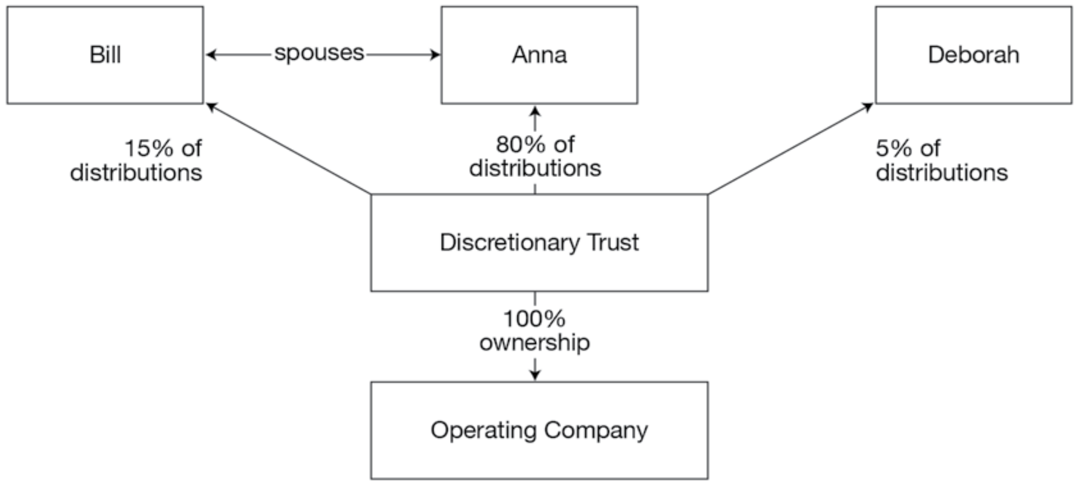
¶11-145 Examples from explanatory memorandum

The explanatory memorandum to the amending Bill that became the *Tax Laws Amendment (2006 Measures No. 7) Act 2007* contains two examples that illustrate the calculation of direct and indirect small business participation percentages. The examples, with some adaptation, are reproduced below. It will be seen in example 1 (which is also given in the ATO Guide) that a trust may have a small business participation percentage in a company or trust.

35 S 152-75 ITAA97.

36 S 152-75(2) ITAA97.

Example 1



Discretionary Trust owns 100% of the shares in Operating Company; therefore, Discretionary Trust has a 100% direct interest (and no indirect interest) in Operating Company.

Anna receives 80% of the distributions from Discretionary Trust; therefore, she has a direct participation percentage of 80% in Discretionary Trust.

Anna's participation percentage in Operating Company is calculated by multiplying Anna's direct participation percentage in Discretionary Trust by Discretionary Trust's total participation percentage in Operating Company:

$$80\% \times 100\% = 80\%.$$

Anna is a significant individual of Operating Company.

Bill receives 15% of the distributions from Discretionary Trust; therefore, he has a direct participation percentage of 15% in Discretionary Trust.

Bill's participation percentage in Operating Company is calculated by multiplying Bill's direct participation percentage in Discretionary Trust by Discretionary Trust's total participation percentage in Operating Company:

$$15\% \times 100\% = 15\%.$$

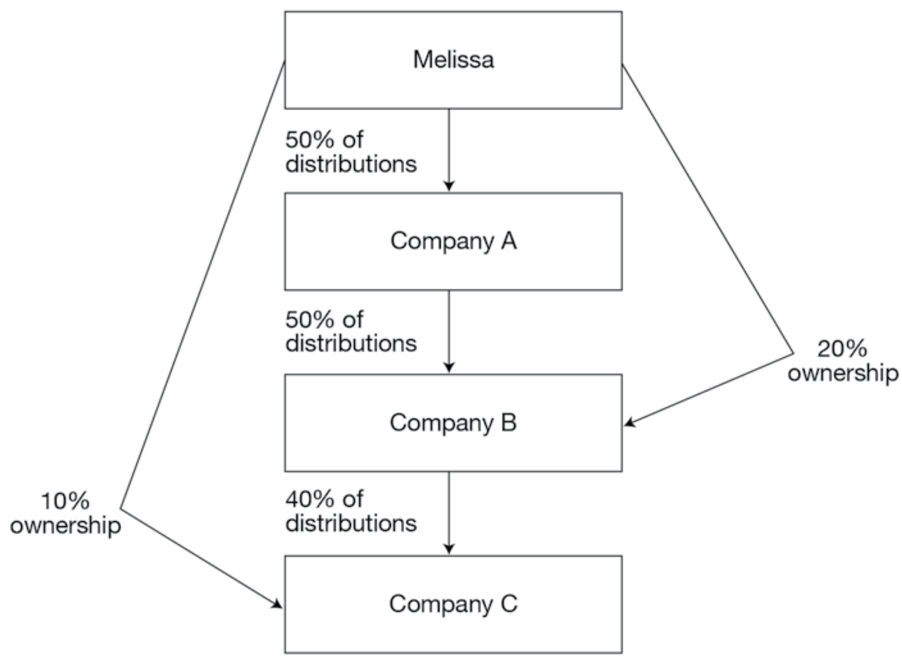
Bill is not a significant individual of Operating Company. However, because he is a spouse of a significant individual and has a participation percentage greater than zero, Bill will be a CGT concession stakeholder of Operating Company.

On the basis of the above, Deborah's participation percentage in Operating Company is 5%. She is neither a significant individual nor a CGT concession stakeholder of Operating Company.

Important note

As pointed out at ¶11-125, there is an issue whether, in this example, it could be said that Discretionary Trust holds the legal and equitable interests in the shares in Operating Company. If it could not be so said, it would mean that Discretionary Trust would not have a direct small business participation percentage in Operating Company. It would seem likely, however, that the provisions should be construed (and that the Commissioner will administer the provisions) in the way contemplated by the example.

Example 2



Melissa's total small business participation percentage in company C is the sum of her direct and indirect participation percentages. Her direct participation percentage is 10% and her indirect participation percentage is the sum of her indirect participation percentage in company C through company A and through company B; that is, (50% × 50% × 40%) + (20% × 40%) = 18%.

Melissa therefore has a small business participation percentage in company C of 28% and she is a significant individual in company C.

¶11-150 Case studies

Case study 1

The trustee of the Tiberius Family Trust, a discretionary trust, can exercise the discretion to distribute the income of the trust for an income year up to two months after the end of the income year (ie within the time permitted by the Commissioner's former administrative practice[37]).

For the 2014-15 income year, the trustee (as permitted by the trust deed) exercised the discretion to distribute income in August 2015 and distributed the 2014-15 income as to $45,000 to Anthony and the balance ($12,000) to Angela. On 30 June 2016, the trustee exercises the discretion to distribute the 2015-16 income and distributes the income as to $10,000 to Anthony, $35,000 to Angela and the balance ($6,000) to Suellen. The trustee makes no other distributions of income and makes no distribution of capital during the period 1 July 2015 to 30 June 2016.

Even though the August 2015 distribution is a distribution of the income of the 2014-15 income year, it is nevertheless taken into account when determining the beneficiaries' small business participation percentages in the trust for the 2015-16 income year because the distribution was in fact made during the 2015-16 income year. The position is as follows:

Beneficiary	August 2015 distribution $	June 2016 distribution $	Total distribution during 2015-16 $
Anthony	45,000	10,000	55,000
Angela	12,000	35,000	47,000
Suellen	–	6,000	6,000
Total	57,000	51,000	108,000

For the 2015-16 income year, the direct small business participation percentages of the beneficiaries in the Tiberius Family Trust are: Anthony – 50.93%; Angela – 43.52%; and Suellen – 5.55%. Had the August 2015 distribution been made in June 2015, the direct small business participation percentages of the beneficiaries in the trust for the 2015-16 income year would have been: Anthony – 19.61%; Angela – 68.63%; and Suellen – 11.76%.

Case study 2

The deed that established the Pawpaw Discretionary Trust has a provision to the effect that (to the extent that the trustee does not distribute or accumulate the income for an income year before the end of the income year) the income is to be treated as being distributed at the end of the income year equally to individuals who fall within a specified class.

37 This administrative practice of the Commissioner does not apply from and including the 2011-12 income year.

For the income year ended 30 June 2016, the trustee calculates the income of the trust to be $100,000 and determines, on 30 June 2016, to distribute $25,000 to each of Henry, Barry, Lynne and Leanne.

It turns out later that the income of the trust for the 2015-16 income year properly calculated is $170,000. The default income beneficiary class (to which the excess of $70,000 is treated as being distributed among) comprises two individuals – Mary and Michael. No other distribution, either of income or capital, is made during the 2015-16 income year.

This means that, if the trustee's calculation of the income for the income year (ie $100,000) had been correct, Henry, Barry, Lynne and Leanne would each be a significant individual of the Pawpaw Discretionary Trust. However, the operation of the default income clause means that each of their direct small business participation percentages would be 14.705% (and they would not be significant individuals).

As Mary and Michael would each receive 20.59% of the distribution of income as a result of the operation of the default income clause, they would (subject to one qualification) each have a direct small business participation percentage in the trust of 20.59% for the 2015-16 income year and would each be a significant individual in the trust for that income year.

The qualification is that it is not clear whether, if a beneficiary has an entitlement as the result of the operation of a default income clause, it can be said that the trustee makes a distribution (see ¶11-135).

Case study 3

Assume the same facts as in case study 2, except that the trustee does not have to exercise its discretion to distribute income for an accounting period before the end of the income year, but can do so within two months after the end of the income year. In addition, the default income clause only operates if, and to the extent that, the trustee has not exercised its discretion in respect of the income of an income year before the end of this two-month period.

If, as above, the trustee exercised the discretion to distribute $100,000 of income of the 2015-16 income year to Henry, Barry, Lynne and Leanne equally on 30 June 2016, the fact that the default income clause operated to make Mary and Michael entitled to the extra $70,000 of income would not prevent Henry, Barry, Lynne and Leanne from each having a small business participation percentage in the trust of 25% for the 2015-16 income year, and they would, therefore, each be a significant individual in the trust for the 2015-16 income year, as the entitlements of Mary and Michael would only arise on 31 August 2016.

Case study 4

Sign Catcher Pty Ltd carries on a business of manufacturing and installing billboards. The company has two classes of shares on issue: "A" class shares that carry all of the voting power in the company, and "B" class shares that carry all of the dividend entitlements. Each share carries the same rights to distribution on a winding up. The "A" class shares are all beneficially held by Ralph. The "B" class shares are all held by the Dinky Di Unit Trust. The units in the Dinky Di Unit Trust are all of one class and are beneficially held as to 40% by Ralph, 20% by Sandra (Ralph's spouse), and 10% by each of Ralph and Sandra's four children.

Because Ralph has no legal and equitable interest in shares in Sign Catcher Pty Ltd that carry dividend entitlements, his direct small business participation percentage in Sign Catcher Pty Ltd is 0%. Further, because Ralph has no relevant indirect interest in shares in Sign Catcher Pty Ltd that carry voting power, his indirect small business participation percentage is also 0%.

Accordingly, Ralph's small business participation percentage in Sign Catcher Pty Ltd is 0%.

Chapter 12

The 15-year exemption

¶12-100 Context

Subject to relevant tests being met, the CGT 15-year small business exemption can apply to a capital gain made by an individual (see ¶12-105), a company or a trust (see ¶12-115).

If the CGT 15-year small business exemption applies, any capital gain that results from the happening of the particular CGT event is disregarded[1] and the other CGT small business reliefs are irrelevant.[2]

In the case of a company or trust, any ordinary or statutory income from the CGT event is also disregarded (see ¶12-120). In addition, distributions by a company or a trust directly or indirectly up to the exempt amount can be tax-free to the recipient(s) in certain circumstances (see ¶12-150).

Retirement

Unless a relevant individual is permanently incapacitated, it is a requirement for the CGT 15-year small business exemption that the CGT event happen in connection with a relevant individual's retirement (see ¶12-105 and ¶12-115). However, this is modified if a deceased's legal personal representative (or other eligible person) is claiming the exemption under the specific deceased estate rule that applies where a CGT event happens within two years of death (see ¶19-105).

Retirement exemption limit unaffected

The operation of the CGT 15-year small business exemption does not affect an individual's retirement exemption limit that applies for the purposes of the CGT small business retirement exemption.

Capital losses not absorbed

The CGT 15-year small business exemption applies by disregarding a capital gain, so that it simply does not enter into the calculation of the net capital gain of the particular entity and does not absorb capital losses or net capital losses.

Capital loss

The 15-year exemption operates to disregard a capital gain, and if the CGT event gives rise to a capital loss and not a capital gain, this is taken into account in accordance with the method statement for the purpose of calculating the net capital gain or net capital loss for the income year in which the CGT event happens.

Superannuation contributions

An individual (including a CGT concession stakeholder) can make non-concessional contributions to a complying superannuation plan (without affecting their non-concessional contributions cap) up to their "CGT cap" where the CGT 15-year small business exemption conditions are met. For more information, see ¶14-150.

1 Ss 152-105 and 152-110 ITAA97.

2 Ss 152-215, 152-330 and 152-430 ITAA97.

¶12-105 Conditions to be met for individuals

Under the CGT 15-year small business exemption, an individual taxpayer can disregard a capital gain arising from a CGT event happening in relation to a CGT asset if:

(1) the basic conditions (see ¶14-100) are met for the CGT small business reliefs to apply to the capital gain, including the active asset test and either the maximum net asset value test or the small business entity requirements;

(2) the taxpayer continuously owned the CGT asset for the 15-year period ending just before the CGT event;

(3) the taxpayer is 55 years of age or over at the time when the CGT event happens; and

(4) the CGT event happens in connection with the taxpayer's retirement (see ¶12-140).[3]

A further condition must be met if the CGT asset is a share in a company or an interest in a trust (see ¶12-110).

Permanent incapacity

If the taxpayer is permanently incapacitated (see ¶12-145) at the time of the CGT event, then (3) and (4) above are not relevant.

Where certain CGT roll-over relief applies

For the purposes of determining whether a CGT asset has been continuously owned by the taxpayer (as required by (2) above), if the taxpayer acquired the asset in circumstances such that CGT involuntary disposal, FSR transition or (subject to a qualification) marriage breakdown roll-over relief has applied, the taxpayer is treated as having acquired the asset at the time when he or she is taken to have acquired the asset as a result of the operation of the particular roll-over relief.[4] The qualification in the case of marriage breakdown roll-over relief is that a choice must have been made for the roll-over relief to apply for the purposes of applying the active asset test (see ¶8-150).

¶12-110 Conditions to be met where CGT asset is share or trust interest

If the CGT asset of an individual taxpayer that has given rise to a capital gain being tested for the CGT 15-year small business exemption is a share in a company or an interest in a trust, the conditions that must be met for the CGT 15-year small business exemption to apply are:

(1) the conditions set out at ¶12-105; and

3 S 152-105 ITAA97.

4 S 152-115 ITAA97.

(2) the company or trust must have had a significant individual for a total of at least 15 years during the period that the individual taxpayer owned the share or trust interest, even if it was not always the same significant individual and even if the 15 years was not continuous.[5]

For a discussion of the significant individual concept, see ¶11-110.

In the case of a non-fixed trust (ie a trust in which entities do not have entitlements to all of the income and capital of the trust), the provisions of s 152-70(4) to (6) ITAA97 apply for the purposes of determining significant individual status for an income year during which the trustee did not make a distribution of either income or capital, provided (broadly) the trust did not have a net tax income or had a tax loss for the income year.[6]

¶12-115 Conditions to be met for companies and trusts

Under the CGT 15-year small business exemption, a company or trust can disregard a capital gain that arises from a CGT event happening in relation to a CGT asset of the company or trust if:

(1) the basic conditions are met for the CGT small business reliefs to apply to the capital gain, including the active asset test and either the maximum net asset value test or the small business entity requirements (see ¶4-100);

(2) the company or trust continuously owned[7] the CGT asset for the 15-year period ending just before the CGT event (take care where assets have been the subject of a CGT roll-over; there is no grandfathering of an acquisition date for the purposes of the CGT 15-year small business exemption);

(3) subject to a special rule noted below that can apply to a non-fixed trust, the company or trust had a significant individual for a total of at least 15 years during the time when the company or trust owned[8] the CGT asset, even if the 15 years was not continuous and even if it was not always the same significant individual; and

(4) an individual who was a significant individual of the company or trust just before the CGT event was 55 years of age or over at that time, and the event happened in connection with the individual's retirement (see ¶12-140).[9]

For a discussion of the significant individual concept, see ¶11-110.

(For determinations on how (2) and (3) above apply in the case of a consolidated group, see TD 2004/44 and TD 2004/45.)

5 S 152-105(c) ITAA97.

6 See ¶11-135 for a discussion of these provisions.

7 A post-CGT change in majority underlying interests in a pre-CGT asset is ignored for this purpose (see ¶12-135).

8 A post-CGT change in majority underlying interests in a pre-CGT asset is ignored for this purpose (see ¶12-135).

9 S 152-110(1) ITAA97.

Permanent incapacity

If an individual who was a significant individual of the company or trust just before the CGT event was permanently incapacitated (see ¶12-145) at that time, then (4) above is not relevant.

More than one significant individual

Where there is more than one significant individual of a company or trust just before the CGT event, it is only necessary that one of the significant individuals satisfy (4) above or be permanently incapacitated.

Non-fixed trust: loss year

In the case of a non-fixed trust (ie a trust in which entities do not have entitlements to all of the income and capital of the trust), the provisions of s 152-70(4) to (6) ITAA97 apply for the purposes of determining significant individual status for an income year during which the trustee did not make a distribution of either income or capital, provided (broadly) the trust did not have a net tax income or had a tax loss for the income year.[10]

Where certain CGT roll-over relief applies

There is a special rule that applies for the purposes of determining whether the company or trust continuously owned the CGT asset (as required by (2) above) or whether the company or trust had a significant individual during the period or periods referred to in (3) above, if the company or trust acquired the asset in circumstances such that CGT involuntary disposal, FSR transition or (subject to a qualification) marriage breakdown roll-over relief has applied. The company or trust is treated as having acquired the asset at the time when the company or trust is taken to have acquired the relevant asset as a result of the operation of the particular roll-over relief.[11] The qualification in the case of marriage breakdown roll-over relief is that a choice must have been made for the roll-over relief to apply for the purposes of the active asset test (see ¶8-150).

¶12-120 Ordinary income and other statutory income of company or trust

If the requirements are met by a company or trust for the CGT 15-year small business exemption to apply, any capital gain made by the company or trust from the happening of the CGT event is disregarded (see ¶12-115). In addition, any ordinary income or statutory income that the company or trust derives from a CGT event that would have given rise to a capital gain that would be disregarded (assuming that the event gave rise to a capital gain even if it did not) is neither assessable income nor exempt income.[12]

10 See ¶11-135 for a discussion of these provisions.

11 S 152-115 ITAA97.

12 S 152-110(2) ITAA97.

The CGT asset may give rise to no capital gain, for example, because the anti-overlap provision[13] has the effect that the ordinary or statutory income reduces any capital gain to nil. However, the treatment of ordinary or statutory income as being neither assessable nor exempt income does not apply to income derived by a company or trust as a result of a balancing adjustment event occurring to a depreciating asset whose decline in value is worked out under Div 40 ITAA97 (capital allowances) or deductions for which are calculated under Div 328 ITAA97 (small business entities).[14]

An example of a situation where the disposal of a CGT asset may give rise to ordinary income from the happening of a CGT event would be where a company or trust ventures land that is a capital asset into a profit-making scheme or undertaking, and the sale of the land gives rise to ordinary income. Even if the land in such a case is a pre-CGT asset (so that any capital gain on its disposal would be disregarded under s 104-10(5) ITAA97) or became trading stock of a business (so that any capital gain would be disregarded under s 118-25 ITAA97), for the purposes of determining whether s 152-110(2) ITAA97 applies, the assumption can be made that the CGT event gave rise to a capital gain (even if it did not).

Where a capital asset becomes trading stock, the effect of s 70-30 ITAA97 is that the landowner is treated as if the land had been sold to someone else and had immediately been bought back. Arguably, this would not interfere with continuity of ownership, having regard to the approach that was adopted in TD 2005/13 (now withdrawn[15]) (see ¶12-135). However, if any ordinary income that would otherwise be derived by the company or trust is not assessable income (because it is disregarded when calculating the taxable income of the trust or company), no general deduction would be allowable for the deemed cost of the trading stock.

¶12-125 Identifying the relevant asset

For the CGT 15-year small business exemption to apply, the CGT asset must have been "continuously owned" by the individual, company or trust for the 15-year period ending just before the CGT event. There are some special rules that can extend the period of ownership of a CGT asset where certain CGT roll-over relief has operated (see ¶12-105 and ¶12-115).

In the case of post-CGT land, the relevant CGT asset will usually be the land (or the taxpayer's legal or equitable interest in the land), regardless of what buildings or other improvements may have been effected to it over the period of ownership. This is because buildings or other improvements will be part of the land according to ordinary real property principles. It is said that this will "usually" be the situation because, in some circumstances, a building, structure or improvement (notably a building, structure or improvement that is depreciable) can be deemed to be a separate CGT asset.[16]

13 S 118-20 ITAA97.

14 S 152-110(3) ITAA97.

15 TD 2005/13 was withdrawn because the issue dealt with in the ruling has been addressed by legislative amendment.

16 Ss 108-55, 108-60 and 108-70 ITAA97.

If pre-CGT land is involved, a building, structure or other improvement that is effected post-CGT may be deemed to be a separate CGT asset and, in that event, there will be two CGT assets to be tested.[17]

In the case of some categories of intangible assets, changes that occur may result in one CGT asset ceasing to exist and a new CGT asset coming into existence. For example, in the case of the goodwill of a business, where there are changes of such a nature that the existing business ceases to be carried on and a new business is commenced, this would mean that the goodwill attached to the new business would be a new CGT asset. That this is more than a theoretical possibility is clearly shown by the observations in the decision of the High Court in *FCT v Murry*[18] in relation to the changing nature of certain hotel businesses. For the Commissioner's views, reference should be made to TR 1999/16.

¶12-130 Interests in CGT asset acquired at different times

If an entity acquires separate interests in the same CGT asset at different times, each interest is considered by the ATO to be a separate CGT asset (see ¶12-105), and the CGT 15-year small business exemption requirements are applied to each interest separately.

The ATO Guide gives the following example (which has been adapted to make it current).

Example

On 1 December 1993, Janet purchased a 40% interest in a 400-hectare parcel of grazing land. On 1 December 2002, she purchased the remaining 60% interest in the land. On 15 December 2015 (Janet's 60th birthday), Janet sold the land and retired.

While Janet owned the 40% interest that she purchased in 1993 for at least 15 years, she owned the 60% interest that she purchased in 2002 for just over 13 years. The two interests are separate CGT assets and, accordingly, the capital gain made on the sale of the 60% interest is not eligible for the CGT 15-year small business exemption (it may be eligible for other CGT concessions).

¶12-135 Change in majority underlying interests

If majority underlying interests have not been maintained post-CGT in a pre-CGT asset owned by a company or trust, the company or trust is taken to have acquired the asset when the majority underlying interests ceased to be maintained.[19]

However, this does not mean that the ownership of the asset by the company or trust for the purposes of applying the conditions that must be met by a company or trust (for the CGT 15-year small business

17 Ss 108-55 and 108-70 ITAA97.

18 [1988] HCA 42.

19 S 149-30 ITAA97.

exemption) ceases and commences again.[20] It is the actual ownership of the asset that is relevant for the purposes of applying the CGT 15-year small business exemption.[21]

¶12-140 "In connection with retirement"

Putting to one side cases of permanent incapacity, the CGT 15-year small business exemption requires that the CGT event giving rise to the particular capital gain must happen "in connection with" the "retirement" of the individual or, in the case of a company or trust, of a significant individual (see ¶12-105 and ¶12-115).

"In connection with"

It has been said that expressions such as "relating to", "in relation to", "in connection with" and "in respect of" invariably raise problems of statutory interpretation. In *Re Nanimo Community Hotel Ltd*,[22] the British Colombia Court of Appeal approved the statement that "the phrase 'having to do with' perhaps gives as good a suggestion of the meaning [of 'in connection with'] as could be had". This meaning has been applied in a number of cases in Australia, including *Claremont Petroleum NL v Cummings*.[23]

Retirement

The meaning of "retirement" in s 152-105 and 152-110 ITAA97 is not subject to any legislative elucidation.

Relevantly, the *Macquarie Dictionary* defines "retirement" as:

> "1. the act of retiring. 2. the state of being retired. 3. removal or retiring from service, office, or business. 4. withdrawal into privacy or seclusion. 5. privacy or seclusion. 6. a private or secluded place"

and "retire" as:

> "1. to withdraw, or go away or apart, to a place of abode, shelter, or seclusion … 3. to withdraw from office, business, or active life: to retire at the age of sixty."

The ATO Guide states that whether a CGT event happens in connection with an individual's retirement depends on the particular circumstances of each case but, to be regarded as a retirement, there would need to be at least a significant reduction in the number of hours the individual works or a significant change in the nature of their present activities. However, it is not necessary for there to be a permanent and everlasting retirement from the workforce.

20 The particular conditions are (2) and (3) set out at ¶12-115.

21 S 152-110(1A) ITAA97.

22 [1945] 3 DLR 225.

23 (1992) 110 ALR 239.

CGT event after retirement

The ATO Guide accepts that the expression "in connection with" can apply where the CGT event occurs some time after retirement.

CGT event before retirement

A CGT event may be "in connection with retirement" even if it occurs at some time before retirement. The following example is given in the ATO Guide:

Example

A small business operator, aged over 55 years, sells some business assets as part of a wind-down in business activity ahead of selling the business. Within six months, she sells the business and ends her present activities. If it can be shown that the earlier CGT event was integral to the business operator's plan to cease her activities and retire, the CGT event may be accepted as happening in connection with retirement.

Further ATO examples

The ATO Guide gives several examples that are intended to provide a guide as to the likely scope of the expression "in connection with retirement". The following example is given where the CGT event would be in connection with retirement:

Example

A small business operator, aged over 55 years, sells his business. Under the terms of the sale, he agrees to be employed by the new owner for a few hours each week for two years. The sale of the business would be in connection with the small business operator's retirement. He has permanently or indefinitely ceased being self-employed and has commenced gainful employment on a much-reduced scale with another party, although still performing similar activities.

On the other hand, the following example is given in the ATO Guide to indicate where the CGT event would not be "in connection with retirement":

Example

A small business operator and spouse are both pharmacists, are both aged over 55 years and carry on business through two pharmacies. They sell one pharmacy (and make a capital gain) and, accordingly, reduce their working hours from 60 hours a week each to 45 and 35 hours a week, respectively. Although there has been some change to their present activities in terms of hours worked and location, there has not been a significant reduction in the number of hours or a significant change in the nature of their activities, and therefore there has been no "retirement".

If, on the other hand, one spouse reduced their hours to nil and stopped working, there would be a significant reduction in the number of hours (ie to nil) that the spouse worked in the business activities. The sale would be in connection with the retirement of that spouse.

¶12-145 Permanent incapacity

If an individual taxpayer or, in the case of a company or trust, a significant individual was permanently incapacitated at the time of the relevant CGT event, there is no age requirement and no requirement to retire for the CGT 15-year small business exemption to apply (see ¶12-105 and ¶12-115).

There is no statutory definition relevant to the concept of an individual being "permanently incapacitated" for the purposes of the CGT 15-year small business exemption. Accordingly, the concept takes its ordinary meaning, subject to any modification of that meaning required by the particular context. Obviously, whether an individual is permanently incapacitated at the time of the CGT event will depend on the particular circumstances of each case.

When considering the ordinary meaning of "permanently incapacitated" in the context of the *Migration Regulations 1994*, Merkel J in *Nguyen v Minister for Immigration & Multicultural Affairs*,[24] relying on the *Macquarie Dictionary*, took "permanent" to mean "indefinite or not temporary".

The ATO Guide states that an indicative description of the term "permanent incapacity" is ill health (whether physical or mental), where it is reasonable to consider that the person is unlikely, because of the ill health, to engage again in gainful employment for which the person is reasonably qualified by education, training or experience. The incapacity does not necessarily need to be permanent in the sense of everlasting.

The following examples are given in the ATO Guide to provide an indication of the ATO's view of the meaning of permanently incapacitated for the purposes of the CGT 15-year small business exemption.

24 (1998) 158 ALR 639.

Example 1

Jack had been carrying on a business for many years. Unfortunately, he developed severe health problems, and his health continued to deteriorate to the point where he was incapable of operating the business and, as a result, he sold the business.

At the time when the business was sold, Jack's doctor provided a written statement that Jack suffered from ill health to the extent that he was unlikely to be able to engage again in gainful employment for which he was reasonably qualified. Jack was under 55 years of age when he sold the business.

Having regard to all of the circumstances, Jack would be considered to be permanently incapacitated at the time when the business was sold. As a result, he may qualify for the CGT 15-year small business exemption if he satisfies the other conditions.

Example 2

Fred had been carrying on a landscape gardening business for over 20 years. One day, Fred fell out of a tree and badly broke both arms and a leg. He was essentially confined to bed in hospital for several weeks and then at home for several more weeks. The doctor said his recovery would take quite some time. Fred underwent extensive physiotherapy for several months, and it was nearly a year before he regained full use of his arms and legs and was able to undertake normal activities again. During this time, as Fred could not operate the business effectively, he sold the business. Fred was under 55 years of age at the time of the sale.

Although Fred suffered a serious injury which required an extensive period of rehabilitation, he was always expected to regain his physical capabilities. Having regard to all of the circumstances, it could not be said that Fred was permanently incapacitated when he sold the business and this would mean that the CGT 15-year exemption would not be available.

Example 3

Reg had been carrying on a business for many years. He suffered a severe stroke that left him paralysed down one side of his body and confined to a wheelchair. Because of the extent of the damage, the doctors thought it was unlikely that Reg would regain much movement in his affected limbs. As Reg was incapable of operating the business, he sold the business. Reg was under 55 years of age at the time of the sale.

Notwithstanding the bleak outlook, Reg and his family were determined that he recover and, accordingly, Reg underwent an extensive program of physiotherapy and exercises over an extended period. Remarkably, after 18 months, Reg had surpassed all expectations and had regained most bodily movements.

Even allowing for this remarkable recovery, at the time when Reg sold the business, the prevailing medical opinion was that he was unlikely to be able to engage again in gainful employment for which he was reasonably qualified. Considering all of the circumstances, Reg would be considered to be permanently incapacitated at the time the business was sold. As a result, he may qualify for the CGT 15-year small business exemption if he satisfies the other conditions.

¶12-150 Companies and trusts: flow-through of concession to CGT concession stakeholders

If the CGT 15-year small business exemption applies to a company or trust, this will mean that:

- a capital gain of the company or trust is disregarded (see ¶12-115); and/or
- an amount of ordinary income or statutory income of the company or trust is neither assessable income nor exempt income (see ¶12-120).

In addition, there is a provision that permits these benefits to flow through, subject to limitations, to an individual who was a CGT concession stakeholder (see ¶11-115) of the company or trust just before the CGT event. This flow-through concession also applies to a capital gain that is made in relation to a pre-CGT asset that would have been disregarded had the relevant CGT asset been acquired post-CGT. The operation of the flow-through concession is explained at ¶12-155 to ¶12-180.

In practical terms, a company or trust can have up to eight recipient CGT concession stakeholders (ie four significant individuals and their spouses, provided the spouses satisfy the CGT concession stakeholder definition) who can benefit from the flow-through concession (see ¶11-115).

The flow-through concession would not seem to have any practical consequences where the entity that makes the capital gain is either a discretionary trust or a trust that is constituted with interests to which CGT event E4 can apply, and the distribution is made directly to a beneficiary. For the position with regard to discretionary trusts, see ¶12-162, and for other trusts, see ¶12-165.

¶12-155 Amounts that can qualify for flow-through concession

The flow-through concession under the CGT 15-year small business exemption can apply if:

(1) under s 152-110 ITAA97, a capital gain of a company or trust is disregarded (see ¶12-115);

(2) under s 152-110 ITAA97, an amount of income is treated as non-assessable non-exempt income of a company or trust (see ¶12-120); or

(3) (1) above would have applied to an amount except that the capital gain was disregarded anyway because the relevant CGT asset was acquired pre-CGT.[25]

There is a special provision that applies to determine the amount that qualifies for the flow-through concession where Div 149 ITAA97 has applied in relation to the asset (see below).

Exempt amount

The amount of a capital gain referred to in (1) above, the amount of income referred to in (2) above and the amount referred to in (3) above are called the "exempt amount".

25 S 152-125(1) ITAA97.

Change in underlying interests in pre-CGT asset

Where Div 149 ITAA97 (majority underlying interests not maintained) has operated to convert a pre-CGT asset of a company or trust into a post-CGT asset, the flow-through concession extends to the pre-CGT capital gain that existed in relation to the asset before the operation of Div 149 ITAA97.[26] The amount of the pre-CGT capital gain is an "exempt amount". This means, in effect, that the asset retains its original cost base and time of acquisition for the purpose of the flow-through concession, and the total capital gain (ie the pre-CGT capital gain and the post-CGT capital gain) is treated as a post-CGT capital gain when applying the concession.

¶12-160 How flow-through concession works

Section 152-125 ITAA97 applies where the company or trust makes one or more payments (whether directly or indirectly through one or more interposed entities) in relation to an "exempt amount" (see ¶12-155) within two years (or a longer period allowed by the Commissioner) after the relevant CGT event to an individual who was a CGT concession stakeholder of the company or trust just before the event.[27] For the definition of a CGT concession stakeholder, see ¶11-115.

If the section applies, when determining the taxable income of the company, the trust, the individual or any of the interposed entities, the total amount of the payment or payments made to the CGT concession stakeholder are disregarded up to the following limit:[28]

$$\text{Stakeholder's participation percentage} \times \text{Exempt amount}$$

For this purpose, a stakeholder's participation percentage is calculated as follows:

- in the case of a company or a trust where entities have entitlements to all of the income and capital of the trust – the stakeholder's small business participation percentage (see ¶11-120) in the company or trust just before the relevant CGT event; or
- in the case of any other trust – the amount (expressed as a percentage) worked out using the following formula:

$$\frac{100}{\text{Number of CGT concession stakeholders of the trust just before the CGT event}}$$

Note that, as part of the introduction of the statutory CGT rules relating to look-through earnout rights, s 152-125(1) ITAA97 was amended to extend the two-year payment period until two years after

26 S 152-125(1)(a)(iv) ITAA97. This provision applies to payments made by a company or trust on or after 18 September 2009.

27 S 152-125(1)(b) and (4) ITAA97.

28 S 152-125(2) ITAA97.

the final potential financial benefit under a look-through earnout right is concluded. For further details of the statutory CGT rules relating to look-through earnout rights, see ¶3-110.

In addition, if a company makes the payment, the ITAA36 and ITAA97 apply to the payment, to the extent that it is less than or equal to the limit set out above, as if:

(1) it were not a dividend; and

(2) it were not a frankable distribution.[29]

Payment

There must be a payment for s 152-125 ITAA97 to apply and, therefore, journal entries alone will not suffice.[30]

In *Brookton Co-operative Society Limited v FCT*,[31] Mason J said (in the context of what may constitute the payment of a dividend):

> "Payment of a dividend may occur in a variety of ways not involving payment in cash or by bill of exchange, as, for example, by an agreed set-off, account stated or an agreement which acknowledges that the amount of the dividend is to be lent by the shareholder to the company and is to be repaid to the shareholder in accordance with the terms of that agreement. It is, however, well settled that the making of a mere entry in the books of a company without the assent of the shareholder does not establish a payment to the shareholder."

To be effective, a payment should be made under the authority and in accordance with the terms of the relevant constituent document; that is, in the case of a company, its constitution and, in the case of a trust, the trust deed or other instrument that established the trust. In addition, it is suggested that it would be advisable (in order to ensure that it could be said that a particular payment is made "in relation to the exempt amount") that the accounts of the company or trust be kept in such a way that, by appropriate resolution and accounting procedures, the payment can be sourced to the exempt amount. If a payment is made by a company or trust that is ultra vires the terms of the relevant constituent document, a range of issues would potentially arise, including whether the amount would in any event be included in the recipient's assessable income.

The payment, however, can be made directly or indirectly through one or more interposed entities. For a discussion of indirect payments, see ¶12-170.

29 S 152-125(3) ITAA97.

30 *Temples Wholesale Flower Supplies Pty Ltd v FCT* 91 ATC 4387.

31 [1981] HCA 28.

¶12-162 Where distribution is made by a discretionary trust

Where a capital gain made by a discretionary trust qualifies for the CGT 15-year small business concession, it would seem that any distributions out of the capital gain to beneficiaries would be tax-free in their hands. This would be so whether or not they were CGT concession stakeholders immediately before the CGT event, and also whether the distribution is made within two years after the CGT event.

The amount of a capital gain disregarded under the CGT 15-year small business concession would simply not enter into the calculation of the net tax income of the trust under s 95 ITAA36, so it could not be assessable on that basis under Div 6 ITAA36. Nor, of course, could such an amount be within the CGT provisions relating to trusts. There does not appear to be any other provision which could make a distribution out of the amount disregarded assessable to a beneficiary.

An example in the explanatory memorandum to the New Business Tax System (Capital Gains Tax) Bill 1999 (which contained the original version of the flow-through concession)[32] indicates that beneficiaries of a discretionary trust would, apart from the flow-through concession, be assessable on a distribution out of a capital gain that is an exempt amount. This example in this respect, it is considered, is wrong.

There could be some scope for the operation of the flow-through concession where a distribution by a discretionary trust is made indirectly to a CGT concession stakeholder (for example, through an interposed company).

¶12-165 CGT events E4 and G1

In the case of a unit or fixed trust, s 104-71(1)(g) ITAA97 provides that an exempt amount (see ¶12-155) is excluded from the "non-assessable part" of a payment by the trustee for the purposes of applying CGT event E4 (see ¶17-115). It should be noted that this exclusion, for the purposes of CGT event E4, appears to extend beyond payments that would fall within the flow-through concession and to be capable of applying regardless of when the payment is made and whether the recipient was a CGT concession stakeholder or not just before the CGT event. The Commissioner's views on this issue are not known.

In the case of a company, an exempt amount for the purposes of s 152-125 ITAA97 is excluded from the non-assessable part for the purposes of CGT event G1.[33]

32 See example 1.8. This issue was raised in C Smailes and A Krawitz, "Small business CGT concessions: some traps, twists, and tips", paper presented at the Taxation Institute of Australia's 2010 WA State Convention, Busselton, WA, August 2010.

33 S 104-135(1A)(c) ITAA97.

¶12-170 Indirect payments

As pointed out at ¶12-160, a payment may fall within the exclusion from taxable income provided for by s 152-125 ITAA97, even if it is made indirectly. The crucial words in this regard are "the company or trust makes one or more payments (whether directly or indirectly through one or more interposed entities)".

In the minutes of the NTLG CGT Subcommittee meeting of 7 June 2000, it is stated that the ATO view is that permitting indirect payments to be taken into account could provide flexibility in the following kinds of cases:

- where a trust and a company have common ownership by the same individual, the trust owns the assets (and claims the CGT 15-year small business exemption) and the company carries on the business – if the trust distributed to the individual via the company, the provision would be flexible enough to allow for this; and
- in between the time that the capital gain is disregarded and the time that the distribution is made, an entity is interposed between the entity claiming the CGT 15-year small business exemption and the individual.

The fact that indirect payments can be relevant when applying the flow-through concession will be particularly relevant where an individual's status as a CGT concession stakeholder is wholly or partly indirect (see ¶11-100).

However, it is a requirement that "the company or trust [ie that made the capital gain] makes" the payment, even if indirect. It is submitted this means that if a payment by an interposed entity is dependent on the exercise of a discretion conferred by the constituent document of the interposed entity, the flow-through concession could not apply unless the company or the trustee that made the capital gain exercised, or controlled the exercise of, the discretion.

¶12-175 What payments can qualify?

Under s 152-125 ITAA97, for a payment to fall within the flow-through concession, the company or trust must make the payment "relating to the exempt amount".[34]

The explanatory memorandum to the amending Bill that became the *Tax Laws Amendment (2006 Measures No. 7) Act 2007* states:

> "A payment relates to the exempt amount to the extent that it represents a distribution of the capital gain. It is not intended that other payments, such as salary, fringe benefits, repayments of loans, dividends or eligible termination payments, should have different consequences for CGT concession stakeholders than they otherwise would."

The relevant provisions as originally enacted simply referred to "any payment" that the company or trust made within the two-year period after the CGT event. There was nothing expressly provided for

34 S 152-125(1)(b) ITAA97.

in the originally enacted provisions that required the payment to be of any particular kind or be related to the exempt amount. The requirement in the present s 152-125 ITAA97 that the payment be made "relating to" the exempt amount is intended to remedy this deficiency.

Notwithstanding the comment in the explanatory memorandum quoted above (which indicates that the payment of a dividend would not be relevant), a payment by a company that falls within the flow-through concession is, in fact, likely to be a dividend within the definition of that term in s 6(1) ITAA36. However, in that event, the payment would not only be disregarded when calculating the individual's taxable income; it would be treated as being neither a dividend nor a frankable distribution and, accordingly, could not carry an imputation credit.[35]

¶12-180 Prudent to pay early

Although there is a two-year period (measured from the happening of the particular CGT event) within which a distribution may be made by a company or trust and fall within the flow-through concession in s 152-125 ITAA97 (see ¶12-160), it would be prudent to ensure that the payment is made as soon as possible and in such a way as to maximise the benefit of the concession.

There may, for example, be circumstances in which the benefit of the concession could be lost due to a delay in making a payment. For example, if a CGT concession stakeholder were to die (so that his or her share or trust interest were to pass to his or her legal personal representative or a beneficiary of his or her estate), the flow-through concession provided by s 152-125 ITAA97 could not apply in relation to that CGT concession stakeholder, and the benefit of the flow-through concession on that part of the exempt amount would be lost. This is because the concession requires, in all cases, an identity between the person who was a CGT concession stakeholder in the company or trust just before the CGT event and the person who is the (direct or indirect) recipient of the payment made by the company or trust.

¶12-185 Case studies

Case study 1

Crop Plus Pty Ltd was incorporated in 1980. In 1981, the company acquired a farming property on which it carried on a wheat farm. The issued shares in Crop Plus Pty Ltd (when it was incorporated) were all of one class and were beneficially held as to 50% by Mark and as to 50% by his spouse (Maude). In 1998, the issued shares were split and Mark and Maude each sold 49% of their shares to their two children (Agnes and Barry), so that the shares in Crop Plus Pty Ltd were then beneficially held as to 25.5% by each of Mark and Maude and as to 24.5% by each of Agnes and Barry.

Crop Plus Pty Ltd sold the property in November 2014 and made a capital gain of $4m. It is assumed that the conditions for the CGT 15-year small business exemption to apply are all met by Crop Plus Pty Ltd. The company is wound up in September 2015. For the sake of simplicity, it is assumed that the

35 S 152-125(3) ITAA97. See ¶12-160.

liquidator makes a distribution (out of the exempt capital gain) of $1m to each shareholder in the course of the winding up, sourced to the capital gain from the sale of the farming property.

CGT event C2 would happen for each shareholder, but any capital gain made by Mark and Maude would be disregarded (because their shares are pre-CGT assets in any event).

So far as Agnes and Barry are concerned, they would both be CGT concession stakeholders. Because the capital gain made by Crop Plus Pty Ltd would have been disregarded anyway if the farming property had been a post-CGT asset, the capital gains made by Agnes and Barry as a result of the happening of CGT event C2 on the liquidation of the company would be disregarded, provided the distribution was made within two years of CGT event A1 happening in relation to the farming property (or a longer period permitted by the Commissioner).

Case study 2

Supa Stick Pty Ltd commenced a business of importing and wholesaling high-grade glues and other adhesives in 1996. At its incorporation, the shares in the company (all of one class) were beneficially held by Michael (60%), his spouse (Patricia) (20%) and their two children (Richard and Anna) (10% each).

Patricia died in May 2009 and her shares passed under her will equally between Anna's spouse (Timothy) and Richard. This means that the shares in Supa Stick Pty Ltd were then beneficially held by Michael (60%), Richard (20%), Anna (10%) and Timothy (10%).

During 2015, at the age of 62 years, Michael wishes to retire and the company sells the business. A capital gain of $1.5m is realised.

The company will be able to claim the CGT 15-year small business exemption, as the sale of the business is in connection with Michael's retirement and Supa Stick Pty Ltd had a significant individual (Michael) for at least 15 years. The flow-through concessions can benefit both Michael and Richard, but not Anna or Timothy. In addition, Anna and Timothy cannot claim the CGT small business reliefs in relation to a capital gain that may arise on a disposal of their shares or on a liquidation of the company.

Chapter 13

Small business 50% reduction

¶13-100 The reduction

If the basic conditions for the CGT small business reliefs are met in relation to a capital gain (see ¶4-100), and the 15-year exemption (see ¶12-100) does not apply:

- the capital gain will be reduced by 50% under the CGT small business reduction, unless the taxpayer chooses not to apply it (see ¶13-110); and
- the capital gain as reduced by the CGT small business 50% reduction (or the capital gain if the choice is made for the reduction not to apply) may qualify for the CGT small business retirement exemption (see ¶14-100) or CGT small business roll-over relief (see ¶15-100), or partly for one concession and partly for the other.[1]

The CGT small business 50% reduction can be claimed by all categories of taxpayers (ie individuals, companies and trusts).

¶13-105 Other concessions and capital losses

If the capital gain that potentially qualifies for the CGT small business 50% reduction is made by an individual or trust, and the capital gain is a discount capital gain, the CGT discount capital gain concession is applied first.[2]

Before any concession (other than the CGT 15-year small business exemption) is applied, any capital loss(es) of the current income year and any net capital loss(es) carried forward are offset. The taxpayer, however, can choose the order in which any capital loss(es) and net capital loss(es) are to be applied, so as to maximise the benefit of the CGT concessions. See further ¶2-130.

¶13-110 The reduction is optional

Even if the CGT small business 50% reduction is potentially available to a taxpayer, it is open to the taxpayer to choose not to apply the reduction.[3]

The choice applies in relation to the whole amount of a capital gain that potentially qualifies for the CGT small business 50% reduction; that is, it is not possible to choose to forgo the CGT small business 50% reduction in respect of part of the capital gain.

In the case of an individual or a discretionary trust, this choice would not usually be of much practical relevance. This is because, if a capital gain that qualifies for the CGT small business reliefs is made by an individual or a discretionary trust, the benefit of the CGT small business 50% reduction can simply be claimed without giving rise to any tax detriment to an individual or, in the case of a discretionary

1 Ss 152-205 to 152-220 ITAA97. If the 15-year exemption applies, this takes precedence (s 152-215 ITAA97).

2 S 102-5 ITAA97.

3 S 152-220 ITAA97.

trust, can be claimed by the trust and effectively passed on to individual beneficiaries without any tax consequences.

However, if a capital gain that qualifies for the CGT small business 50% reduction is made by a company or by a trust (including a unit trust with discretionary units on issue) in which the beneficiaries have interests that are CGT assets (typically units), there are problems in extracting the amount of the capital gain disregarded by the application of the CGT small business 50% reduction out of the company or trust in a tax-effective manner. The position is set out in the table at ¶13-125.

The better course in some circumstances would be for the company or trust to choose not to apply the CGT small business 50% reduction, and to take CGT small business retirement relief (if that relief were otherwise available).

¶13-115 Making the choice

The choice not to apply the CGT small business 50% reduction must be made by the day on which the taxpayer lodges the income tax return for the income year in which the relevant CGT event happened, or within a further period of time allowed by the Commissioner. For a discussion of the making of CGT choices, see ¶2-135.

¶13-120 Trustee: concession reversed

A trustee that is assessable on the net income or some part of the net income under s 99A ITAA36 (ie where a beneficiary is not presently entitled) is ineligible for the CGT small business 50% reduction.[4] See further ¶17-125.

The benefit of the CGT small business 50% reduction is not affected if the trust is of a kind that can be assessed under s 99 ITAA36 (eg a trust created by will), and the Commissioner exercises his discretion to assess the trustee under that section.

¶13-125 Obtaining benefit of reduction amount

If an individual, whether a sole trader or a partner, claims the CGT small business 50% reduction, the benefit of the amount by which the capital gain is reduced (which may for convenience be called the reduction amount) is, of course, simply enjoyed tax-free by the individual.

If, however, a company or a trust claims the CGT small business 50% reduction, there are a number of issues that will need to be considered in relation to the position of a shareholder or a beneficiary.

In the case of a company taxpayer, if the reduction amount is distributed before the company goes into liquidation, the distribution would either be a dividend that was a frankable distribution[2] or, if not, a potential deemed assessable dividend under Div 7A ITAA36.

4 S 115-225 ITAA97.

If the reduction amount is distributed in the liquidation of the company, either the distribution will be capital proceeds for the happening of CGT event C2 in relation to the shares[3] or CGT event G1 may happen, with the distribution reducing the cost base and reduced cost base of the shares, and potentially giving rise to a capital gain if the shares are post-CGT assets. See further ¶16-100.

In the case of a capital gain made by a trust, there are a number of issues that may arise depending on the circumstances, including whether the capital gain was reduced to nil and, if not, whether any beneficiaries are specifically entitled to the capital gain. Importantly, different considerations will apply depending on whether the trust is a unit trust or a discretionary trust. For further discussion, see ¶17-100.

As pointed out at ¶13-110, a choice can be made for the CGT small business 50% reduction not to apply.

Chapter 14

Retirement exemption

¶14-100 Context

If the basic conditions for CGT small business relief (see ¶4-100) are met in relation to a capital gain and the CGT 15-year small business exemption does not apply, so much of the capital gain as is not disregarded by the CGT small business 50% reduction is potentially eligible for the CGT small business retirement exemption or CGT small business roll-over relief.[1]

A taxpayer can choose not to apply the CGT small business reduction.[2] The making of such a choice would mean that the CGT small business retirement exemption or CGT small business roll-over relief (or partly one and partly the other concession) would be potentially available in respect of the whole amount of the capital gain that qualifies for the CGT small business reliefs.

Where CGT small business roll-over relief has been chosen, a capital gain that subsequently arises from the happening of CGT event J2, J5 or J6 cannot qualify for the CGT small business 50% reduction, but it may be eligible for the CGT small business retirement exemption or, in the case of a CGT event J2 capital gain, CGT small business roll-over relief (see ¶15-155).

If a capital gain (or part of a capital gain) potentially qualifies for both the CGT small business retirement exemption and CGT small business roll-over relief, the taxpayer may choose the order in which to apply them.[3]

Retirement not necessary

Although the title to Subdiv 152-D ITAA97 is “Small business retirement exemption” and the guide to the Subdivision[4] refers to the capital proceeds from a CGT event being “used in connection with your retirement”, this is somewhat misleading because there is, in fact, no need for an individual to retire for the exemption to be accessed by an individual, company or trust. There is, however, a requirement to make a contribution to a complying superannuation fund or a retirement savings account (RSA) if the relevant individual is under 55 years of age (see ¶14-145 and ¶14-180).

Individual

Broadly, if the taxpayer is an individual, the amount chosen for the CGT small business retirement exemption (called the CGT exempt amount) cannot exceed the taxpayer’s CGT retirement exemption limit and, if the taxpayer is under 55 years of age, must be contributed to a complying superannuation fund or an RSA (see ¶14-120).

1 S 152-210 ITAA97.

2 S 152-220 ITAA97. See ¶13-110.

3 S 152-210(2) ITAA97.

4 S 152-300 ITAA97.

Company or trust

Where a company or trust is claiming the CGT small business retirement exemption, the company or trust must make a payment (which may be made directly or indirectly) to one or more CGT concession stakeholders (up to but not exceeding a concession stakeholder's retirement exemption limit) (see ¶14-155).

If the CGT concession stakeholder is under 55 years of age, the payment must be made by contributing it to a complying superannuation fund or an RSA.

Choice cannot be altered

Once a choice is made in respect of a capital gain (or part of a capital gain) for the CGT small business retirement exemption and/or small business roll-over relief to apply, the choice cannot be altered.[5]

¶14-110 Actual capital proceeds not required

As the CGT small business retirement exemption provisions were originally enacted, the retirement exemption was only available if actual (ie not deemed) capital proceeds (at least equal to the amount of the capital gain for which the CGT small business retirement exemption was chosen) were received for the CGT event happening.[6] This followed from express provisions to the effect that the capital proceeds from a CGT event were to be worked out disregarding the market value substitution rule.[7]

If the relevant CGT event was CGT event J2, the ATO view was that the requirement for actual capital proceeds would be met if there were actual capital proceeds for the capital gain that was rolled over and in respect of which CGT event J2 happened.[8]

As a result of amendments made by the *Tax Laws Amendment (2006 Measures No. 7) Act 2007* (which apply to CGT events that happen in the 2006-07 or a later income year), the fact that no capital proceeds are received from the happening of a relevant CGT event will not prevent the CGT small business retirement exemption from being potentially available. See also the discussion under the heading "Market value substitution rule" at ¶14-180.

It may be noted that, if CGT event J2 were to happen in the 2006-07 or a later income year in relation to a capital gain that was made in an earlier income year and had been rolled over under CGT small business roll-over relief, it would seem to be arguable that the fact that there were no actual capital proceeds for the CGT event in the earlier income year would not matter. This is because the amendments made by the *Tax Laws Amendment (2006 Measures No. 7) Act 2007* apply to CGT events that happen in the 2006-07 or a later income year.

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5 ID 2003/103.

6 TD 2006/69 (withdrawn following the amendments explained below).

7 Former ss 152-310(3) and 152-325(4) ITAA97.

8 TD 2006/69 (withdrawn following the amendments noted in the text).

¶14-115 Retirement exemption and CGT events J2, J5 and J6

If CGT small business roll-over relief is claimed in respect of a capital gain, there are CGT events that can happen that (in effect) cause the capital gain to arise again in a later income year. These are CGT event J2 (change in relation to a replacement or improved asset (see ¶15-145)), CGT event J5 (failure to acquire replacement asset and to incur fourth element expenditure (see ¶15-130)) and CGT event J6 (cost of acquisition of replacement asset or amount of fourth element expenditure not sufficient to cover disregarded capital gain (see ¶15-140)).

The effect of s 152-305(4) ITAA97 is that satisfaction of the basic conditions for CGT small business relief is not necessary to claim the CGT small business retirement exemption in respect of a capital gain that arises from the happening of either CGT event J5 or J6. As none of the basic conditions need to be satisfied, it is not necessary, for example, for the taxpayer to satisfy the maximum net asset value test or the small business entity conditions where the capital gain arises from the happening of either CGT event J5 or J6.

It should be noted that there are some CGT small business retirement exemption provisions that should be amended to fully reflect this position. Thus, s 152-310 ITAA97, which sets out the consequences of a choice being made for the CGT small business retirement exemption to apply, provides (in subsec (1)) that, if the choice is made for any part of the capital gain "from the CGT asset", that part of the capital gain equal to its CGT exempt amount is disregarded (see ¶14-140 and ¶14-160). Further, s 152-315 ITAA97, which provides for the choosing of the amount to be disregarded, provides (in subsec (3)) that the amount chosen "for the asset" is its CGT exempt amount (see ¶14-130). The definition of "CGT retirement exemption limit" suffers from a similar drafting deficiency (see ¶14-135).

¶14-120 How CGT small business retirement exemption operates for individuals

The following charts set out how the CGT small business retirement exemption currently operates in the case of an individual taxpayer. It is necessary to consider separately the operation of the CGT small business retirement exemption where the relevant capital gain is made from the happening of a CGT event other than CGT event J5 or J6 (see Chart 1) and where the relevant capital gain is made from the happening of either of those events (see Chart 2).

Chart 1: CGT events other than CGT event J5 or J6

Are the basic conditions met for the CGT small business reliefs to apply (¶4-100)?

No → The CGT small business reliefs are not relevant.

Yes ↓

Is the CGT 15-year small business exemption applicable (¶12-100)?

Yes → No other CGT small business reliefs are relevant.

No ↓

Determine whether a choice should be made for the CGT small business 50% reduction not to apply (¶13-110).

↓

Determine what amount (if any) of the remaining capital gain should be chosen for retirement relief. The amount chosen is disregarded (¶14-125).

1. The amount chosen for retirement relief cannot exceed the individual's CGT retirement exemption limit and is called the CGT exempt amount (¶14-125).
2. The CGT exempt amount must be specified in writing (¶14-130).

↓

Is the taxpayer under 55 years of age just before the choice for retirement relief is made?

No ↓

The amount is tax-free and there is no requirement to contribute to a complying superannuation fund or an RSA.

Yes ↓

An amount equal to the CGT exempt amount must be contributed to a complying superannuation fund or an RSA (¶14-145).

Chart 2: CGT events J5 or J6

Where a capital gain is made from the happening of either CGT event J5 or J6, the basic conditions for CGT small business relief apply do not need to be satisfied, and no other CGT small business reliefs (other than the retirement exemption) are available.

Did the capital gain arise from the happening of CGT event J5 (¶15-130) or J6 (¶15-140)?

If yes, only the CGT small business retirement exemption is available.

Yes

Determine what amount (if any) of the capital gain should be chosen for retirement relief. The amount chosen is disregarded (¶14-125).

1. The amount chosen for retirement relief cannot exceed the individual's CGT retirement exemption limit and is called the CGT exempt amount (¶14-125).
2. The CGT exempt amount must be specified in writing (¶14-130).

Is the taxpayer under 55 years of age just before the choice for retirement relief is made?

No

The amount is tax-free and there is no requirement to contribute to a complying superannuation fund or an RSA.

Yes

An amount equal to the CGT exempt amount must be contributed to a complying superannuation fund or an RSA (¶14-145).

¶14-125 When individual taxpayer may choose retirement exemption

Under the CGT small business retirement exemption, an individual may choose to disregard all or part of a capital gain if the basic conditions for CGT small business relief are satisfied for the gain (see ¶4-100).[9] This is subject to the qualification that where the capital gain results from the happening of either CGT event J5 or J6, the basic conditions for CGT small business relief to apply do not need to be satisfied.[10]

Amount available for retirement relief

Putting to one side a capital gain that is made from the happening of either CGT event J5 or J6, the amount of the capital gain for which CGT small business retirement relief may be chosen will depend on how the taxpayer applies the other CGT small business reliefs. For example, if the taxpayer were

9 S 152-305(1)(a) ITAA97.

10 S 152-305(4) ITAA97.

to make a choice to not apply the CGT small business 50% reduction (which would be unusual if the taxpayer is an individual), potentially the whole of the amount of the capital gain eligible for CGT small business relief could be chosen for retirement relief (subject to the taxpayer's retirement exemption limit); that is, if no choice is made for CGT small business roll-over relief.

In the case of a capital gain that is made from the happening of either CGT event J5 or J6, no other CGT small business reliefs are available. This means that the whole of the capital gain is potentially available for retirement relief, subject to the particular individual's CGT retirement exemption limit.

Limitation on amount

The amount of a capital gain chosen by an individual taxpayer for the CGT small business retirement exemption is called the asset's "CGT exempt amount", and the choice must be made in such a way that the individual's CGT retirement exemption limit (see ¶14-135) is not exceeded.[11]

Taxpayer under 55 years of age

If the taxpayer is under 55 years of age just before the choice is made for CGT small business retirement relief, an amount equal to the asset's CGT exempt amount must be contributed to a complying superannuation fund or an RSA (see ¶14-145).

There is no requirement for the individual to retire or terminate any activity that he or she is carrying on.

Taxpayer 55 years of age or more

If the individual is at least 55 years of age just before the choice is made for CGT small business retirement relief, to the extent to which the retirement exemption is chosen in respect of a capital gain, it can be taken directly by the taxpayer.

Making the choice

The timing of the making of a choice for CGT small business retirement relief in relation to a capital gain is governed by the general CGT choice-making rules in s 103-25 ITAA97, which are discussed at ¶2-135. For more information, see ¶14-130.

Consequences of choice

For the consequences of making a choice for the CGT small business retirement exemption, see ¶14-140.

11 S 152-315(2) ITAA97.

¶14-130 Specifying amount chosen (CGT exempt amount)

The amount chosen by an individual taxpayer for CGT small business retirement exemption must not result in the individual's CGT retirement exemption being exceeded (see ¶14-135). The amount chosen (called the asset's "CGT exempt amount") must be specified in writing.[12]

Section 152-315(3) ITAA97 refers to "the amount chosen [under the CGT small business retirement exemption] for the asset". This reflects the basic condition that a CGT event happen in relation to a CGT asset for CGT small business relief to be available (see ¶5-100). However, as explained at ¶14-115, the basic conditions for CGT small business relief do not need to be satisfied where the capital gain is made from the happening of either CGT event J5 or J6.

Because the CGT exempt amount is the amount chosen for the CGT small business retirement exemption and must be specified in writing, the choice and the written specification of the CGT exempt amount would be made in the same document.

Precedent choice and specification

The following is a precedent choice for the CGT small business retirement exemption to apply, and specification of a CGT exempt amount:

Choice and Specification of CGT Exempt Amount
Subdivision 152-D of the Income Tax Assessment Act 1997 ("the Act")

This choice and specification relates to the following:

1. CGT asset involved: #*
2. CGT event: #
3. Time of CGT event: #
4. Capital gain: $#
5. Amount of capital gain to which Subdivision 152-D of the Act applies: $#

I hereby choose to apply Subdivision 152-D of the Act in relation to the capital gain and specify $# as being the CGT exempt amount for the purposes of the Subdivision.

Dated the   day of   20##

....
[full name]

Tax File No.: #

* It will not be possible to specify a CGT asset where the CGT event that has given rise to the capital gain is either CGT event J5 or J6. It is suggested that, in the case of such a capital gain, this item be omitted, the remaining items be renumbered, and what becomes 1 (after the renumbering) be altered to read: CGT event: CGT event J[5 or 6] which happened in respect of small business roll-over that was chosen in relation to [description if asset].

12 S 152-315(3) and (4) ITAA97.

¶14-135 CGT retirement exemption limit

An individual's CGT retirement exemption limit at a particular time is $500,000, reduced by the CGT exempt amounts of CGT assets specified in choices previously made by or for the individual under the CGT small business retirement exemption.[13] The reference to a choice made previously "for" the individual would cover choices made by a company or trust in relation to the individual. If a company or trust has more than one CGT concession stakeholder, what is relevant to be taken into account in relation to a stakeholder is the percentage of the CGT exempt amount specified for the stakeholder.[14]

Note that an individual's CGT retirement exemption limit is reduced by the CGT exempt amounts "of CGT assets" that have been previously specified. This creates some difficulties where the CGT small business retirement exemption has been chosen in respect of a capital gain that is made from the happening of CGT event J5 or J6 as there is no CGT asset involved in the happening of these events.

It is important to note that, under transitional provisions, if an individual's retirement exemption limit was reduced under the former CGT small business retirement relief provisions contained in the ITAA97 or the ITAA36, the individual's retirement exemption limit for the purposes of s 152-320(1) ITAA97 is similarly reduced.[15]

¶14-140 Capital gain disregarded for individuals

If an individual taxpayer duly makes a choice for the CGT small business retirement exemption to apply for any part of a capital gain, that part of the capital gain equal to its CGT exempt amount (ie the amount of the capital gain chosen for CGT small business retirement exemption) is disregarded.[16] If the taxpayer is under 55 years of age just before the choice for retirement relief is made, see ¶14-145.

¶14-145 Procedure for individuals under 55 years of age

If an individual taxpayer (who makes a choice for the CGT small business retirement exemption) is under 55 years of age just before the choice for retirement relief is made, the individual must contribute an amount (equal to the asset's CGT exempt amount) to a complying superannuation fund or an RSA.[17] A complying superannuation fund is a complying superannuation fund within the meaning of s 45 of the *Superannuation Industry (Supervision) Act 1993*.

An amount contributed to a complying superannuation fund or an RSA to comply with this requirement is not an allowable deduction.[18]

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13 S 152-320(1) ITAA97.

14 S 152-320(2) ITAA97.

15 See the note to s 152-320(1) ITAA97.

16 S 152-310(1) ITAA97.

17 S 152-305(1)(b) ITAA97.

18 S 290-150(4) ITAA97.

Time of contribution

The contribution to a complying superannuation fund or an RSA that is required to be made by an individual who is under 55 years of age (just before the choice for retirement relief is made) must generally be made at the later of:

(1) when the individual makes the choice for retirement relief; and

(2) when the individual receives the proceeds.[19]

The only qualification is if the CGT event that has happened is CGT event J2, J5 or J6 (ie where a capital gain accrues under the CGT small business roll-over relief events). In that kind of case, the contribution must in all cases be made when the choice is made.

The requirement that the contribution to a complying superannuation fund or an RSA be made "when" the relevant happening occurs (the making of the choice or the receipt of the proceeds) fixes a precise point in time, and the contribution could not be made at any other time if it is to qualify as a contribution for the purposes of the CGT small business retirement exemption. The explanatory memorandum to the amending Bill that became the *Superannuation Legislation Amendment (Simplification) Act 2007* states that the individual must make the contribution "immediately". The ATO Guide states that "to satisfy this requirement, you must pay the amount into a complying superannuation fund or RSA *by* the relevant date" (emphasis added).

Capital proceeds received in instalments

If the individual receives the capital proceeds from the CGT event in instalments, the contribution requirements that apply where the individual is under 55 years of age at the relevant time apply to each instalment in succession up to the relevant CGT exempt amount.[20] This means that the total amount of each instalment must be paid in relation to the individual until the total of the payments equals the amount of the capital gain being disregarded.

The CGT small business retirement exemption can be chosen where the capital proceeds from the relevant CGT event are calculated in accordance with the market value substitution rule. For a discussion of when such capital proceeds are received, see ¶14-180.

Contractual provisions

If it is at all likely that the capital proceeds (or some of the capital proceeds) from a CGT event will be received after the time for making a choice for CGT small business retirement relief, and the taxpayer will be under 55 years of age at that time, it may be prudent to include a provision in the contract that permits the taxpayer to direct the payer to pay a relevant amount of the capital proceeds to a complying superannuation fund or an RSA. This would satisfy the requirement for the contribution to a complying

19 S 152-305(1)(c) ITAA97.

20 S 152-305(1A) ITAA97. Note that, as part of the introduction of the statutory CGT rules relating to look-through earnout rights, s 152-305(1B) ITAA97 was inserted to specifically provide that financial benefits received under or in respect of earnout rights are to be treated as instalments. For further details of the statutory CGT rules relating to look-through earnout rights, see ¶3-110.

superannuation fund or an RSA to be made "when" the proceeds are received. The taxpayer would, of course, be taken to have received the capital proceeds for CGT purposes.[21]

Transfer of real property

Where an individual taxpayer chooses the CGT retirement exemption to apply, the taxpayer may make the required contribution by transferring real property to a complying superannuation fund instead of money, provided the transfer satisfies the relevant provisions of the *Superannuation Industry (Supervision) Act 1993* (SISA) (ID 2010/217).

Generally speaking, a superannuation contribution can be made in a number of ways, including by transferring an asset to the superannuation provider (an in specie contribution). A superannuation provider may breach s 66 SISA when an asset is acquired from a related party of the fund, such as a member. Section 66(2) SISA does, however, provide an exception to the prohibition relating to the acquisition by a superannuation fund of an asset from related parties where the asset is "business real property" (as defined) and other conditions are satisfied.

¶14-150 CGT small business concessions and superannuation contributions

Under the simplified superannuation regime that has applied from 1 July 2007 (subject to transitional provisions), a non-concessional contribution by an individual to a complying superannuation plan will be excluded from an individual's non-concessional contributions cap for a financial year if it is made in relation to capital gains to which (broadly) the CGT 15-year small business exemption or small business retirement exemption has applied (to the extent that the contribution does not exceed the individual's "CGT cap amount" when it is made).[22]

Eligible contributions

The relevant contributions are those covered by s 292-100 ITAA97. For a contribution to be covered by this section:

(1) the contribution must be made by the individual to a "complying superannuation plan" (ie a complying superannuation fund, a regulated or exempt public sector superannuation scheme, a complying ADF or an RSA) in respect of the individual in a financial year;

(2) *one* of four requirements must be met (see below); and

(3) the individual must choose to apply the section to an amount that is all or part of the contribution.[23]

21 S 103-10(1) ITAA97.

22 S 292-90(2)(c)(iii) ITAA97.

23 S 292-100(1) ITAA97.

The four alternative requirements relate to the following circumstances:

(1) where the contribution to the complying superannuation plan is equal to all or part of the capital proceeds from a CGT event for which the individual can disregard any capital gain under the CGT 15-year small business exemption (or would be able to do so, assuming that a capital gain arose from the event);[24]

(2) where, just before a CGT event, the individual was a CGT concession stakeholder of an entity that could, under the CGT 15-year small business exemption, disregard any capital gain arising from the CGT event (or would be able to do so, assuming that a capital gain arose from the event);[25]

(3) where the contribution to the complying superannuation plan is equal to all or part of the capital gain from a CGT event that the individual disregarded under the CGT small business retirement exemption;[26] and

(4) where, just before a CGT event, the individual was a CGT concession stakeholder of a company or trust that could disregard all or part of a capital gain arising from the CGT event under the CGT small business retirement exemption.[27]

Each requirement contains conditions that must be met.

Making the choice

To make a choice for these purposes, the individual must make the choice in the approved form and give it to the superannuation provider in relation to the complying superannuation plan by the time the contribution is made.[28]

CGT cap amount

An individual's CGT cap amount at the start of the 2007-08 financial year was \$1m[29] and is indexed annually for the 2008-09 and subsequent financial years.

The cap amounts for the 2008-09 and later financial years are as follows:

- 2008-09 — \$1.045m;
- 2009-10 — \$1.1m;
- 2010-11 — \$1.155m;
- 2011-12 — \$1.205m;
- 2012-13 — \$1.255m;

24 S 292-100(2) ITAA97.

25 S 292-100(4) ITAA97.

26 S 292-100(7) ITAA97.

27 S 292-100(8) ITAA97.

28 S 292-100(9) ITAA97.

29 S 292-105(1) ITAA97.

- 2013-14 — $1.315m;
- 2014-15 — $1.355m;
- 2015-16 — $1.395m; and
- 2016-17 — $1.415m.

If a contribution covered by the above rules is made in respect of the individual, the individual's CGT cap amount is reduced by the amount of the contribution (but not below nil) just after the time when the contribution is made.[30]

Transitional arrangements

Under transitional provisions in the *Income Tax (Transitional Provisions) Act 1997*, an individual's CGT cap amount is $1m at 10 May 2006, and any contributions made during the period 10 May 2006 to 30 June 2007 reduced their CGT cap from 1 July 2007. For such contributions, the choice to use the CGT cap exemption from the non-concessional contributions cap had to be given to the superannuation provider by 31 July 2007.

¶14-155 How CGT small business retirement exemption operates for companies and trusts

The following charts set out how the CGT small business retirement exemption operates in the case of a company or trust. It is necessary to consider separately the operation of the CGT small business retirement exemption where the relevant capital gain is made from the happening of a CGT event other than CGT event J5 or J6 (see Chart 1), and where the relevant capital gain is made from the happening of either of those events (see Chart 2).

30 S 292-105(2) ITAA97.

Chart 1: CGT events other than CGT event J5 or J6

Are the basic conditions met for the CGT small business reliefs to apply (¶4-100)?

No → The CGT small business reliefs are not relevant.

Yes

Is the CGT 15-year small business exemption applicable (¶12-100)?

Yes → No other CGT small business reliefs are relevant.

No

Determine whether a choice should be made for the CGT small business 50% reduction not to apply (¶13-110).

Does the company or trust satisfy the significant individual test (¶11-105)?

No → CGT small business retirement relief cannot be chosen.

Yes

Determine who the CGT concession stakeholders of the company or trust are at the time of the CGT event and what amount of the capital gain should be chosen for retirement relief in respect of them and in what percentages (¶14-165). The amount chosen is disregarded (¶14-160).

1. The percentage specified for a CGT concession stakeholder must not result in a stakeholder's CGT retirement exemption limit being exceeded. The total amount specified is called the CGT exempt amount (¶14-170).
2. The CGT exempt amount and a CGT concession stakeholder's percentage entitlement must be specified in writing (¶14-170).

The company or trust must make a payment to the CGT concession stakeholders in accordance with their percentages (¶14-180). Is a CGT concession stakeholder under 55 years of age just before the company or trust makes a payment?

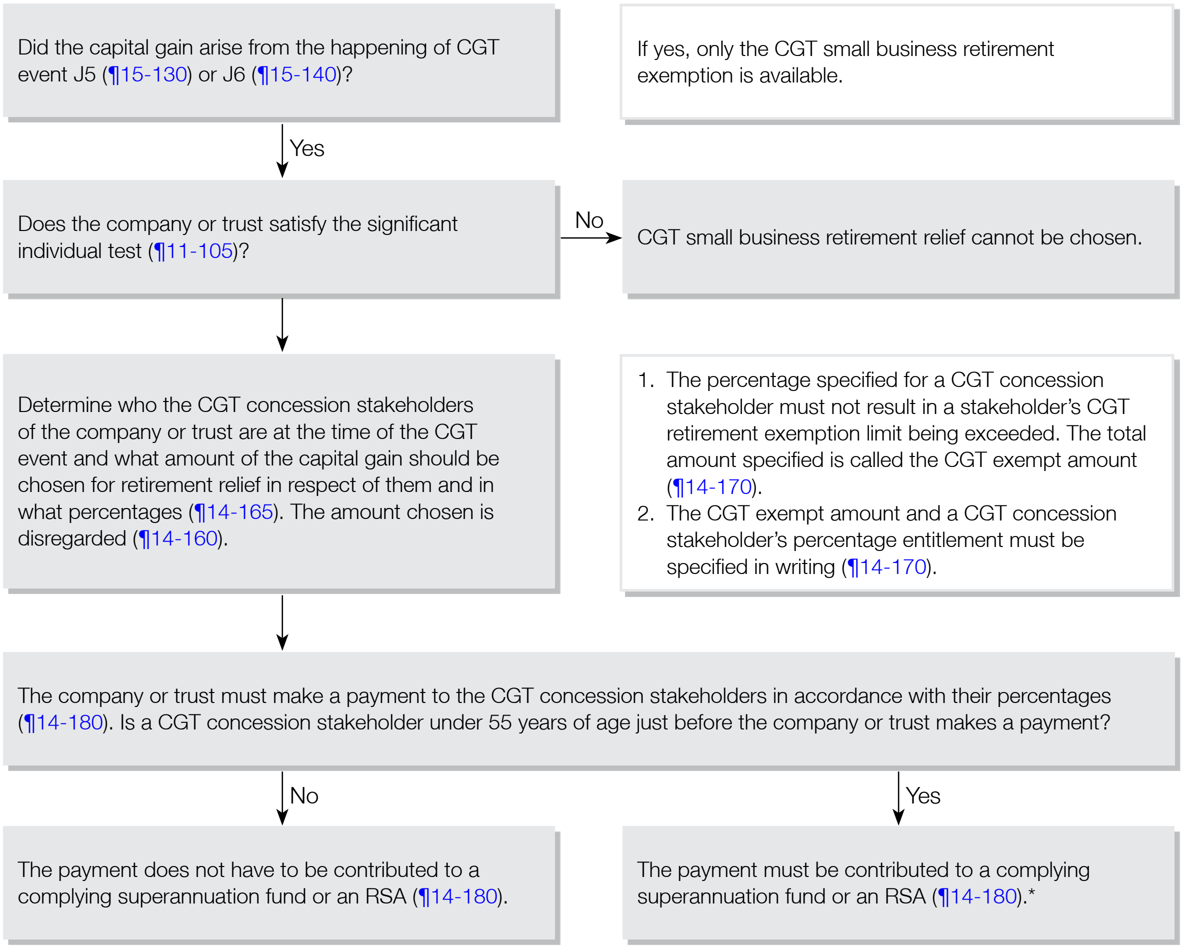
No → The payment does not have to be contributed to a complying superannuation fund or an RSA (¶14-180).

Yes → The payment must be contributed to a complying superannuation fund or an RSA (¶14-180).*

* There is a requirement to duly notify the trustee of the fund or the RSA provider about the contribution (see ¶14-180).

Chart 2: CGT events J5 or J6

Where the capital gain is made from the happening of either CGT event J5 or J6, the basic conditions for CGT small business relief apply do not need to be satisfied, and no other CGT small business reliefs other than the retirement exemption are available.



* There is a requirement to duly notify the trustee of the fund or the RSA provider about the contribution (see ¶14-180).

¶14-160 When company or trust may choose retirement exemption

Under the CGT small business retirement exemption, a company or trust (but not a public entity (see below)) may choose to disregard all or part of a capital gain that potentially qualifies for CGT small business relief if:

(1) the basic conditions for CGT small business relief are satisfied for the gain (see ¶4-100);

(2) the company or trust satisfies the significant individual test (see ¶11-105); and

(3) the company or trust conditions set out at ¶14-180 are satisfied.[31]

This is subject to the qualification that where the capital gain results from the happening of either CGT event J5 or J6, the basic conditions for CGT small business relief to apply do not need to be satisfied.[32]

Putting to one side a capital gain that is made from the happening of either CGT event J5 or J6, the amount of the capital gain for which CGT small business retirement relief may be chosen will depend on how the company or trust applies the other CGT small business reliefs. For example, if a choice were made to not apply the CGT small business 50% reduction, potentially the whole of the amount of the capital gain eligible for CGT small business relief could be chosen for retirement relief (subject to the CGT retirement exemption limits of the CGT concession stakeholders); that is, if no choice is made for CGT small business roll-over relief.

As indicated, the significant individual test is explained at ¶11-105. An important point is the fact that the significant individual test cannot be met by a discretionary trust unless the trustee makes a distribution during the income year (see ¶11-135).

If the company or trust makes a choice for the CGT small business retirement exemption, that part of the capital gain for which the exemption is chosen is called the CGT exempt amount, and this amount of the capital gain is disregarded, provided the special company and trust conditions explained at ¶14-180 are met.[33]

As noted above, public entities cannot choose the CGT small business retirement exemption.[34] These entities include (broadly) a publicly listed company, a publicly traded unit trust, a mutual insurance company, a mutual affiliate company, and a company in which all of the shares are beneficially owned by one or more of the foregoing.[35]

¶14-165 Individuals for whom retirement exemption can be chosen

A company or trust may only make a choice under the CGT small business retirement exemption in respect of one or more individuals who are CGT concession stakeholders in the company or trust. It is not expressly stated at what point in time the status of an individual as a CGT concession stakeholder is to be determined. This creates uncertainty. It would seem likely, however, that the individuals who are relevant are individuals who are CGT concession stakeholders just before the time when the CGT event that gave rise to the capital gain happened, or, in the case of a discretionary trust, became CGT

31 S 152-305(2) and (3) ITAA97.

32 S 152-305(4) ITAA97.

33 S 152-310(1) ITAA97.

34 S 152-305(2) and (3) ITAA97.

35 S 328-125(8) ITAA97.

concession stakeholders as a result of distributions made by the trustee during the income year in which the CGT event happened. The position, however, needs to be clarified.

For the circumstances in which an individual will be a CGT concession stakeholder, see ¶11-115. It should be kept in mind that a company or trust may have up to eight CGT concession stakeholders (ie four significant individuals and their spouses).[36]

¶14-170 Specifying CGT exempt amount and stakeholder percentages

The choice by a company or trust under the CGT small business retirement exemption must be made in such a way that the CGT retirement exemption limit of each CGT concession stakeholder for whom the choice is made is not exceeded.[37] For a discussion of an individual's CGT retirement exemption limit, see ¶14-135.

The amount of a capital gain for which the CGT small business retirement exemption is chosen is called the asset's CGT exempt amount, and must be specified in writing.[38] The written specification of the CGT exempt amount must be made at or before the time when the choice for the CGT small business retirement exemption is made. The wording of s 152-315(3) ITAA97 creates a difficulty where the CGT event that has given rise to the capital gain is CGT event J5 or J6 (see ¶14-130.)

In addition, if the company or trust that is making the choice has more than one CGT concession stakeholder, the company or trust must specify in writing the percentage of each CGT asset's CGT exempt amount that is attributable to each of the stakeholders.[39] One or more of the percentages may be nil, but all of the percentages must add up to 100%.

Making the choice

The timing of the making of a choice by a company or trust to disregard all or part of a capital gain under the CGT small business retirement exemption is governed by the general CGT choice-making rules in s 103-25 ITAA97 (see ¶2-135).

Precedent choice and specification

The following is a precedent choice and specification of a CGT exempt amount and CGT concession stakeholder percentages by a company (X Pty Ltd) with four CGT concession stakeholders (M, N, O and P):

36 Note, however, that the definition of "spouse" means that, in some circumstances, an individual may be regarded as having two spouses – a legal spouse from whom the individual is separated and a person who would satisfy the definition of "spouse" as set out at ¶11-115.

37 S 152-315(2) ITAA97.

38 S 152-315(3) and (4) ITAA97.

39 S 152-315(5) ITAA97.

Choice and Specification of CGT Exempt Amount
Subdivision 152-D of the Income Tax Assessment Act 1997 ("the Act")

This choice and specification relates to the following:

1. CGT asset involved: #*

2. CGT event: #

3. Time of CGT event: #

4. Capital gain: $#

5. Amount of capital gain to which Subdivision 152-D of the Act applies: $#

X Pty Ltd hereby chooses to apply Subdivision 152-D of the Act in relation to the capital gain and specifies:

(a) $# as being the CGT exempt amount for the purposes of the Subdivision; and

(b) that the percentages of the CGT exempt amount attributable to its four CGT concession stakeholders are:

 (i) for M – # per cent;

 (ii) for N – # per cent;

 (iii) for O – # per cent;

 (iv) for P – # per cent.†

Dated the day of 20##

X Pty Ltd by its public officer

....

[full name]

Tax File No.: #

* It will not be possible to specify a CGT asset where the CGT event that has given rise to the capital gain is either CGT event J5 or J6. It is suggested that, in the case of such a capital gain, this item be omitted, the remaining items be renumbered, and what becomes 1 (after the renumbering) be altered to read: CGT event: CGT event J[5 or 6] which happened in respect of small business roll-over that was chosen in relation to [description if asset].

† These percentages must add up to 100%, but one or more may be 0%.

¶14-175 Capital gain disregarded for companies and trusts

If a company or trust duly makes a choice for the CGT small business retirement exemption to apply for any part of a capital gain, that part of the capital gain equal to its CGT exempt amount (ie the amount of the capital gain chosen for CGT small business retirement exemption) is disregarded.[40] The special conditions discussed at ¶14-180 must also be met.

¶14-180 Special company and trust conditions

A company or trust can only choose the CGT small business retirement exemption if the special company and trust conditions in s 152-325 ITAA97 are met.[41] These conditions are set out below.

Company or trust must make a payment

The first condition to be met is that the company or trust must make payments (directly or indirectly through one or more interposed entities) to its CGT concession stakeholders in accordance with the stakeholders' percentages specified.[42]

The making of indirect payments through an interposed entity or interposed entities will satisfy this condition as a result of an amendment made by the *Tax Laws Amendment (2009 Measures No. 2) Act 2009*.

The explanatory memorandum to the amending Bill that became the *Tax Laws Amendment (2009 Measures No. 2) Act 2009* explains that the interposed entity amendments (that were made by that amending Act) would overcome practical difficulties (such as breaching non-tax laws) that arose out of the requirement to make a payment directly to a CGT concession stakeholder under the retirement exemption, where the CGT concession stakeholder is traced indirectly.

If the payment is made to an employee of a company or trust, the payment must not be of a kind mentioned in s 82-135 ITAA97 (disregarding para (fa) of that section).[43] That section sets out the various payments that are not employment termination payments. Paragraph (fa) of the section covers a payment made by a company or trust to a CGT concession stakeholder for the purposes of the CGT small business retirement exemption. The relevant explanatory memorandum stated that, because of para (h), a payment made by a company or trust to a CGT concession stakeholder who is or was an employee would not qualify for the retirement exemption if it was considered a deemed dividend under s 109 ITAA36. As explained below under the heading "Nature of payment", a payment by a company or trust to a CGT concession stakeholder cannot be a deemed dividend.

40 S 152-310(1) ITAA97.

41 S 152-305(2)(c) ITAA97.

42 S 152-325(1) and (3) ITAA97.

43 S 152-325(3A) ITAA97.

When a payment is to be made (whether by the company or trust or by an interposed entity), regard should be had to the relevant constituent document; that is, the constitution in the case of a company and the governing trust instrument in the case of a trust.

Time of making of payment

If the choice for small business retirement exemption relates to a capital gain from the happening of CGT event J2, J5 or J6 (ie the CGT events that can happen in relation to a capital gain rolled over under CGT small business roll-over relief), the payment must be made by seven days after the company or trust makes the choice.[44]

If the choice relates to a capital gain made from the happening of any other CGT event, the payment must be made by the later of:

(1) seven days after the company or trust makes the choice; and

(2) seven days after the company or trust receives an amount of capital proceeds from the CGT event.[45]

The Commissioner does not have a discretion to extend this period. For a payment to be made by a particular date, it would need to be made on or before that date.[46]

Market value substitution rule

The CGT small business retirement exemption can be claimed where there are no actual capital proceeds, but a capital gain is made as a result of the market value substitution rule applying to determine the capital proceeds from the happening of the CGT event (see ¶14-110). In such a case, the effect of s 116-30(1) ITAA97 is that the taxpayer is "taken to have received" the market value of the relevant CGT asset. Presumably, although not expressly stated, the market value would be taken to have been received at the time of the CGT event happening, for the purposes of determining when the payment is required to be made.

If the market value substitution rule applies because the actual capital proceeds are less than the market value of the CGT asset, the actual capital proceeds are "replaced with the market value".[47] This presumably means that the deemed market value capital proceeds would be taken to be received when the actual capital proceeds are received. It is not clear what the position would be if the actual capital proceeds are received in instalments.

44 S 152-325(1) and (4) ITAA97.

45 S 152-325(1) and (4) ITAA97.

46 *Eastaugh v McPherson* [1954] 3 All ER 214.

47 S 116-30(2) ITAA97.

Capital proceeds received in instalments

If the company or trust receives the capital proceeds from the CGT event in instalments, the payment requirements apply to each instalment in succession (up to the relevant CGT exempt amount).[48] This means that the total amount of each instalment must be paid in relation to each CGT concession stakeholder (in accordance with the specified stakeholder percentages) until the total of the payments equals the capital gain being disregarded. The requirement to make a payment must be satisfied to the greatest extent possible out of the initial instalments and not in some other way – such as an apportionment across all of the instalments received.

Amount of payment

The amount of a payment, or the sum of the amounts of the payments, required to be made by the company or trust must be equal to the lesser of:

(1) if CGT event J2, J5 or J6 happened, the amount of the capital gain from the CGT event that the company or trust disregarded or (in any other case) the amount of capital proceeds received; and

(2) the relevant CGT exempt amount.[49]

Joint or separate payments

If a company or trust is required to make two or more payments to a single CGT concession stakeholder (whether or not by the same time), the company or trust may meet that requirement by making one payment or by making separate payments.[50]

Nature of payment

A payment made by a company to satisfy the payment condition (whether directly to the CGT concession stakeholder or to an interposed entity) is treated as if it were not a dividend or a frankable distribution, and the deemed dividend rules in s 109 and Div 7A ITAA36 do not apply.[51] The position is the same where a payment that is received by an interposed entity is passed on by that entity to the CGT concession stakeholder or to another interposed entity.

Further, a payment received by an interposed entity (whether directly or indirectly through one or more interposed entities), which the recipient entity passes on either to the CGT concession stakeholder or to another interposed entity, is not assessable income or exempt income of the recipient entity.[52]

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48 S 152-325(2) ITAA97. Note that, as part of the introduction of the statutory CGT rules relating to look-through earnout rights, s 152-325(2A) ITAA97 was inserted to specifically provide that financial benefits received under or in respect of earnout rights are to be treated as instalments. For further details of the statutory CGT rules relating to look-through earnout rights, see ¶3-110.

49 S 152-325(5) ITAA97.

50 S 152-325(6) ITAA97.

51 S 152-325(9) to (11) ITAA97.

52 S 152-310(3) ITAA97.

Stakeholder under 55 years of age

If a CGT concession stakeholder is under 55 years of age just before a payment is made in relation to him or her:

(1) the company or trust must make the payment to the CGT concession stakeholder by contributing it for the stakeholder to a complying superannuation fund or an RSA in respect of the stakeholder; and

(2) the company or trust must notify the trustee of the fund or the RSA provider at the time when the contribution is made that the contribution is made in accordance with s 152-325 ITAA97.[53]

For the purposes of Pt 3-30 ITAA97 (Superannuation), a payment mentioned in (1) above that is made in accordance with s 152-325 ITAA97 is treated as a contribution made by the CGT concession stakeholder.[54] No deduction is allowable to the stakeholder.[55] The payment is not assessable income and is not exempt income of the stakeholder.[56]

As explained above, a payment by a company or trust to a CGT concession stakeholder may be made either directly or through one or more interposed entities. Where the concession stakeholder is under 55 years of age just before the payment, the contribution to the complying superannuation fund or an RSA could be made by an interposed entity. However, it would seem that the notification to the trustee or the RSA provider could only be made by the company or trust itself (ie not by an interposed entity).

Where the CGT concession stakeholder is 55 years of age or more just before the payment, so that the payment can be made directly to the concession stakeholder, the payment is not assessable income and is not exempt income of the concession stakeholder.[57]

No allowable deduction

A payment that a company or trust makes, to comply with the above conditions, is not an allowable deduction to the company or trust.[58] Similarly, where an interposed entity makes a payment that is to ensure compliance with the above conditions, the payment is not an allowable deduction to the interposed entity.[59]

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53 S 152-325(7) ITAA97. The view expressed in ID 2010/217 (see (4) at ¶14-145) that a transfer of real property by an individual taxpayer to a complying superannuation fund can satisfy the requirement to make a contribution also applies to the requirement for a company or trust to make a contribution.

54 S 152-325(8) ITAA97.

55 S 290-150(4)(b) ITAA97.

56 S 152-310(2)(a) ITAA97. This reflects an amendment made by the *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (applicable to payments made after 30 June 2007) which ensures that the payment, if made by a trust, is excluded from the operation of CGT event E4 (s 104-71(1)(a) ITAA97) and, if made by a company, is excluded from the operation of CGT event G1 (s 104-135(1A) ITAA97).

57 S 152-310(2)(a) ITAA97. This reflects an amendment made by the *Tax Laws Amendment (2010 Measures No. 1) Act 2010* (applicable to payments made after 30 June 2007) which ensures that the payment, if made by a trust, is excluded from the operation of CGT event E4 (s 104-71(1)(a) ITAA97) and, if made by a company, is excluded from the operation of CGT event G1 (s 104-135(1A) ITAA97).

58 S 152-310(2)(b) ITAA97.

59 S 152-310(3)(c) ITAA97.

Chapter 15

Roll-over relief

¶15-100 Context

If a capital gain is made that potentially qualifies for the CGT small business reliefs, and the CGT 15-year small business exemption does not apply, so much of the capital gain as is not disregarded by the CGT small business 50% reduction is potentially eligible for the CGT small business retirement exemption or CGT small business roll-over relief.[1]

A taxpayer can choose not to apply the CGT small business 50% reduction[2] (see ¶13-110). The making of such a choice would mean that the CGT small business retirement exemption or CGT small business roll-over relief (or partly one and partly the other concession) would be potentially available in respect of the whole amount of the capital gain that qualifies for the CGT small business reliefs.

If a capital gain (or part of a capital gain) potentially qualifies for both the CGT small business retirement exemption and CGT small business roll-over relief, the taxpayer may choose the order in which to apply them.[3]

If a capital gain qualifies for both CGT small business roll-over relief and CGT replacement asset roll-over relief provided for by Subdiv 124-B ITAA97 for the compulsory acquisition, loss or destruction of a CGT asset, either roll-over relief may be chosen.[4]

Overview

In broad terms, small business roll-over relief can be chosen in respect of the whole or part of so much of a capital gain that qualifies for the CGT small business reliefs, as has not been disregarded or reduced under the CGT discount capital gain concession and the other CGT small business reliefs.

The making of the choice means that the amount of the capital gain that is chosen is disregarded; but if, at the end of the replacement asset period, the taxpayer does not have a CGT asset that is an active asset and was either acquired during that period, or had fourth element expenditure incurred on it during that period, CGT event J5 will happen and a capital gain equal to the capital gain rolled over will be made (see ¶15-130).

If, at the end of the replacement asset period, a part of the amount of the capital gain rolled over is not represented by a relevant replacement asset or fourth element expenditure, CGT event J6 will happen, and a capital gain equal to that part will be made (see ¶15-140).

In addition, to the extent that a capital gain rolled over has not been remade by the happening of CGT event J5 or J6, it will be remade by the happening of CGT event J2 if and when (broadly) the relevant replacement active asset (or a CGT asset in respect of which fourth element expenditure has been incurred) ceases to be an active asset of the taxpayer (see ¶15-145).

1 S 152-210 ITAA97.

2 S 152-220 ITAA97.

3 S 152-210(2) ITAA97.

4 ID 2009/147.

Transitional provisions

The present CGT small business roll-over relief provisions were enacted by the *Tax Laws Amendment (2006 Measures No. 7) Act 2007*. It should be noted that the amending Act enacted transitional provisions that can apply where roll-over relief was chosen under the former provisions in respect of a CGT event that occurred in the 2005-06 or an earlier income year.

¶15-105 How CGT small business roll-over relief works

The following table sets out how CGT small business roll-over relief works where a capital gain is made from a CGT event that happens in the 2006-07 or a later income year.

Steps	Comments
1. Are the basic conditions met for the CGT small business reliefs to apply to the capital gain?	If the basic conditions are not met, the CGT small business reliefs do not apply. For the basic conditions, see chapter 4 (see ¶4-100).
2. If yes to 1, does the CGT small business 15-year exemption apply to the capital gain?	If this exemption applies, no other CGT concession is relevant. For this exemption, see chapter 12 (see ¶12-100).
3. If no to 2, does any part of the capital gain remain after the CGT concessions (other than CGT small business roll-over relief) have been applied?	For the CGT small business 50% reduction, see chapter 13 (¶13-100), and for the CGT small business retirement exemption, see chapter 14 (see ¶14-100). The amount of a capital gain that remains after the CGT small business 50% reduction can be claimed by way of CGT small business retirement exemption or CGT small business roll-over relief in the order in which the taxpayer chooses (see ¶15-100).
4. If yes to 3, CGT small business roll-over relief may be chosen in respect of the whole or part of the remaining capital gain calculated under 3.	To the extent that roll-over relief is chosen, the capital gain is disregarded (see ¶15-110).
5. If roll-over relief is chosen, during the replacement asset period, was a replacement asset acquired or fourth element expenditure incurred on a CGT asset, and was the replacement asset or CGT asset in respect of which the expenditure was incurred an active asset at the end of the replacement asset period?	If the answer to 5 is no, CGT event J5 happens at the end of the replacement asset period, and a capital gain equal to the rolled-over capital gain is made (see ¶15-130). This capital gain may qualify for the CGT small business retirement exemption (and for no other CGT small business relief) without the need for the basic conditions for CGT small business relief to apply being met (see ¶15-155).

Steps	Comments
6. If yes to 5, was the cost of acquisition (including incidental costs) of the replacement asset, and the amount of any fourth element capital expenditure incurred, greater than or equal to the whole of the rolled-over capital gain?	If the answer to 6 is no, CGT event J6 happens at the end of the replacement asset period, and a capital gain equal to the unutilised amount of the rolled-over capital gain is made (see ¶15-140). This capital gain may qualify for the CGT small business retirement exemption (and for no other CGT small business relief) without the need for the basic conditions for CGT small business relief to apply being met (see ¶15-155). (Note that there may be more than one replacement asset.)
7. To the extent that the rolled-over capital gain is not remade by the happening of CGT event J5 or J6, it will be retriggered if and when CGT event J2 happens (eg if the relevant replacement asset is disposed of or ceases to be an active asset).	See ¶15-145. This capital gain can only qualify for the CGT small business retirement exemption or CGT small business roll-over relief (or partly for one and partly the other concession) (see ¶15-155).
8. There are special rules that apply if an individual taxpayer who has chosen roll-over relief dies after the end of the replacement asset period.	See ¶15-150.
9. CGT small business roll-over relief does not operate to reduce the cost base of a replacement asset or of a CGT asset in respect of which fourth element expenditure has been incurred.	See ¶15-145.

¶15-110 Choosing roll-over relief

If the basic conditions are met for the CGT small business reliefs to apply to a capital gain, and the CGT 15-year small business exemption does not apply, a taxpayer may choose roll-over relief for the capital gain.[5]

If a taxpayer chooses roll-over relief, the taxpayer can choose to disregard all or part of the capital gain for which the relief is chosen.[6] For example, if a capital gain made by a taxpayer for an income year is reduced (after the application of the other CGT small business reliefs) to $60,000, the taxpayer may choose roll-over relief for $60,000 (so that the capital gain would be reduced to nil), or for some lesser amount, such as $40,000 (in which event, a capital gain of $20,000 would remain to be taken into account in the calculation of the taxpayer's net capital gain for the income year).

5 S 152-410 ITAA97. For the basic conditions, see chapter 4 (see ¶4-100).

6 S 152-415 ITAA97.

Amount available for roll-over

The amount of the capital gain for which CGT small business roll-over relief may be chosen will depend on how the taxpayer applies the other CGT small business reliefs. For example, if the taxpayer were to make the choice to not apply the CGT small business 50% reduction (which would be unusual if the taxpayer is an individual or the trustee of a discretionary trust), potentially the whole of the amount of the capital gain eligible for CGT small business relief could be chosen for roll-over relief (ie if no choice is made for CGT small business retirement relief).

In some circumstances, particularly if the capital gain is large, it may be that, for part of the capital gain, CGT small business roll-over relief is the only available small business relief.

Example

Fred sells a post-CGT active asset in April 2015 and makes a capital gain of $2m. This capital gain qualifies for the CGT discount capital gain concession and the CGT small business reliefs.

Fred does not make the choice to not apply the CGT small business 50% reduction. In addition, because $280,000 of his CGT retirement exemption limit is already used up, he can only take retirement relief in respect of $220,000 of the capital gain.

Fred's position would be as follows:

Capital gain	$2,000,000
Less: discount concession	$1,000,000
	$1,000,000
Less: CGT small business 50% reduction	$500,000
	$500,000
Less: CGT small business retirement exemption amount	$220,000
Balance of capital gain	$280,000

If Fred wishes to reduce or eliminate the balance of the capital gain for the 2014-15 income year, he would need to choose CGT small business roll-over relief in respect of $280,000.

Deferring a capital gain

An important point is that a taxpayer may choose CGT small business roll-over relief, even if the taxpayer has not yet acquired a replacement asset or incurred fourth element expenditure or, indeed, does not anticipate acquiring a replacement asset or incurring fourth element expenditure.

However, CGT event J5 will happen if, by the end of the replacement asset period:

- a replacement asset has not been acquired that is then an active asset; or
- fourth element expenditure has not been incurred on a CGT asset that is then an active asset (see ¶15-130).

Further, if, by the end of the replacement asset period, the cost of the replacement asset or the amount of the fourth element expenditure incurred is less than the amount of the capital gain that has been disregarded under roll-over relief, CGT event J6 will happen (see ¶15-140).

Because the amount of a capital gain chosen for CGT roll-over relief is disregarded in the income year in which the capital gain is made, and the capital gain may be remade only at or after the end of the replacement asset period, a taxpayer can reduce the capital gain that qualifies for the CGT small business concessions to nil, without the possibility of the assessment for that income year being reopened.

For a discussion of the various advantages that may be gained by making a choice for CGT small business roll-over relief and deferring a capital gain, see ¶15-170.

Consolidated group

The Commissioner's view is that, if an entity makes a capital gain prior to becoming a subsidiary member of a consolidated group, the entity can choose to apply the CGT small business roll-over relief after it has become a member of the group (TD 2004/79). The single entity rule in s 701-1 ITAA97 does not affect the entity's ability to choose to apply the roll-over relief.

Making the choice

The making of a choice for CGT small business roll-over relief in relation to a capital gain, and the choice as to whether all or only part of the capital gain should be disregarded, are governed by the general CGT choice-making rules in s 103-25 ITAA97 (see ¶2-135).

¶15-115 Retriggering of rolled-over capital gain

CGT small business roll-over relief operates as a deferral mechanism. Any capital gain that is disregarded in an income year because a choice for roll-over relief was made will arise again in a later income year in which CGT event J2, J5 or J6 happens. These CGT events happen (broadly) in the following circumstances:

- CGT event J5 happens if either no replacement asset has been acquired (and no relevant expenditure has been incurred) before the end of the replacement asset period, or any replacement asset is not an active asset at the end of the replacement asset period (see ¶15-130);
- CGT event J6 happens if the whole of the capital gain for which roll-over relief was chosen has not been utilised by the end of the replacement asset period (see ¶15-140); and
- CGT event J2 happens if, after the end of the replacement asset period, the status of the replacement asset changes in a defined way (eg it ceases to be an active asset) (see ¶15-145).

A capital gain that arises from the happening of CGT event J2, J5 or J6:

- cannot qualify for the CGT discount capital gain concession, the CGT 15-year small business exemption or the CGT small business 50% reduction;[7]
- but can qualify for the CGT small business retirement exemption or, in the case of a capital gain from the happening of CGT event J2, CGT small business roll-over relief[8] (see ¶15-155).

¶15-120 Replacement asset period

The replacement asset period is (broadly) the period within which a replacement asset must be acquired or fourth element expenditure must be incurred, and by the end of which the replacement asset or the CGT asset on which expenditure has been incurred must be an active asset, if CGT event J5 is not to happen (see ¶15-130).

The replacement asset period is the period starting one year before, and ending two years after, the last CGT event in the income year for which the taxpayer obtains CGT small business roll-over relief.[9] Care needs to be exercised to ascertain the precise CGT event date to ensure that the replacement asset period is correctly calculated.

Example

During the 2013-14 income year, the trustee of the Pingpong Discretionary Trust disposes of three active assets. A capital gain is made from each disposal, and CGT small business roll-over relief is potentially available for each capital gain. The three CGT events happen on 10 July 2013, 18 November 2013 and 29 June 2014.

If CGT small business roll-over relief is chosen in relation to the first and second disposals, but not the third disposal, the replacement asset period in relation to both capital gains would run from 18 November 2012 to 18 November 2015 (unless the Commissioner exercised the discretion (see below) to extend the period).

Discretion to extend period

The Commissioner has a discretion to extend the replacement asset period.[10] The explanatory memorandum to the relevant amending Bill[11] states that the Commissioner "can extend the two-year time limit" for CGT event J5 or J6. However, it is submitted that the discretion conferred on the

7 Ss 115-25(3) and 152-10(4) ITAA97.

8 S 152-10(4) ITAA97.

9 S 104-190(1A) ITAA97. Note that, as part of the introduction of the statutory CGT rules relating to look-through earnout rights, s 104-190(1A) ITAA97 extends the replacement asset period until two years after the final potential financial benefit under the look-through earnout right could have been provided. For further details of the statutory CGT rules relating to look-through earnout rights, see ¶3-110.

10 S 104-190(2) ITAA97.

11 The Tax Laws Amendment (2006 Measures No. 7) Bill 2006.

Commissioner is wide enough to permit him to allow the one-year period before the relevant CGT event to commence at an earlier time. The *Macquarie Dictionary* defines "extend" to mean (inter alia) "to increase the length or duration of; lengthen; prolong" and "to stretch out in various or all directions; expand; spread out in area".

An example of where it would be expected that the Commissioner would exercise his discretion to extend the replacement asset period is where the taxpayer is carrying out capital improvements to land that will be an active asset, but completion of the improvements (and, therefore, the incurring of capital expenditure and the asset becoming an active asset) is delayed because of circumstances beyond the taxpayer's control; for example, adverse weather conditions or the financial failure of the builder.

Increase of capital proceeds

A special provision for the purposes of the replacement asset period applies where the capital proceeds from a CGT event are increased under s 116-45(2) ITAA97 (where there has been a reduction in the capital proceeds under the non-receipt rule, but this reduction is reversed by a later receipt of capital proceeds) and the increase occurs after the end of the replacement asset period.[12]

¶15-125 Fourth element expenditure

CGT small business roll-over relief may be utilised by incurring (during the replacement asset period) what is called "fourth element expenditure" in relation to a CGT asset that is an active asset at the end of the replacement asset period.

For this purpose, a taxpayer incurs fourth element expenditure in relation to a CGT asset if the taxpayer incurs capital expenditure that is included in the fourth element of the cost base of the asset.[13]

The fourth element of the cost base of a CGT asset is capital expenditure incurred by the taxpayer:

(1) the purpose or expected effect of which is to increase or preserve the asset's value; or

(2) that relates to installing or moving the asset,

but does not include expenditure incurred in relation to goodwill.[14]

An obvious example of fourth element expenditure is the cost of constructing or effecting improvements to a building on post-CGT land. Another example would be the cost of removing or varying a restrictive covenant that prevented development of land.

It should be noted that, under the deemed separate CGT asset rules, a building or structure that is constructed post-CGT on pre-CGT land is a separate CGT asset.[15] In this kind of case, no fourth

12 S 104-190(1) ITAA97.

13 S 104-185(9) ITAA97.

14 S 110-25(5) and (5A) ITAA97.

15 S 108-55(2) ITAA97.

element expenditure would be incurred, and the replacement asset conditions would need to be satisfied by the building or structure itself becoming an active asset. This means that, in such a case, the fact that the land on which the building or structure is constructed is being used as an active asset during the period of construction would be irrelevant.

To the extent to which there is a non-assessable recoupment of expenditure, the expenditure cannot form part of the fourth element of the cost base of a CGT asset.

In addition, expenditure cannot form part of the fourth element of the cost base of an asset acquired after 7.30pm on 13 May 1997 to the extent to which the taxpayer has deducted or can deduct it in an income year, except (broadly) where the expenditure is subject to an assessable recoupment provision. This exclusion from the cost base also applies to expenditure incurred after 30 June 1999 on land or a building acquired before the time mentioned. It would seem, however, that the amount of expenditure that qualifies as fourth element expenditure should be determined at the time when it is incurred, so the fact that deductions will or may be allowable in respect of the expenditure under Div 43 ITAA97 (deductions for capital works) should be immaterial.[16]

¶15-130 CGT event J5

CGT event J5 will happen if a taxpayer has chosen CGT small business roll-over relief (see ¶15-110) for a capital gain and, by the end of the replacement asset period (see ¶15-120):

(1) the taxpayer has not acquired a replacement asset (the "replacement asset") and has not incurred fourth element expenditure (see ¶15-125) in relation to a CGT asset (also called the "replacement asset"); or

(2) the replacement asset is not the taxpayer's active asset and, if the replacement asset is a share or trust interest, the additional requirement set out below is not met.[17]

For the circumstances in which a CGT asset that is not a share or trust interest will be an active asset, see ¶8-110, and for the circumstances in which a share or trust interest will be an active asset, see ¶8-115 and ¶8-120.

Share or trust interest: additional requirement

If the replacement asset is a share in a company or an interest in a trust, CGT event J5 will happen unless the share or trust interest is an active asset at the end of the replacement asset period, and either of the following requirements is met at that time:

(1) the taxpayer (or an entity connected with the taxpayer) is a CGT concession stakeholder in the company or trust; or

16 Cf TD 2005/47.

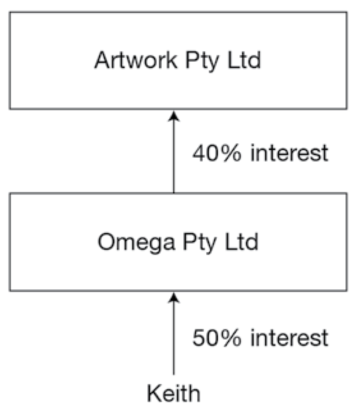
17 S 104-197(1) and (2) ITAA97.

(2) CGT concession stakeholders in the company or trust have a small business participation percentage in the taxpayer (which will be a company or trust) of at least 90%.[18]

For what constitutes a small business participation percentage, see ¶11-120, and for the circumstances in which an individual will be a CGT concession stakeholder in a company or trust, see ¶11-115. For the rules that govern when one entity is connected with another entity, see chapter 10 (¶10-100).

While it may have been intended that the special spouse/child under 18 affiliate rule (¶9-135) could apply when determining connected entity status for the purposes of (1) above, it is not clear that this is the case. This is because the special affiliate rule applies “for the purposes of this Subdivision” (ie Subdiv 152-A ITAA97). The CGT small business roll-over events (CGT events J2, J5 and J6) are in Subdiv 104-J ITAA97. It is submitted that the position should be clarified.

The requirement in (1) above could be met if the taxpayer is either an individual or a company or trust. It would, for example, be met in the following scenario (all of the shares in each company are of one class and are beneficially held):



Omega Pty Ltd is connected with Keith (see ¶10-130), and Keith is a CGT concession stakeholder in Artwork Pty Ltd because he has an indirect small business participation percentage of 20% (ie 50% × 40%). Accordingly, (1) above is satisfied and the shares in Artwork Pty Ltd could qualify as replacement assets. The shares in Artwork Pty Ltd would, of course, need to be active assets (see ¶8-115).

The requirement in (2) above can only be met if the taxpayer is a company or trust.

Example

Angie and Brian (Angie’s spouse) beneficially hold shares in Zap Pty Ltd, which carries on a successful business manufacturing insect repellants and has only one class of share on issue. They also beneficially hold units in the Topup Unit Trust, a fixed unit trust, which has only one class of units on issue, beneficially held by Angie (61%), Brian (30%) and two unrelated individuals (4.5% each).

18 S 104-197(2) ITAA97.

Example (cont)

The trust disposes of an active asset in September 2014 and makes a capital gain of $120,000, which satisfies the basic conditions for CGT small business relief. Of this capital gain, the trustee makes a choice for CGT small business roll-over relief for $20,000. The trustee subscribes for shares to this value in Zap Pty Ltd and, after these shares are issued, the shares in Zap Pty Ltd are held as to 15% by Angie, 5% by Brian, 40% by the Topup Unit Trust and 40% by unrelated entities.

Assuming that the shares in Zap Pty Ltd are active assets (see ¶8-115), the additional requirement in (2) above will be met because:

- Angie has a small business participation percentage in Zap Pty Ltd of 39.4% (ie 15% + (61% × 40%)) and is, therefore, a CGT concession stakeholder in Zap Pty Ltd;
- Brian is a CGT concession stakeholder in Zap Pty Ltd because he is Angie's spouse and has a small business participation percentage in Zap Pty Ltd; and
- Angie and Brian have between them small business participation percentages in the Topup Unit Trust of at least 90% (91% in fact).

Time of event

CGT event J5 happens at the end of the replacement asset period.[19] If the Commissioner has extended the replacement asset period, CGT event J5 would happen at the end of the extended period.

Capital gain

The capital gain that is made from the happening of CGT event J5 is equal to the amount of the capital gain that was disregarded as a result of the choice for roll-over relief.[20]

Concessions available

A capital gain that arises from the happening of CGT event J5 cannot qualify for the CGT discount capital gain concession or any of the CGT small business reliefs, other than the retirement exemption (see ¶15-155).

¶15-135 What can qualify as a replacement asset?

A replacement asset, providing it is an active asset (see ¶8-100) at the end of the replacement asset period, can be any kind of CGT asset. It could, for example, be a CGT asset, the disposal of which would give rise to a capital gain or capital loss that would be disregarded. A depreciating asset or trading stock could qualify as a replacement asset. However, from a practical perspective, it is generally not advisable to use a short-term asset as the replacement asset as this increases the probability that the deferred gain is brought to account sooner than normally advisable. There is a special additional requirement if a share or trust interest is to qualify as a replacement asset (see ¶15-130).

19 S 104-197(3) ITAA97.

20 S 104-197(4) ITAA97.

In ID 2002/753, it is accepted that a company that anticipated making a capital gain from the sale of a business could utilise CGT small business roll-over relief by acquiring a 30% interest in a house from which it would conduct a new business. The remaining interest in the property was to be held by several individuals who intended using the dwelling as their main residence. This interpretative decision points out that, even if the company's interest in the property were greater than the business use of the property, the company could still use all of its interest in the property as a replacement asset. The definition of "active asset" does not require exclusive use of the asset for business purposes. For example, if the company's interest in the property was 30% and the business use was 20%, the company could still treat its entire interest in the property as a replacement asset. This interpretative decision was issued in relation to CGT small business roll-over relief as it operated in relation to CGT events that happened in the 2005-06 or an earlier income year but appears to be relevant to the current provisions and has not been withdrawn.

In relation to trading stock, the minutes for the NTLG Losses and CGT Subcommittee meeting of 19 November 2008 (item 10) indicate that the ATO accepts that, provided sufficient trading stock acquired during the relevant replacement asset period is held at the end of that period, this will avoid the happening of CGT event J5. Further, if CGT event J2 were to happen on the disposal of such an item of trading stock, again the operation of CGT event J5 will be avoided if there is sufficient trading stock acquired during the relevant replacement asset period for the happening of CGT event J2, and is on hand at the end of that period. For this kind of perpetual deferral, the taxpayer would need adequate and accurate records that identify trading stock movements. Note that the question and answer in the minutes (possibly impliedly) assumes that the taxpayer can choose whether a CGT asset is a replacement asset. Whether this is correct is not clear (see ¶15-165).

¶15-140 CGT event J6

CGT event J6 will happen if a taxpayer has chosen CGT small business roll-over relief (see ¶15-110) for a capital gain and:

(1) at the end of the replacement asset period (see ¶15-120), the taxpayer has acquired a replacement asset (the "replacement asset") or incurred fourth element expenditure in relation to a CGT asset (also called the "replacement asset"), and the replacement asset is an active asset (and, in the case of a share or trust interest, satisfies the additional requirement set out at ¶15-130); and

(2) the total of the first element of the cost base, the incidental costs (as defined in s 110-35 ITAA97) incurred by the taxpayer and the amount of the fourth element expenditure (see ¶15-125) incurred in relation to the replacement asset is less than the amount of the capital gain that was chosen for roll-over relief.[21]

Note that more than one replacement asset and fourth element expenditure incurred on more than one CGT asset may be relevant for the operation of CGT event J6.

21 S 104-198 ITAA97.

For the circumstances in which a CGT asset that is not a share or trust interest will be an active asset, see ¶8-110, and for the circumstances in which a share or trust interest will be an active asset, see ¶8-115 and ¶8-120.

Time of event

CGT event J6 happens at the end of the replacement asset period.[22] If the Commissioner has extended the replacement asset period, CGT event J6 would happen at the end of the extended period.

Capital gain

If CGT event J6 happens, the taxpayer makes a capital gain equal to the difference between the amount of the capital gain that was chosen for roll-over relief and the total of the first element of the cost base, the incidental costs and the fourth element expenditure referred to in (2) above.[23]

Example 1 (adapted from explanatory memorandum)

Brian disposes of an active asset on 14 October 2013 and makes a capital gain of $200,000. Brian chooses CGT small business roll-over relief for $40,000 of the capital gain.

Brian acquires a replacement asset in May 2015, which is still an active asset at the end of the replacement asset period on 14 October 2015. If this is the only replacement asset, and the cost (including incidental costs) of acquisition amounted to $35,000, CGT event J6 would happen at the end of the replacement asset period and Brian would make a capital gain of $5,000.

What CGT concessions are available?

A capital gain that results from the happening of CGT event J6 cannot qualify for the CGT discount capital gain concession or any of the CGT small business reliefs, other than the retirement exemption (see ¶15-155).

¶15-145 CGT event J2

If CGT event J5 (see ¶15-130) has not happened at the end of the replacement asset period, CGT event J2 will happen at a later time if:

(1) the replacement asset stops being an active asset of the taxpayer – for example, it is sold or ceases to be used, or held ready for use, in a relevant business;[24]

(2) the replacement asset becomes trading stock of the taxpayer; or

22 S 104-198(2) ITAA97.

23 S 104-198(3) ITAA97.

24 For what constitutes an active asset, see ¶8-110, ¶8-115 and ¶8-120.

(3) the taxpayer starts to use the replacement asset solely to produce exempt income or non-assessable non-exempt income.[25]

If the replacement asset is a share or trust interest, CGT event J2 will also happen if:

- CGT event G3 (liquidator or administrator declares shares or financial instruments worthless) or I1 (individual or company stops being an Australian resident) happens in relation to the share or trust interest; or
- the additional share or trust interest requirement set out at ¶15-130 stops being satisfied.[26]

An asset may stop being an active asset in unexpected circumstances. For example, assume that post-CGT land with a building on it is an active asset, and that it is decided to demolish the building and construct a new building. If the land is vacated while the demolition and construction is in progress, the land would cease to be an active asset (because it would not then be used, or held ready for use, in the business) and, if the land and (demolished) building is a replacement asset and the replacement asset period has ended, CGT event J2 would happen.

CGT event J2 and former roll-over provisions

There are transitional provisions that mean that CGT event J2 can happen in relation to a capital gain rolled over under the former ITAA36 or ITAA97 small business concessions.[27]

Share or trust interest

There is a provision that is to the effect that where the replacement asset is a share or trust interest, if the share or trust interest ceases to be an active asset only because of changes in the market values of assets that were owned by the company or trust when the share or trust interest was acquired or fourth element expenditure was incurred, then CGT event J2 does not happen.[28]

Other CGT event may also happen

If the circumstances that caused CGT event J2 to happen involve the happening of another CGT event (eg if the disposal of the replacement asset causes CGT event J2 to happen, CGT event A1 would also happen), any capital gain from the other event will be treated as any other capital gain for CGT purposes, and could qualify for the CGT discount capital gain concession and the CGT small business reliefs, if the relevant conditions for the concession and reliefs to apply were met.

25 S 104-185(2) ITAA97. Before an amendment that was made by the *Tax Laws Amendment (2011 Measures No. 9) Act 2012*, and which was effective 21 March 2013, this provision provided for CGT event J2 to be activiated if the taxpayer made a testamentary gift of the replacement asset under the Cultural Bequests Program.

26 S 104-185(3) ITAA97.

27 S 104-185 of the *Income Tax (Transitional Provisions) Act 1997.* These concessions were contained in former Div 17A, Pt 111A ITAA36 and former Div 123 ITAA97.

28 S 104-185(8) ITAA97.

It is important to keep in mind that CGT small business roll-over relief does not affect the cost base or reduced cost base of a replacement asset, so a capital gain or capital loss from a CGT event happening to a replacement asset is calculated in the normal way.

Time of event

CGT event J2 happens when the change that causes the event to happen occurs.[29]

Capital gain

If CGT event J2 happens, the taxpayer makes a capital gain that is equal to the amount of the capital gain that was disregarded because of the choice for roll-over relief.[30] However, if there are two or more replacement assets, and a change that causes CGT event J2 to happen occurs in relation to one or more, but not all, of the replacement assets, the capital gain that is made from CGT event J2 happening is the excess of the amount of the capital gain for which roll-over relief was chosen, over the sum of the following amounts for each replacement asset in relation to which the change did not occur:

(1) the first element of the cost base;

(2) the incidental costs of acquisition; and

(3) the amount of fourth element expenditure incurred.[31]

If CGT event J6 has already brought to account part of a capital gain for which roll-over relief was chosen, CGT event J2 operates in relation to the balance of the capital gain.[32] Similarly, if CGT event J2 has already brought to account part of a capital gain, CGT event J2 will thereafter operate in relation to the balance of the capital gain.[33]

Other concessions

A capital gain that arises from the happening of CGT event J2 cannot qualify for the CGT discount capital gain concession, the CGT 15-year small business exemption or the CGT small business 50% reduction. It can qualify for the CGT small business retirement exemption or CGT small business roll-over relief (see ¶15-155).

¶15-150 Death of individual

There is a provision which applies where:

(1) an individual who has obtained CGT small business roll-over relief dies;

29 S 104-185(4) ITAA97.

30 S 104-185(5) ITAA97.

31 S 104-185(5)(c) ITAA97.

32 S 104-185(6) ITAA97.

33 S 104-185(7) ITAA97.

(2) at the time of his or her death, the individual still owned a replacement asset (or an asset in respect of which eligible fourth element expenditure was incurred) and the asset devolves to the deceased's legal personal representative; and

(3) CGT event J2 (see ¶15-145) did not happen before the individual died.

It is then provided that, for the purposes of the CGT small business roll-over relief provisions, anything done or not done by the deceased in relation to the asset is treated as though it had been done or not done by the deceased's legal personal representative.[34]

The position is similar if the asset has passed to a beneficiary of the deceased's estate, and CGT event J2 has not happened before the asset passed to the beneficiary; that is, anything done or not done by the deceased or by the deceased's legal personal representative in relation to the asset is treated as though it had been done or not done by the beneficiary.[35] For this purpose, it would seem that whether a replacement asset passes to a beneficiary would be determined in accordance with the rules set out in s 128-20 ITAA97.

It is clear that these provisions can only apply if the deceased dies after the replacement asset period has ended. (Note that there is a difficulty when applying the provisions of s 152-420 ITAA97 in relation to CGT event J2, because the provisions of that section are expressed to apply "for the purposes of this Subdivision" (ie Subdiv 152-E ITAA97), but CGT event J2 is provided for in Subdiv 104-J ITAA97.)

The provisions discussed above raise some issues of construction, and their effect and operation is not clear. Any capital gain or capital loss from the happening of CGT event J2 as a result of the deceased's death would be disregarded under the general CGT deceased estate provisions.[36] A possible view is that the broad intended effect of the provisions is that, instead of CGT event J2 happening as a result of the deceased's death, CGT event J2 will be deferred if the particular CGT asset remains an active asset in the hands of the legal personal representative or a beneficiary. If the deceased's death causes the CGT asset to cease to be an active asset because a relevant connected entity link is broken, it is doubtful whether the provisions could prevent CGT event J2 from happening.

The ATO Guide states that, if, just before dying, a person still owned a replacement or capital-improved asset from an earlier small business roll-over, CGT event J2 will happen on the person's death. This is because the replacement or capital-improved asset will stop being the deceased's active asset, having devolved to their legal personal representative (LPR). The Guide goes on:

> "However, the general rules concerning death, in addition to disregarding any capital gain made on the replacement asset from CGT event A1, will also disregard the capital gain from CGT event J2. Although any capital gain from CGT event A1 is effectively deferred until a later sale of the asset by the LPR or beneficiary, the capital gain from CGT event J2 is not transferred to the LPR or beneficiary. This means that the capital gain from CGT event J2 is permanently disregarded under the general rules concerning death."

34 S 152-420(1) and (2) ITAA97.

35 S 152-420(1) and (3) ITAA97.

36 S 128-10 ITAA97.

The following example is given:

> "**Example**
>
> Jack disposed of an active asset and made a capital gain of $400,000. After applying the CGT discount and the active asset reduction, his remaining capital gain was $100,000. Jack acquired a replacement asset (for more than $100,000) and chose the small business roll-over, disregarding the remaining capital gain of $100,000. Jack continued to carry on his business using the replacement asset until his death.
>
> On Jack's death, the replacement asset (which had increased in value) devolved to his LPR. Accordingly, CGT event A1 and CGT event J2 happened. The capital gains from CGT event A1 and CGT event J2 are disregarded under the general rules concerning death. The capital gain on the replacement asset from CGT event A1 is effectively deferred until a later sale of the asset by the LPR or beneficiary. However, the $100,000 capital gain from CGT event J2 is not transferred to the LPR or beneficiary and, as a result, remains permanently disregarded."

For the position where an individual (who has chosen CGT small business roll-over relief) dies during the replacement asset period, see ¶15-160.

¶15-155 Small business reliefs and CGT events J2, J5 and J6

The basic conditions for CGT small business relief do not apply for the purposes of claiming the CGT small business retirement exemption in respect of a capital gain that arises from CGT event J5 or J6 (s 152-305(4) ITAA97).

Accordingly, it is not necessary, in order to claim the CGT small business retirement exemption in respect of a capital gain that arises from CGT event J5 or J6, for the taxpayer to satisfy the maximum net asset value test or any of the small business entity conditions.

A capital gain from CGT event J5 or J6 cannot qualify for any CGT small business relief, other than retirement relief.

A capital gain from CGT event J2 may qualify for the CGT small business retirement exemption or roll-over relief (or partly for one and partly for the other concession) (see ¶15-145).

¶15-160 What if the taxpayer ceases to exist during the replacement asset period?

If a taxpayer chooses CGT small business roll-over relief (see ¶15-110), a capital gain may arise from the happening of CGT event J5 or J6 at the end of the replacement asset period (see ¶15-130 and ¶15-140). The replacement asset period can extend to one year before and two years after (or a longer period of time allowed by the Commissioner) the time of the last CGT event in the income year for which roll-over relief is chosen (see ¶15-120).

No provision is made for the situation where the taxpayer ceases to exist during the replacement asset period – for example, in the case of an individual, he or she dies or, in the case of a company or trust, the company or trust is wound up. CGT events J5 and J6 can only happen at the end of the replacement asset period, and the capital gain from the happening of either of the events can only arise to the entity who or which claimed the roll-over relief.[37] CGT event J2 can only happen after the replacement asset period ends (see ¶15-145).

While it may have been expected that the operation of CGT events J5 and J6 could be activated on an appropriate basis in some circumstances if the taxpayer ceases to exist during the replacement asset period, there is no provision that has this effect.

In the case of an individual, the overall effect of the general CGT death rules is that (subject to exceptions) any capital gain or capital loss that arises as a result of the death of an individual is disregarded.[38] No capital gain could, in any event, be made in the kind of case envisaged because the individual's death occurs before the end of the replacement asset period. The provisions of s 152-420 ITAA97 (see ¶15-150) do not assist because those provisions are premised on the assumption that the replacement asset period has expired before the deceased's death. Further, those provisions only apply "for the purposes of this Subdivision", ie Subdiv 152-E ITAA97, which deals with the choice for CGT small business roll-over relief. The provisions could not apply for the purposes of Subdiv 104-J ITAA97, which provides for the happening of CGT events J5 and J6.

In the case of a company or trust, if steps were deliberately taken with the purpose of ensuring that an expected capital gain from the happening of CGT event J5 or J6 was avoided, this could potentially give rise to issues under the general anti-avoidance provisions[39] and, possibly, to implications under the *Crimes (Taxation Offences) Act 1980*. Further, an entity who or which promotes schemes to achieve this result may fall foul of the scheme promotion provisions in Div 290 of Sch 1 of the *Taxation Administration Act 1953*.

¶15-165 How the rolled-over capital gain is applied against replacement assets or expenditure

The way that the provisions that govern the operation of CGT small business roll-over relief (and, in particular, the provisions governing the happening of CGT events J5 or J6) are structured does not provide the taxpayer with a choice of which CGT asset or fourth element capital expenditure is to be taken into account when applying the relief. This contrasts with how CGT small business roll-over relief operated for CGT events that happened in the 2005-06 and earlier income years. For those income years, the taxpayer had to choose one or more replacement assets.[40]

37 Ss 104-197(3) and 104-198(2) ITAA97.

38 S 128-10 ITAA97.

39 Pt IVA ITAA36.

40 Former s 152-410(b) ITAA97.

One possible construction of the provisions governing the happening of CGT events J5 and J6 is that, if a choice for roll-over relief is made, the provisions simply operate automatically. According to this construction, the CGT assets that are relevant replacement assets, and expenditure that is relevant fourth element expenditure, are determined solely on a chronological basis. That is, the amount of a capital gain rolled over would be applied towards the first qualifying CGT asset acquired (or to the first fourth element expenditure incurred in relation to a CGT asset) that was an active asset at the expiration of the replacement asset period. Any balance of the capital gain would be applied towards the second acquisition or expenditure incurred, and so on.

This would mean that the provisions could have a rather harsh operation. For example, the first potential eligible expenditure by a taxpayer during the replacement asset period may be to acquire motor vehicles or other relatively short-term CGT assets. However, the taxpayer may acquire a long-term CGT asset (say, business premises) shortly after and more than one year before the end of the replacement asset period. If the motor vehicles were to be disposed of just after the end of the replacement asset period, and roll-over relief operated automatically as discussed above, CGT event J2 would happen in relation to the motor vehicles, but the CGT event J2 capital gain could not be utilised by way of roll-over relief against the long-term asset (unless the Commissioner were to exercise the discretion to extend the replacement asset period) (see ¶15-120).

It is submitted that the provisions should be amended to expressly permit a taxpayer to allocate the amount of a rolled-over capital gain against specific replacement assets or fourth element capital expenditure. In the meantime, the Commissioner, it is submitted, should administer the provisions in a commonsense manner so as to permit a taxpayer to make an allocation. It would be of assistance if the Commissioner were to clarify his view on how the provisions operate.

¶15-170 Using roll-over relief as a deferral mechanism

If a capital gain potentially qualifies for CGT small business roll-over relief, choosing roll-over relief will at least defer recognition of the capital gain until the end of the replacement asset period.

Subject to an important qualification, choosing roll-over relief would result in obtaining a tax benefit as defined for the purposes of the general anti-avoidance provisions of Pt IVA ITAA36,[41] and the making of the choice could be a scheme for the purposes of the Part.[42] However, s 177C(2) ITAA36 provides for what could be called a “choice exclusion” from the operation of Pt IVA that should usually be applicable. Under this exclusion (so far as is relevant), the obtaining of a tax benefit in connection with a scheme does not include a tax benefit that is attributable to the making of (*inter alia*) a choice expressly provided for by the ITAA36 or the ITAA97, provided the scheme was not entered into or carried out by any person for the sole or dominant purpose of creating any circumstance or state of affairs, the existence of which is necessary to enable the choice to be made.

41 S 177C ITAA36.

42 Cf *FCT v Hart* [2004] HCA 26.

Accordingly, in the usual kind of case (and provided there is no wider scheme that could be attacked under Pt IVA), there seems to be nothing that would prevent a taxpayer who or which disposes of a post-CGT active asset choosing roll-over relief for a capital gain, even if the taxpayer had no intention of acquiring a replacement asset or incurring fourth element expenditure.

Depending on the circumstances, the deferral of a capital gain by making a choice for CGT small business roll-over relief could have a number of advantages, including:

(1) simply deferring the taxation of a capital gain;

(2) ensuring that a capital loss that is expected to be made in the near future can be offset against the capital gain;

(3) in the case of a company or trust, other or additional CGT concession stakeholders (at the later time when the capital gain will again arise under CGT event J5) may be able to take advantage of CGT small business retirement relief;

(4) ensuring that a net capital loss carried forward or a capital loss incurred in the current income year is offset against a capital gain that is expected to be made in the next income year and which will not qualify for CGT small business relief;

(5) in the case of a trust, if the trustee is to be assessable under s 99A ITAA36, the benefit of the discount capital gain concession and the CGT small business 50% reduction would be preserved (see ¶17-125); and

(6) an individual taxpayer or, in the case of a company or trust, a CGT concession stakeholder, may turn 55 years of age after the lodgment of the tax return for the income year in which the capital gain has arisen, but before the time for making a choice for the CGT small business retirement exemption in respect of a CGT event J5 capital gain. This would mean that the CGT small business retirement relief in respect of the capital gain arising under CGT event J5 would be able to be taken directly at the end of the replacement asset period without being rolled over.

Maximum net asset value test/small business entity

An important point is that, if CGT small business roll-over relief is chosen for deferral purposes and with a view to choosing CGT retirement relief when the capital gain arises from the happening of CGT event J5, the taxpayer would not need to satisfy the basic conditions for CGT small business relief to be able to choose retirement relief (see ¶15-155).

How a rolled-over capital gain is applied

It should be noted that there is an issue as to how the relevant replacement asset or relevant fourth element expenditure is identified, given that the taxpayer is not required to make any nomination as to a replacement asset or eligible expenditure. It is not clear, for example, whether the mere fact that a taxpayer has (at the end of the replacement asset period) a replacement active asset would mean that CGT event J5 would not happen. See ¶15-165.

¶15-180 Case studies

Case study 1

Supercharge Pty Ltd sold a post-CGT active asset under a contract entered into on 8 March 2013. The company made a capital gain of $200,000 from the sale of the asset. Supercharge Pty Ltd claimed CGT small business roll-over relief in respect of $100,000 of the capital gain.

A replacement asset (business premises) was acquired in July 2012, and this is an active asset at the end of the replacement asset period.

In November 2012, it is decided that the premises should be demolished and new premises built. While the demolition and rebuilding is undertaken, Supercharge Pty Ltd intends to vacate the premises and use rented premises.

As the premises owned by the company would cease to be an active asset of Supercharge Pty Ltd when the premises are vacated, CGT event J2 would happen (see ¶15-145).

However, if CGT small business roll-over relief is able to be claimed in respect of the capital gain that is made from the happening of CGT event J2 and the relief is claimed, the capital expenditure incurred on the rebuilding of the premises could qualify as fourth element expenditure for the purposes of CGT event J5 and J6.

Alternatively, Supercharge Pty Ltd could claim CGT small business retirement relief in respect of the CGT event J2 capital gain (or part of it), providing the conditions were met for retirement relief to apply (see ¶14-160) and either the maximum net asset value test was met or Supercharge Pty Ltd was a small business entity for the income year in which CGT event J2 happened.

Case study 2

The Wacky Discretionary Trust was established by deed dated 29 May 1993. The trust sells an active asset under a contract dated 19 August 2014, making a capital gain of $1m. This capital gain qualifies for the CGT discount capital gain concession and the CGT small business reliefs. The application of the CGT discount capital gain concession and the CGT small business 50% reduction reduces the capital gain to $250,000.

The Wacky Discretionary Trust has no other capital gains and no capital losses for the income year, and otherwise has a tax loss. Because of the tax loss, the trustee makes no distribution of income during the 2014-15 income year and, in addition, makes no distribution of capital during that income year. This means that the Wacky Discretionary Trust does not have a significant individual just before the CGT event on 19 August 2014 (see ¶11-110) and, accordingly, the CGT small business retirement exemption cannot be chosen.

However, if the trustee chooses CGT small business roll-over relief in respect of the balance of the capital gain ($250,000), and no relevant replacement asset has been acquired or fourth element expenditure incurred by the end of the replacement asset period, CGT event J5 would happen on 19 August 2016.

Providing the trustee makes a sufficient distribution of income or capital during the 2016-17 income year to ensure that the trust had one or more CGT concession stakeholders, a choice could be made for the CGT small business retirement exemption to apply to the capital gain.

Chapter 16

Company distributions

¶16-100 Context

The CGT small business reliefs are available to a company if the basic conditions (see ¶4-100) for the reliefs to apply are met and if any special conditions relating to the operation of a particular relief being claimed are also met. There are, for example, special requirements that must be met by a company under the CGT 15-year small business exemption (see ¶12-115) and the CGT small business retirement exemption (see ¶14-160).

This chapter briefly considers the consequences for the shareholders of a company if there is a distribution that consists of, or includes, an amount that has been excluded from the calculation of the net capital gain of the company by the operation of the CGT small business reliefs.

There are, of course, a number of issues and considerations that can arise under the CGT small business relief provisions in the case of a company and its shareholders (eg the circumstances in which a share will be an active asset), and these have been noted in other chapters of this handbook.

¶16-105 Treatment of non-taxed amount

Where a company makes a capital gain that qualifies for the CGT small business reliefs, it is important to understand the consequences of a distribution by the company of any amount by which the capital gain has been reduced by the reliefs.

15-year exempt amount

If a capital gain made by a company qualifies for the CGT 15-year small business exemption, the exempt amount can be distributed to individuals who were CGT concession stakeholders just before the CGT event happened (to the extent of their stakeholder participation percentages) without tax implications for up to two years (or a longer period allowed by the Commissioner) after the CGT event. For more information, see ¶12-150.

Retirement exemption amount

If CGT small business retirement relief is claimed in respect of a capital gain, the capital gain to this extent will have been paid to (or contributed to a complying superannuation fund or an RSA on behalf of) one or more CGT concession stakeholders (see ¶14-180).

50% reduction amount

If a capital gain of a company has been reduced under the CGT small business 50% reduction, and if the amount of the reduction is distributed while the company is a going concern, it will be an assessable and frankable dividend or, if the circumstances are such that the payment provisions of Div 7A ITAA36 apply, a deemed assessable, but unfrankable, dividend (subject to the exercise of the Commissioner's discretion under s 109RB ITAA36).

In practical terms, a distribution of the amount of the reduction that is an actual (rather than a deemed) dividend could only carry franking credits if, and to the extent that, the company in fact has surplus franking credits for some reason. Further, if there are no surplus franking credits, the amount could not be distributed without adverse imputation consequences in any year for which the company's benchmark rate for the purposes of imputation exceeded 0%.

If, however, the amount of the reduction is distributed on the liquidation of the company:

- it would not be "income" for the purposes of s 47(1) ITAA36[1] and would not be assessable as a deemed liquidator's dividend; and
- it would be capital proceeds from the happening of CGT event C2 in relation to the relevant share or shares, provided the company is dissolved within 18 months of the payment. If the company is dissolved later, CGT event G1 would happen, and the amount would be a non-assessable part for the purposes of the event.

For more information, see TD 2001/27. The time of the happening of CGT events C2 and G1 is explained at ¶2-125.

If the share is a pre-CGT asset, any capital gain or capital loss from the happening of CGT event C2 or G1 would, of course, be disregarded. In a liquidation of a company, a capital gain would be most unlikely to arise in relation to a pre-CGT share under CGT event K6. This is because CGT event K6 has no application if CGT event G1 happens to the share and, if CGT event C2 happens on the liquidation, the conditions for a capital gain arising under CGT event K6 could not be met, given the time when CGT event C2 would happen (see ¶8-155).

If the share is a post-CGT asset, the share or shares have been held for at least 12 months, and the shareholder is an individual or the trustee of a trust, the CGT discount capital gain concession will potentially be available.

In addition, if a share in a company (the object company) satisfies the active asset test and is owned either by a CGT concession stakeholder in the object company, or by a company or trust in which CGT concession stakeholders in the object company together have at least a 90% small business participation percentage, a capital gain made by the shareholder can qualify for the CGT small business reliefs (provided the maximum net asset value test or a small business entity test and any conditions for the particular relief or reliefs to apply are met). For more information, see ¶4-110 and ¶11-125.

If a share is or has been an active asset, it would be of crucial importance to pay careful regard to the timing rules for the happening of CGT events C2 and G1 to ensure that the share satisfies the active asset test. This is explained at ¶8-155.

1 TD 2001/14.

Roll-over amount

If CGT small business roll-over relief is claimed in respect of a capital gain, the consequences of the distribution of the amount of the capital gain disregarded as a result of roll-over relief would be the same as for the distribution of the 50% reduction amount.

Chapter 17

Trust distributions

¶17-100 Context

The CGT small business reliefs are available to trusts if the basic conditions for the reliefs to apply (see ¶4-100) are met, and any special conditions relating to the operation of the particular relief being claimed, including any special conditions that apply in the case of a trust, are also met. The CGT 15-year small business exemption (see ¶12-115) and the CGT small business retirement exemption (see ¶14-155) contain special rules that apply to trusts.

This chapter briefly considers the consequences for the beneficiaries of a trust where an amount of a capital gain has been disregarded as a result of the operation of the CGT small business reliefs.

Because the discount capital gain concession will frequently have been applied in addition to the CGT small business reliefs, it is convenient to also consider the consequences for beneficiaries of a distribution by the trustee of the amount of the discount.

In addition, this chapter discusses the consequences for a trustee who or which is assessed under s 99A ITAA36 on part of the net tax income of the trust, which reflects a capital gain to which the CGT discount capital gain concession or the CGT small business 50% reduction has applied (see ¶17-125).

The discussion in this chapter is not comprehensive and is only intended to provide a broad overview of the way the CGT discount capital gain concession and the CGT small business reliefs operate in the context of the CGT regime where a trust is eligible to claim the concession and/or the reliefs.

¶17-105 Capital gain may or may not be reduced to nil

If a trust makes a capital gain for an income year to which the CGT small business reliefs (other than the 15-year small business exemption) apply (whether or not the discount capital gain concession also applies), the amount of the capital gain may be:

(1) reduced to a lesser amount so that the lesser amount of the capital gain is taken into account in the calculation of the net capital gain of the trust for the income year; or

(2) reduced to nil.

Capital gain reduced to nil

A capital gain will, of course, be reduced to nil if the CGT small business 15-year exemption applies. For further discussion of the specific provisions which govern the treatment of distributions of the "exempt amount", see ¶12-150.

Where a capital gain that is made by a trust qualifies for the CGT small business reliefs (other than the small business 15-year exemption) and is reduced to nil by the operation of the reliefs (whether with or without the operation of the CGT discount capital gain concession), no amount of the capital gain would have entered into the calculation of the net tax income of the trust for the income year in which the capital amount arose.

One consequence of this is that capital losses (or net capital losses) that a beneficiary has available for determining the net capital gain of the beneficiary for the particular income year would not be used up to any extent, by reason of the trust having made the capital gain and the beneficiary being presently entitled to income of the trust estate for the income year.

It should be noted that, if a capital gain qualifies for the CGT small business reliefs, it will always be possible to reduce the capital gain to nil; if the other reliefs do not have this effect, a choice for roll-over relief will (see ¶15-110 and ¶15-170).

Discretionary trust

Where the trust is a discretionary trust and the amount representing the capital gain (that is reduced to nil) is distributed by the trustee to a beneficiary, it would seem that the distribution could only be assessable income of the recipient beneficiary if s 99B ITAA36 operated to produce this effect.

Section 99B ITAA36 provides (in subs (1)) that, where, at any time during an income year, an amount, being property of a trust estate, is paid to, or applied for the benefit of, a beneficiary of the trust estate who was a resident at any time during the income year, the assessable income of the beneficiary of the income year shall, subject to subs (2), include that amount.

This means that the income tax treatment of the distribution will turn on the scope and operation of the exceptions in subs (2). The two potentially relevant exceptions are those provided by paras (a) and (b). Those paragraphs provide that an amount that would otherwise be assessable under s 99B ITAA36 is reduced by so much of the amount as represents:

> "(a) corpus of the trust estate (except to the extent to which it is attributable to amounts derived by the trust estate that, if they had been derived by a taxpayer being a resident, would have been included in the assessable income of that taxpayer of a year of income); [or]
>
> (b) an amount that, if it had been derived by a taxpayer being a resident, would not have been included in the assessable income of that taxpayer of a year of income;"

If the capital gain is corpus of the trust estate (as would usually be the case), it is submitted that the terms of the exclusion provided for by para (a) would be met. The exceptive words would not be relevant because the net tax income of a trust for an income year is determined on the basis that the assessable income of the trust is calculated as if the trustee were a resident (s 95 ITAA36 (definition of "net income")) and, as a matter of fact, that calculation did not bring any part of the amount of the capital gain to account as assessable income.

If, for some reason, the capital gain was not corpus of the trust estate (for example, possibly if the trustee, acting in accordance with the terms of the trust deed, treated the amount as income), the reason given for the exclusion in para (a) applying would have the consequence that the exclusion in para (b) would apply.

Accordingly, if the trust is a discretionary trust, the distribution by the trustee of an amount attributable to a capital gain that has been reduced to nil should not cause any income tax issues.

Nor should such a distribution cause any CGT issues. The Commissioner accepts that a beneficiary of a discretionary trust, even a default beneficiary, does not have any relevant interest that would attract the operation of CGT event E4 (TD 2003/28). This is subject to the qualification that the position is not clear where a default beneficiary has acquired the default interest by transfer or assignment.

Unit trust

If the trust is a unit trust or otherwise has fixed interests in it, there may be CGT issues and, in particular, issues arising out of CGT events C2 and E4. For further discussion, see ¶17-115.

Capital gain not reduced to nil

Where, after the application of the CGT small business reliefs, a capital gain of a discretionary trust is not reduced to nil and is not otherwise absorbed when applying the net capital gain method statement, then (providing the trust deed contains an adequate power to do so) the trustee may stream the capital gain to particular beneficiaries. This is done by making one or more beneficiaries "specifically entitled" to the capital gain or some part of it. The specifically entitled concept is explained below.

If beneficiaries are specifically entitled to the whole of the capital gain, the CGT consequences will flow to those beneficiaries.

If the trustee does not make any beneficiaries specifically entitled to the capital gain (or makes beneficiaries specifically entitled to part, but not all, of the capital gain), the capital gain (or the balance of the capital gain) is attributed to beneficiaries of the trust on a proportionate basis in accordance with their present entitlements to the income of the trust estate for the income year.

More particularly, the broad effect of the relevant provisions is as follows:

(1) when calculating the amount on which a beneficiary (or the trustee) is assessed under Div 6 ITAA36, to the extent that a capital gain made by the trust is included in the net capital gain of the trust, it is ignored in the calculation of the income of the trust and of the net tax income of the trust.[1] The way that such a capital gain is treated is governed by the CGT provisions;

(2) for the purposes of the CGT provisions, a beneficiary (or the trustee) has a "share" of a capital gain (that is not reduced to nil when calculating the net capital gain of the trust) equal to the sum of:

    (a) the amount (if any) of the capital gain (before it is reduced to any extent by the CGT method statement) to which the beneficiary (or the trustee) is "specifically entitled"; and

    (b) to the extent to which there is an amount of the capital gain to which no beneficiary or the trustee is specifically entitled — the amount of the capital gain multiplied by the beneficiary's (or the trustee's) "adjusted Division 6 percentage" of the income of the trust for the year;[2]

1 Div 6E ITAA36.

2 S 115-227 ITAA97.

(3) where a beneficiary (or the trustee) has a share of a capital gain (see (2) above), so much of the capital gain as is reflected in the net capital gain of the trust is attributed to the beneficiary (or the trustee) in accordance with the following calculation:[3]

$$\text{Amount of capital gain of trust after applying CGT method statement} \times \frac{\text{Beneficiary's (or trustee's) share of capital gain}}{\text{Amount of capital gain}}$$

(4) if the capital gain:

(a) was reduced by the discount capital gain concession (and not by the CGT small business 50% reduction) — the attributed capital gain is multiplied by two and the beneficiary (or the trustee[4]), when applying the net capital gain method statement, is entitled to claim the CGT discount capital gain concession if the beneficiary is not a company;

(b) was reduced by the CGT small business 50% reduction (but not by the CGT discount capital gain concession) — the attributed capital gain is multiplied by two and the beneficiary (or the trustee[5]), when applying the net capital gain method statement, is entitled to claim the CGT small business 50% reduction; and

(c) was reduced by both the CGT discount capital gain concession and the CGT small business 50% reduction — the attributed capital gain is multiplied by four and the beneficiary (or the trustee[6]), when applying the net capital gain method statement, is entitled to claim the CGT discount capital gain concession (if not a company) and also the CGT small business 50% reduction.[7]

Specific entitlement

For a beneficiary to be "specifically entitled" to an amount of a capital gain (before the application of the CGT method statement (see ¶2-130)), the requirements of s 115-228 ITAA97 must be met. The way a capital gain that is reflected in a trust's net capital gain is streamed is by the trustee exercising a streaming power in the trust deed to make a beneficiary or beneficiaries specifically entitled to an amount of what might be called the "gross capital gain" (that is, the capital gain before it is reduced by any CGT concessions). To the extent that the capital gain is not streamed, it is attributed to the beneficiaries in accordance with their "adjusted Division 6 percentages" (see below).

The circumstances in which a beneficiary will be specifically entitled to an amount of a capital gain made by a trust are governed by s 115-228 ITAA97.

3 S 115-225 ITAA97.

4 A trustee assessed under s 98(3) or (4) ITAA36 or s 99A ITAA36 cannot get the benefit of the CGT discount capital gain concession (see ¶17-120).

5 A trustee assessed under s 99A ITAA36 cannot get the benefit of the CGT small business 50% reduction (see ¶17-120).

6 A trustee assessed under s 98(3) or (4) ITAA36 or s 99A ITAA36 cannot get the benefit of the CGT discount capital gain concession, and a trustee assessed under s 99A ITAA36 cannot get the benefit of the CGT small business 50% reduction (see ¶17-120).

7 S 115-215 ITAA97.

Adjusted Division 6 percentage

A beneficiary's adjusted Division 6 percentage of the income of a trust estate is the beneficiary's share of the income of the trust for the income year, calculated on the assumption that the amount of a capital gain or franked distribution to which any beneficiary or the trustee is specifically entitled is disregarded when working out the income of the trust estate.

Practice points

- Because a beneficiary's "share" of a capital gain is calculated by reference to the capital gain before applying the CGT method statement (that is, before applying any capital loss, any net capital loss or any CGT concessions), it is not possible to separately "stream" that part of a capital gain that remains after applying the CGT concessions.
- If a capital gain of a trust is reduced to nil by the CGT concessions, there will be no capital gain to which the CGT trust provisions can apply (see "Capital gain reduced to nil" above).

Example

For the 2015-16 income year, the Twinkle Discretionary Trust has net ordinary income of $40,000 and a capital gain of $60,000 which qualified for the CGT discount capital gain concession (but no other CGT concessions). The trust has no other capital gains and no capital losses or net capital losses and, accordingly, the net capital gain of the trust for the income year is $30,000 (after applying the CGT discount capital gain concession).

It is not possible for the trustee to "stream" the assessable component of the capital gain to a particular beneficiary and the balance of the capital gain to another beneficiary. The effect of the provisions which govern how a beneficiary is made specifically entitled to an amount of a capital gain (before the CGT method statement is applied) simply operate on a proportional basis by reference to the particular beneficiary's share of the net financial benefit and the amount of the net financial benefit.

Note that, where a trust deed has an income equalisation provision which has the effect of equating the trust income of the trust for an accounting period with the net tax income of the trust for the accounting period, and a capital gain is partly excluded from the calculation of the net capital gain of the trust for an accounting period, part of the capital gain will be treated as income and part treated as capital. The way that this situation is dealt with requires some care.

There can only be an adjusted Division 6 percentage if there is a capital gain or some part of a capital gain made by the trust to which no beneficiary is specifically entitled.

Example

The way the "streaming" provisions operate may be illustrated by a simple example.

For the 2015-16 income year, the Anteater Discretionary Trust has:

- ordinary income (less allowable deductions) of $80,000;
- the following capital gains and capital loss:
  - a capital gain (capital gain 1) of $20,000 which does not qualify for any of the CGT concessions;

- a capital gain (capital gain 2) of $100,000 which qualifies for the CGT discount capital gain concession but no other CGT concession;
- a capital gain (capital gain 3) of $500,000 which qualifies for the CGT discount capital gain concession and the CGT small business 50% reduction and no other CGT small business reliefs are claimed; and
- a capital loss of $30,000.

Assuming that the capital loss is applied first against capital gain 1 and, to the extent of the balance ($10,000), is applied against capital gain 2, this would mean that the Anteater Discretionary Trust has a net capital gain for the income year of $170,000.

The trustee took steps to make Brian (a beneficiary) specifically entitled to the whole of capital gain 3 but did not make any beneficiary specifically entitled to any part of capital gain 2. The trustee distributes the ordinary income (less deductions) between two individual beneficiaries equally, namely, Amy and Jerry. Assuming that a capital gain is not income for the purposes of the trust deed, the following sets out the position of each beneficiary:

	Capital gain 2		Capital gain 3	
Beneficiary	**Share**	**Attributed amount**	**Share**	**Attributed amount**
Brian	–	–	$500,000	$125,000
Amy	$50,000	$45,000	–	–
Jerry	$50,000	$45,000	–	–

Brian would gross up the attributed capital gain by a multiple of four and the amount of this grossed-up capital gain that remained after offsetting any relevant capital losses and net capital losses of Brian would be subject to the CGT discount capital gain and the CGT small business 50% reduction.

Each of Amy and Jerry would gross up the attributable amount by two, and the amount remaining after applying relevant capital losses and net capital losses would qualify for the CGT discount capital gain concession.

¶17-110 Distribution of 15-year exempt amount

If a capital gain of a trust is disregarded under the CGT small business 15-year exemption, distributions made within two years to CGT concession stakeholders can be tax-free under s 152-125 ITAA97 (see ¶12-150).

If a distribution out of the 15-year exemption amount is made that is not tax-free under that section, it seems that there will only be CGT consequences if the trust is a unit trust and the distribution causes CGT event C2 (see ¶2-125) to happen; that is, if there is a redemption or cancellation of the unit. This means, for example, that if the distribution is made by the trustee of a discretionary trust, there should be no CGT consequences (see ¶12-162).

If CGT event C2 does not happen (because the unit is not redeemed or cancelled), the only CGT event that could be relevant is CGT event E4. However, to the extent to which a payment by the trustee is attributable to a 15-year exempt amount, it is excluded from the operation of CGT event E4; regardless, it would seem, of when it is paid and whether or not the recipient is a CGT concession stakeholder.[8]

¶17-115 CGT events C2 and E4: distribution of discount and reduction amount

Where a unit trust, or a trust in which beneficiaries have an interest which constitutes a CGT asset, distributes an amount that represents either the discount obtained by the operation of the CGT discount capital gain concession or the amount of the CGT small business 50% reduction, the CGT consequences for the recipient of the distribution will turn on the operation of CGT events C2 and E4.

CGT event C2

CGT event C2 happens if a taxpayer's ownership of an intangible CGT asset (which a unit or an interest in a trust would be) ends as a result of the asset being, for example, redeemed or cancelled, satisfied, or surrendered or forfeited.[9] CGT event C2 would typically happen if the unit ceases to exist by being redeemed (whether or not the trust remains in existence) or otherwise cancelled.

Where CGT event C2 happens in relation to a post-CGT unit, a capital gain arises if the capital proceeds from the ending of the unit are more than the relevant unit's cost base and, conversely, a capital loss is made if the capital proceeds are less than the unit's reduced cost base.[10]

The general capital proceeds rules in Div 116 ITAA97 will usually apply for the purpose of determining whether a capital gain or capital loss arises under CGT event C2, so that the discount amount or the reduction amount distributed would form part of the capital proceeds for the purposes of CGT event C2.

A capital gain that is made from the happening of CGT event C2 would potentially qualify for the CGT discount capital gain concession and the CGT small business reliefs, providing the conditions are met for the concession or reliefs to apply.

Although a capital gain from the happening of CGT event C2 is disregarded if the unit is a pre-CGT asset, there may be cases in which CGT event K6 (pre-CGT shares or trust interest) could happen.

CGT event E4

CGT event E4 does not happen if CGT event C2 happens, so for the operation of CGT event C2 to be precluded in a given case, the distribution by the trustee must not relate to the redemption or cancellation of the unit or of the interest in the trust.

8 S 104-71(1)(g) ITAA97. This depends on what is meant by "an amount referred to in s 152-125 [ITAA97] … as an exempt amount".

9 S 104-25 ITAA97.

10 S 104-25(3) ITAA97.

Circumstances in which CGT event E4 will happen

So far as is relevant, CGT event E4 happens if the trustee of a trust makes a payment (which can include the giving of property) to a taxpayer in respect of the taxpayer's unit or interest in the trust, and some or all of the payment (called the "non-assessable part") is not included in the taxpayer's assessable income.[11]

A capital gain made from CGT event E4 is disregarded if the unit or interest in the trust was acquired pre-CGT.[12] CGT event K6 (pre-CGT shares or trust interest) has no operation where CGT event E4 happens.

A payment for the purposes of the operation of CGT event E4 can include the giving of property, but the concept of payment is not otherwise defined. Where a beneficiary is made specifically entitled to an amount of a capital gain in accordance with s 115-228 ITAA97, it is submitted that whether there has been a payment may depend on the nature of the entitlement. For example, an amount distributed could constitute a payment but if the basis of the beneficiary's specific entitlement is that the beneficiary can be reasonably expected to receive a financial benefit, it is arguable that it could not be said that there had been a payment.

Consequences of CGT event E4 happening

Where CGT event E4 happens, the non-assessable part of the payment reduces the cost base and reduced cost base of the unit or interest to which the payment relates and, if the sum of the non-assessable parts of all payments made by the trustee during the income year exceeds the cost base, the excess is a capital gain.[13]

A CGT event E4 capital gain may qualify for the discount capital gain concession and the CGT small business reliefs. CGT event E4 cannot give rise to a capital loss.

Time of CGT event E4

CGT event E4 happens just before the end of the income year in which the trustee makes the payment, unless a CGT event (other than CGT event E4) happens in relation to the unit or interest after the payment and before the end of the income year, in which case CGT event E4 happens just before the other event.[14]

11 S 104-70(1) ITAA97.

12 S 104-70(7) ITAA97.

13 S 104-70(4) ITAA97.

14 S 104-70(3) ITAA97.

The non-assessable part

For CGT event E4 to happen, some or all of the payment by the trustee in respect of a unit or interest in the trust must not be included in the recipient's assessable income.[15] This is called the "non-assessable part" of the payment.

There are a number of exclusions from the amount of the non-assessable part of a payment; the following are presently relevant:

(1) **discount amount:** so much of a payment as is excluded from the net capital gain of the trust by the operation of the discount capital gain concession is excluded from the non-assessable part of the payment (and, therefore, is excluded from the operation of CGT event E4).[16] This exclusion from CGT event E4 applies to all categories of beneficiaries, including companies. If the particular capital gain was not reduced to nil by the operation of the CGT small business reliefs, a company would have effectively been taxed on the discount amount of a discount capital gain by the operation of the extra capital gain provision (see ¶17-105), but if the capital gain was reduced to nil, it would seem that a company would, effectively, get the benefit of the discount capital gain without any CGT consequences; and

(2) **beneficiary's capital loss or net capital loss offset against extra capital gain:** if the beneficiary has applied a capital loss or net capital loss against an extra capital gain (see ¶17-105), an appropriate part of the loss or net capital loss is excluded from the non-assessable amount (and, therefore, from the operation of CGT event E4). This exclusion ensures that the beneficiary is not taxed on the amount of any capital loss or net capital loss that has been applied against the extra capital gain.

CGT event E4 and a reduction amount

In TD 2006/71, it is stated (correctly) that the part of a payment by a trustee that is a small business 50% reduction amount is a non-assessable part for the purposes of CGT event E4 and, therefore, is subject to the CGT event E4 provisions.

CGT event E4 capital gain and the CGT concessions

A capital gain that is made from the happening of CGT event E4 may qualify for the CGT discount capital gain concession if the requirements for that concession are otherwise met. In addition, if a unit or other interest in a trust (the object trust) qualifies as an active asset, a CGT event E4 capital gain may qualify for the CGT small business reliefs if the unitholder (or the holder of the interest) is either:

- a CGT concession stakeholder in the object trust; or
- a company or trust in which CGT concession stakeholders in the object trust together have at least a 90% small business participation percentage,

provided either the maximum net asset value test or the small business entity test and the relevant conditions for the particular relief or reliefs to apply are met. For more information, see ¶4-110.

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15 S 104-70(1) ITAA97.

16 S 104-71(4) ITAA97, item 1 in table.

¶17-120 CGT event E4 v CGT event C2

Because of the exclusions from the operation of CGT event E4 (see ¶17-115), it would often be more advantageous for CGT event E4, rather than CGT event C2, to apply to the distribution of a discount amount or a reduction amount by the trustee of a unit trust.

In particular, this will be the case if:

- the amount of a payment by a trust represents (in whole or part) a discount amount; or
- the trust has claimed the CGT discount capital gain concession and/or the CGT small business 50% reduction, and the beneficiary has offset a capital loss or net capital loss against the extra capital gain that the beneficiary has by virtue of s 115-215 ITAA97 (see ¶17-105).

In addition, as pointed out at ¶17-110, it seems arguable that a distribution out of a 15-year exempt amount may be excluded from the operation of CGT event E4 by s 104-71(1)(g) ITAA97, even though the distribution would not fall within the flow-through concession that applies for the purposes of the CGT 15-year small business exemption (see ¶12-150).

¶17-125 Trustee assessed under s 99A ITAA36

If the net tax income of a trust for an income year is in whole or in part not taxed to or on behalf of beneficiaries who are presently entitled, the trustee is generally assessed on the whole or part (as the case may be) under s 99 or 99A ITAA36.

Section 99A ITAA36 will be the relevant section unless (broadly) the trust resulted from a will or an intestacy (in either case as varied or modified by court order), is a bankrupt estate, is in respect of certain compensation amounts, or arose from a "family breakdown", and the Commissioner is of the opinion that it would be unreasonable for s 99A ITAA36 to apply. Accordingly, in the ordinary kind of case involving an inter vivos trust, it will be s 99A ITAA36 that applies, and the trustee will be assessed at the maximum marginal rate of individual tax, plus Medicare levy.

Where the trustee of a trust is assessable under s 99A ITAA36 on an amount of a capital gain that is attributed to the trustee, the effect of s 115-222 ITAA97 is that the allowance of the CGT discount capital gain concession and the CGT small business 50% reduction is reversed out. This provision could, of course, have no practical effect if a capital gain of a trust is reduced to nil by the operation of the CGT small business reliefs. A capital gain that qualifies for CGT small business relief can always be reduced to nil by choosing CGT small business roll-over relief (see ¶15-100 and ¶15-170).

Rolled-over capital gain

It would seem that the above provisions would not have any operation if and when a capital gain rolled over under CGT small business roll-over relief is retriggered by the happening of CGT event J2, J5 or J6 (see ¶15-120 and ¶17-105).

Section 98(3) or 98(4) ITAA36

If a trustee is assessed under s 98(3) ITAA36 on behalf of a beneficiary that is a non-resident company, and the share of the net tax income that is assessed includes a capital gain that has qualified for the CGT discount capital gain concession, the benefit of the concession is reversed.[17] This is also the case if a trustee is assessed under s 98(4) ITAA36 where a trust which has a non-resident trustee is a beneficiary.[18]

¶17-130 Case study

The Penultimate Unit Trust was formed in 1990. The trust has only one asset; namely, factory premises that are used by a connected entity to carry on a business. The trustee sells the factory premises in May 2016, and a capital gain of $120,000 is made as a result of the happening of CGT event A1. The trust has no other capital gains for the 2015-16 income year, no capital loss for that income year, and no net capital loss from an earlier income year.

The capital gain qualifies for the CGT discount capital gain concession and the CGT small business 50% reduction. Neither the CGT small business retirement exemption nor CGT small business roll-over relief is chosen.

The Penultimate Unit Trust has a net capital gain of $30,000 for the 2015-16 income year. If the trust has other assessable income for the 2015-16 income year of $20,000 and allowable deductions of $5,000, the trust will have a net tax income of $45,000.

The issued units of the Penultimate Unit Trust are of one class and, at all relevant times, are beneficially held equally by two unitholders, Fred and Ticktock Pty Ltd. The cost base of the units of each unitholder is $5,000 and, for the 2015-16 income year, each unitholder had a capital loss of $10,000 but no net capital loss being carried forward and no capital gain (other than the capital gain attributable to the Penultimate Unit Trust).

For the sake of simplicity, it is assumed that after the sale of the factory premises and the repayment of loans used to acquire the premises, the assets of the Penultimate Unit Trust comprise the amount paid up on the units ($10,000) and the remaining part of the capital gain not included in the net tax capital gain ($90,000).

It is also assumed that, even if each of Fred and Ticktock Pty Ltd are specifically entitled to one-half of the gross capital gain in the 2015-16 income year, this will not mean that there has been a payment by the trustee for the purposes of CGT event E4.

In November 2016, the trustee is contemplating winding up the Penultimate Unit Trust. The trustee has the option of either making a distribution to the unitholders (CGT event E4) and then winding up the trust (CGT event C2), or of simply winding up the trust without the intermediate step of the CGT event E4 payment.

The CGT consequences of these alternative courses of action for each unitholder are set out below.

17 S 115-220 ITAA97.

18 S 115-220 ITAA97; former s 115-222 ITAA97.

Fred

2015-16

Extra capital gain ($15,000 x 4)	$60,000
Less: capital loss	$10,000
	$50,000
CGT discount capital gain concession	$25,000
	$25,000
CGT small business 50% reduction	$12,500
Capital gain	$12,500

2016-17

Situation 1: Distribution of remaining capital gain (CGT event E4) and later winding up of trust (CGT event C2)

CGT event E4

Amount distributed by trustee			$45,000
Less:	adjustments		
	discount capital gain	$30,000	
	¼ x capital loss applied in 2015-16	$2,500	$32,500
			$12,500
Less:	cost base of units		$5,000
Capital gain			$7,500

This capital gain can qualify for the CGT discount capital gain concession and the CGT small business reliefs, if the basic conditions for the reliefs to apply are met.

CGT event C2

Capital proceeds		$5,000
Less:	cost base of units	$ Nil
Capital gain		$5,000

This capital gain can qualify for the CGT discount capital gain concession and the CGT small business reliefs, if the basic conditions for the reliefs to apply are met.

Situation 2: Distribution of remaining capital gain on winding up (CGT event C2)

Capital proceeds	$50,000
Less: cost base of units	$5,000
Capital gain	$45,000

This capital gain can qualify for the CGT discount capital gain concession and the CGT small business reliefs, if the basic conditions for the reliefs to apply are met.

Ticktock Pty Ltd

2015-16

Extra capital gain ($15,000 x 4)	$60,000
Less: capital loss	$10,000
	$50,000
Less: CGT small business reduction	$25,000
Capital gain	$25,000

2016-17

Situation 1: Distribution of remaining capital gain (CGT event E4) and later winding up of trust (CGT event C2)

CGT event E4

Amount distributed by trustee		$45,000
Less: adjustments		
discount capital gains	$30,000	
1/2 x capital loss applied in 2015-16	$5,000	$35,000
		$10,000
Less: cost base of units		$5,000
Capital gain		$5,000

Because the unitholder is a company, this capital gain cannot qualify for the CGT discount capital gain concession. The CGT small business reliefs may be available if the basic conditions set out at ¶4-110 are met. Note that the benefit of the CGT discount capital gain concession would be reversed out in the extra capital gain required to be included in the company's net capital gain or loss calculation for the 2015-16 income year.

CGT event C2

Capital proceeds	$5,000
Less: cost base of units	$ Nil
Capital gain	$5,000

Because the unitholder is a company, this capital gain cannot qualify for the CGT discount capital gain concession. The CGT small business reliefs may be available if the basic conditions set out at ¶4-110 are met.

Situation 2: Distribution of remaining capital gain on winding up (CGT event C2)

Capital proceeds	$50,000
Less: cost base of units	$5,000
Capital gain	$45,000

Because the unitholder is a company, this capital gain cannot qualify for the CGT discount capital gain concession. The CGT small business reliefs may be available if the basic conditions set out at ¶4-110 are met.

Chapter 18

Partnerships and partners

¶18-100 What is a partnership?

For the purposes of the ITAA97, except so far as the contrary intention appears, a partnership includes not only what may be described as a general law partnership (an association of persons carrying on business in common, with a view of profit), but also an association of persons in receipt of ordinary income or statutory income jointly.[1]

An association of persons who are a partnership (as defined) because they are in receipt of ordinary income or statutory income jointly is often referred to as a tax law partnership. An example would be individuals who are joint owners of a rental property.[2]

The persons who comprise a tax law partnership would not be carrying on a business. This means that, for the purposes of the CGT small business reliefs:

- the interest of a "partner" in an asset of a tax law partnership could not qualify as an active asset unless it is used (or held ready for use) in the business of some other relevant entity (see ¶18-125); and
- a tax law partnership could not be a small business entity and could not have an annual turnover (see ¶7-110 and ¶7-140).

There is a fundamental question whether a tax law partnership can be an entity that is connected with another entity for the purposes of the CGT small business reliefs (see ¶18-110). This is potentially important for the purpose of applying the maximum net asset value test.

¶18-105 Some fundamental propositions

When applying the CGT small business reliefs in the context of a partnership, the following three important propositions need to be kept in mind:

(1) for CGT purposes, a capital gain or capital loss from a CGT event happening in relation to a partnership or one of its CGT assets is not taken into account in the calculation of the partnership net income or loss, but is taken into account directly in each partner's calculation of his, her or its net capital gain or net capital loss.[3] In the case of a partnership asset, each partner's interest in the asset is a CGT asset (see ¶2-105);[4]

(2) a partnership is not a separate legal entity,[5] which means that if a partnership is carrying on a business, each partner is him/her/itself carrying on business (see ¶18-125); and

1 S 995-1 ITAA97.

2 *FCT v McDonald* 87 ATC 4541.

3 S 106-5 ITAA97. The nature of a partner's interest in the assets of the partnership was recently considered by the High Court in *CST (SA) v Cyril Henschke Pty Ltd* [2010] HCA 43. The specific provisions of the ITAA97 in relation to CGT, of course, prevail.

4 S 108-5(2)(c) ITAA97.

5 *CST (SA) v Cyril Henschke Pty Ltd* [2010] HCA 43.

(3) a partnership (as defined) is an entity within the meaning of the definition of entity in s 960-100 ITAA97. In the context of the small business entity and the CGT small business relief provisions (as presently enacted) it is clear that an entity may control a general law partnership so that the entity and the partnership will be connected with each other (see ¶18-110). It is also clear that a general law partnership may be a small business entity. It is arguable that a tax law partnership cannot be connected with another entity (see ¶18-110).

A partner's interest in a partnership and its assets may change over time; for example, because of the retirement or admission of a partner. If a partner's interest in a CGT asset of the partnership increases, the partner will acquire a separate CGT asset that represents the increased interest in the CGT asset.[6]

¶18-110 Is a partnership an entity?

The question of whether a partnership could be an entity for the purposes of the CGT small business relief provisions as enacted before the *Tax Laws Amendment (Small Business) Act 2007* was considered in *White v FCT*.[7]

In the *White* case, the taxpayer, in the 2002-03 income year, sold a pharmacy business which she had purchased in 1999. Just before the sale, her assets included an interest as a partner in two partnerships (a 75% interest in one partnership and a 50% interest in the other partnership). If the partnerships were not connected with the taxpayer, the net values of the CGT assets taken into account for the purposes of applying the maximum net asset value test to the taxpayer was less than $5,000,000 (the then threshold) but, if the partnerships were connected with the taxpayer, the maximum net asset value test threshold was exceeded. Whether each partnership was connected with the taxpayer depended on whether (within the meaning of the former s 152-30(2) ITAA97) it could be said that the taxpayer "controls another entity" (ie the partnership). Sundberg J held that a partnership could not be an "entity" for the purposes of this provision because there was a contrary intention which meant that the definition of entity in s 960-100 ITAA97 did not apply. His Honour said:

> "Section 106[-5] is in the same position as s 152-15(b), which applies the maximum net asset value test to a partnership where a CGT event happens in relation to a CGT asset of the partnership. The 'control' provisions in [former] s 152-30 are in a different position, and the extrinsic material shows that for 'control' purposes a partnership is not treated as an 'entity'. In other words 'entity' does not mean the same thing whenever it is encountered. In the same way that a body politic (one of the entities in s 960-100) would not be an entity for the purposes of [former] s 152-30, it may be for some other purpose. An individual (one of the entities in s 960-100) is not an entity for the purposes of [former] s 152-30(2)(a), though he or she would be for the purposes of s 106-60, which deals with enforcing a security held over an asset.
>
> Accordingly, while I accept that the Guide to [Div] 106 shows that the capital gains scheme does, when appropriate, treat partnerships as entities, I do not accept the generality of the submission that the scheme expressly treats partnerships as entities, in the sense that whenever the word

6 S 106-5 ITAA97.

7 [2009] FCA 880.

> 'entity' appears it can be replaced by 'partnership'. In particular I do not accept that the fact that the Guide to [Div] 106 identifies a partnership as an entity leads to the conclusion that a partnership is an entity for the purposes of s 152-15(a)(ii) and [former] s 152-30."

It is considered that there may possibly be some doubt as to the correctness of the decision of Sundberg J. However, regardless of the merits or otherwise of the decision, the practical consequences of the decision (at least in the case of a general law partnership) have been effectively superseded by legislative amendment. The *Tax Laws Amendment (Small Business) Act 2007* enacted the connected entity rules that apply in relation to CGT events that happen in the 2007-08 or a later income year and these rules expressly recognise the fact that a partnership may be an entity that is connected with another entity (see ¶18-135). It is also beyond question that a general law partnership may be a small business entity, this being expressly recognised in a number of the CGT small business relief provisions (eg s 152-10(1)(c)(iii) and (1B) ITAA97 (¶18-120)).

However, it would seem that some provisions relating to the connected entity rules cannot sensibly operate on the basis that a partnership is an entity. In particular, although a partnership may be controlled by another entity, it is difficult to see how a general law partnership could control another entity within the meaning of the control rules. If this is correct, it would mean, for example, that an entity which controls a partnership could not, by virtue of that control, indirectly control a third entity.

Tax law partnership

As noted at ¶18-100, there is a question of whether a tax law partnership (that is, an association of persons who are not carrying on business but are in receipt of ordinary income or statutory income jointly) is to be regarded as an entity for the purposes of the control rules that apply when determining whether one entity is connected with another entity.

The control provisions which apply to determine connected entity status do refer specifically to a partnership (s 328-125(2)(a)(ii) ITAA97). The word "partnership" is not asterisked but this is not relevant when determining whether there is a contrary intention (s 950-100(2) ITAA97).

What is of considerable significance, however, is the fact that the connected entity rules are contained in the provisions that define a small business entity. To treat a tax law partnership as being an entity that is connected with another entity would not achieve any relevant consequence for the purposes of those provisions because a tax law partnership can neither be a small business entity nor have an annual turnover that could enter into the calculation of the aggregated turnover of another entity (because no business is carried on). It is submitted that this provides some basis for contending that the references to "you", an "entity" or a "partnership" in the control rules in the small business entity provisions do not include a tax law partnership. If that is correct, it would have the significant flow-on consequence that a tax law partnership could not be a connected entity for the purposes of applying the maximum net asset value test under the CGT small business relief provisions. For an illustration of the consequences of this view, see case study 1 at ¶18-140.

The issue discussed is far from clear and the Commissioner's views are not known. In any case where the whole of the assets of a tax law partnership are being sought to be excluded from being taken into account (when applying the maximum net asset value test) on the basis of the contention set out above, it would be advisable that a private ruling be obtained from the Commissioner. If the private ruling was not favourable, an objection against the ruling (or the relevant assessment) could, of course, be lodged.

¶18-115 Basic conditions: issues for assets used by partnerships

When a CGT asset is used in (or is held ready for use in or is inherently connected with) a business carried on by a partnership, the application of the CGT small business reliefs may need to be considered in relation to several different scenarios. These scenarios include the following:

(1) where the asset is a partnership asset (and, accordingly, the relevant CGT asset for each partner is the partner's interest in the partnership asset);

(2) where the asset is owned by a partner and is not a partnership asset; and

(3) where the asset is owned by an entity who or which is not a partner.

The way the CGT small business relief basic conditions apply in each of these scenarios is explained below.

Asset a partnership asset

A partner in a general law partnership carries on business by virtue of being a partner in the partnership (see ¶18-125). This means that, where a CGT asset is a partnership asset, each partner may potentially qualify for CGT small business relief in respect of a capital gain that is made from the happening of a CGT event in relation to the partner's CGT asset (ie the interest of the partner in the partnership asset).

In such a case, for the CGT small business relief basic conditions to be met:

(1) the partner must satisfy the maximum net asset value test (see ¶6-100); or

(2) the small business entity test must be met,

and the CGT asset of the partner must meet the active asset test.[8]

How the small business entity test may be met (see (2) above) depends on whether the partner carries on a business on his, her or its own account in the income year in which the CGT event happens (ie whether or not the partner carries on a business otherwise than as a partner). The position is as follows:

- if the partner does carry on such a business, either the partner or the partnership must be a small business entity (see ¶7-110) for the income year in which the CGT event happens; and
- if the partner does not carry on such a business, the partnership must be a small business entity (see ¶7-110) for the income year in which the CGT event happens.

8 S 152-10(1)(c)(i), (ii) and (iii) and (d) ITAA97.

Asset owned by a partner

Again, because a partner in a general law partnership carries on business by virtue of the fact of being a partner, where a CGT asset owned by a partner is used in (or is held ready for use in or is inherently connected with) the partnership business, CGT small business relief may be potentially available in relation to a capital gain that is made from the happening of a CGT event in relation to the CGT asset. In such a case, for the CGT small business relief basic conditions to be met:

(1) the partner must satisfy the maximum net asset value test (see ¶6-100); or

(2) the small business entity test must be met,

and the CGT asset of the partner must meet the active asset test.[9]

How the small business entity test may be met (see (2) above) will depend on whether or not the partner in fact carries on a business on his, her or its own account in the income year in which the CGT event happens (ie whether or not the partner carries on a business otherwise than as a partner). The position is as follows:

- if the partner does carry on such a business, the partner must be a small business entity (see ¶7-110) for the income year in which the CGT event happens; or
- if the partner does not carry on such a business, the CGT asset must be used in (or held ready for use in or be inherently connected with) the partnership business at a time in the income year in which the CGT event happens and the partnership must be a small business entity (see ¶7-110) for the income year.

See case study 9 at ¶18-140.

Asset owned by entity that is not a partner

Where a CGT asset is owned by an entity that is not a partner, and the asset is used in (or is held ready for use in or is inherently connected with) a business carried on by a partnership, CGT small business relief may be potentially available in respect of a capital gain that is made from the happening of a CGT event in relation to the asset. In such a case, for the CGT small business basic conditions to be met:

(1) either:

  (a) a partner in the partnership must be an affiliate of, or be connected with, the entity that owns the CGT asset; or

  (b) the partnership must be connected with the entity that owns the CGT asset;

(2) either:

  (a) the entity that owns the CGT asset must satisfy the maximum net asset value test (see ¶6-100); or

  (b) the small business entity test must be met; and

(3) the CGT asset must meet the active asset test.[10]

9 S 152-10(1)(c)(i), (ii) and (iv) and (d) and (1B) ITAA97.

10 S 152-10(1)(c)(i), (ii) and (iv) and (d) and (1A) ITAA97.

How the small business entity test may be met (see (2)(b) above) depends on whether the entity that owns the CGT asset carries on a business on his, her or its own account in the income year in which the CGT event happens (ie whether or not the entity carries on business otherwise than as a partner). The position is as follows:

- if the entity does carry on such a business, the entity must be a small business entity (see ¶7-110) for the income year in which the CGT event happens; or
- if the entity does not carry on such a business, the CGT asset must be used in (or held ready for use in or be inherently connected with) the partnership business at a time in the income year in which the CGT event happens and the partnership must be a small business entity (see ¶7-110) for the income year.

¶18-120 Small business entity issues

A general law partnership (but not a tax law partnership) may be a small business entity for an income year. A partner in a general law partnership, however (even though the partner would be carrying on business (see ¶18-125)), cannot, in the capacity of partner, be a small business entity.[11]

When considering whether a general law partnership is a small business entity for an income year, there is a special rule that applies when calculating the aggregated turnover of an entity that does not own the CGT asset that has given rise to the capital gain.[12] This rule is discussed at ¶7-135.

There is also a provision that applies for the purpose of calculating the aggregated turnover of a partnership where a taxpayer (who does not otherwise carry on a business on his, her or its own account) makes a CGT asset available for use in the business of more than one partnership of which the taxpayer is a partner.[13] The purpose of this provision is to limit tax planning opportunities that could otherwise arise, having regard to the fact that the partnerships do not have to be connected with the taxpayer for access to the CGT small business concessions to be obtained via the small business entity test.[14] If the partnerships are neither connected with each other nor with the taxpayer, each partnership would calculate its aggregated turnover without having to include the annual turnover of any of the other partnerships(s). In these circumstances, it is provided that each partnership that is not already connected with the partnership being tested for small business entity status is treated as being connected with that partnership.

11 S 328-110(6) ITAA97.

12 S 152-48(1) and (2) ITAA97.

13 S 152-48(3) ITAA97.

14 S 152-10(1B) ITAA97; see ¶4-105.

Example (adapted from the explanatory memorandum to the amending Bill that became the *Tax Laws Amendment (2009 Measures No. 2) Act 2009*)

Michael owns a CGT asset that he makes equally available for use in the businesses of two partnerships (Partnership One and Partnership Two). He is a partner in each partnership and does not otherwise carry on a business. The partnerships are not connected with each other or with Michael.

Michael disposes of the asset under a contract entered into in June 2015, and makes a capital gain. For the conditions in s 152-10(1B) ITAA97 to be met in respect of the asset (being each of Michael's interests in the asset that is used separately in the businesses Michael carries on in the two partnerships), each partnership must be a small business entity for the 2014-15 income year.

Because the partnerships are not otherwise connected with each other, they are taken to be connected with each other (under s 152-48(3) ITAA97). This means that the aggregated turnover of Partnership One will include the annual turnover of Partnership Two, and the aggregated turnover of Partnership Two will include the annual turnover of Partnership One.

¶18-125 Active asset issues

If an entity owns a CGT asset that is used in (or is held ready for use in or is inherently connected with) a business carried on by a partnership, the asset will be an active asset if:

(1) the entity that owns the CGT asset is a partner in the partnership;

(2) a partner in the partnership is an affiliate of the entity that owns the CGT asset;

(3) the entity that owns the CGT asset and the partnership are connected entities (see ¶18-135) (see case study 6 at ¶18-140); or

(4) the entity that owns the CGT asset and a partner are connected entities (see case study 7 at ¶18-140).

Where an entity and a partnership are connected entities, it is not easy to envisage circumstances where the entity will not be either connected with, or an affiliate of, a partner. However, whether an entity and a partnership are connected entities will be relevant when applying the maximum net asset value test.

In relation to the above, it is clear that each partner in a partnership that carries on a business carries on business him/her/itself.[15] This means, for example, that a partner's interest in a CGT asset that is a partnership asset (and is used in the partnership business) will be an active asset, unless the asset falls within an exclusion in the definition of active asset (see ¶8-125 to ¶8-135).

Further, if a partner owns a CGT asset in his, her or its own right, and the asset is used in the business carried on by the partnership, the asset, while it is so used and is owned by the partner, may qualify as an active asset because it is used by the partner in the carrying on of a business. This will be so, regardless of the level of the interest that the partner has in the partnership.

15 *FCT v Happ* (1952) 9 ATD 447; ID 2003/359; this is recognised in, for example, ss 152-10(1A) and (1B) and 152-40(1) ITAA97.

By extension, if a partner is an affiliate of a person (see ¶9-110) who owns a CGT asset that is used in the partnership business, the CGT asset will qualify as an active asset while it is so used, and the affiliate relationship continues. For more information, see ¶18-130.

The views expressed above on the operation of the definition of active asset, where a CGT asset is used in a partnership business and a partner either owns the asset or is connected with, or is an affiliate of, the person who owns the asset, are recognised in the definition of active asset (see ¶8-100).

See case studies 2 and 6 at ¶18-140.

¶18-130 Affiliate issues

According to s 328-130(2) ITAA97, an individual or a company is not an entity's affiliate merely because of the nature of the business relationship that the entity and the individual or company share (see ¶9-110).

An example in s 328-130(2) ITAA97 states that a partner in a partnership would not be an affiliate of another partner merely because the first partner acts, or could reasonably be expected to act, in accordance with the directions or wishes of the second partner, or in concert with the second partner, in relation to the affairs of the partnership.

Further, under the definition of "affiliate", the fact that two individuals are spouses of each other will not of itself make them affiliates. However, there is a provision under which an individual's spouse or child under 18 years of age may be treated as being an affiliate of the individual for the purposes of the CGT small business reliefs. This will be so where one entity (entity 1) owns a CGT asset that is used in (or is held ready for use in or is inherently connected with) a business that is carried on by another entity (entity 2). The individual's spouse or child under 18 will be treated as being the individual's affiliate for the purposes of determining whether entity 2 is an affiliate of, or connected with, entity 1.[16] This provision, however, only applies if entity 2 is not otherwise an affiliate of, or connected with, entity 1.

Once a spouse or child under 18 years of age is taken to be an affiliate under this special spouse/child under 18 affiliate rule, the affiliate relationship applies generally for the purposes of applying the CGT small business reliefs, including the small business entity provisions as they apply for the purposes of the reliefs.[17]

The following examples illustrate the operation of this special spouse/child under 18 affiliate rule in the context of a partnership. (It is assumed in each example that relevant affiliate or connected entity status would otherwise not exist.)

16 S 152-47(1) and (2) ITAA97; see ¶9-135.

17 S 152-47(3) ITAA97.

Example 1

Andrew owns a CGT asset that is used in a business carried on by a partnership in which the partners are Marcia (Andrew's spouse) and two unrelated individuals. Marcia will be taken to be an affiliate of Andrew under the special spouse/child under 18 affiliate rule.

Example 2

Emily owns a CGT asset that is used in a partnership that is carried on by two companies (T Pty Ltd and U Pty Ltd). The sole director and sole shareholder of T Pty Ltd is Emily's spouse (Ken). T Pty Ltd will be taken to be connected with Emily because Ken is to be treated as being Emily's affiliate.

Example 3

Belinda beneficially owns 70% and her spouse (Brian) 30% of the issued shares (which are all of one class) in Property Services Pty Ltd. This company owns a factory that it leases to a partnership for use in its business. There are two equal partners in the partnership; namely, Acorn Pty Ltd and a discretionary trust that is controlled by individuals who are unrelated to either Belinda or Brian. Brian beneficially owns all of the issued shares in Acorn Pty Ltd. Property Services Pty Ltd and Acorn Pty Ltd will be connected entities and Property Services Pty Ltd and the partnership will be connected entities. This is because Belinda will be taken to be Brian's affiliate for the purpose of determining connected entity status. It may be noted that, alternatively, it would seem that Brian could be taken to be Belinda's affiliate and, so, she would also control both Property Services Pty Ltd and Acorn Pty Ltd (see ¶9-135).

¶18-135 Connected entity issues

A general law partnership is an "entity" for the purposes of the connected entity rules and may be an entity that is connected with another entity. It is not clear whether a tax law partnership is an entity that can be connected with another entity for the purposes of the CGT small business relief provisions (see ¶18-110).

If an entity and a partnership are connected:

(1) a CGT asset owned by the entity will be an active asset when it is used (or is held ready for use in or is inherently connected with) a business carried on by the partnership. (Active asset status for a CGT asset may, of course, be also obtained if a partner is an affiliate of, or is connected with, the entity that owns the CGT asset.);

(2) where the entity does not carry on business on his, her or its own account, but owns a CGT asset that is used in (or is held ready for use in or is inherently connected with) a business carried on by the partnership, the CGT small business reliefs may be available if the partnership is a small business entity (see ¶7-110);

(3) when applying the maximum net asset value test (see ¶6-100) to the entity, the net value of the CGT assets of the partnership will be taken into account (unless the connection is only because of the entity's affiliate and the excluding rule (explained at ¶6-135) otherwise applies); and

(4) the partnership's annual turnover is taken into account for the purposes of determining whether the entity is a small business entity (see ¶7-100). Correspondingly, if the entity is carrying on a business, the entity's annual turnover is taken into account when determining whether the partnership is a small business entity (see ¶7-100).

The only direct "control" rule under the connected entity provisions that could apply in the case of a partnership is the right to distribution control rule (see ¶10-140). Under that control rule as presently enacted, an entity (P) will control another entity if P and/or P's affiliates own, or have the right to acquire the ownership of, interests in the other entity that carry between them the right to receive at least 40% of:

(1) any distribution of income by the other entity;

(2) any distribution of capital by the other entity; or

(3) if the other entity is a partnership, the net income of the partnership.[18]

Although the relevant explanatory memorandum envisages that there may be a distribution of income or of capital by a partnership (see (1) and (2) above), whether there may be such a distribution by a partnership is an issue that was raised, but was not decided, in *White v FCT*.[19]

For the purposes of determining whether an entity controls a partnership, the special spouse/child under 18 affiliate rule may be relevant. That special rule is explained at ¶9-135, and examples 2 and 3 at ¶18-130 illustrate its operation in the context of a partnership.

As pointed out at ¶10-140, there are circumstances in which the Commissioner has a discretion to treat an entity that (either alone or in combination with affiliates) has at least a 40% interest, but not a 50% interest, in any distribution of income or capital or the net income of a partnership, as not controlling the partnership.

See case studies 1, 5 and 6 at ¶18-140.

¶18-140 Case studies

Case study 1

In 2007, Sam and Sandra bought a rental property as tenants in common in equal shares. It is assumed that this activity does not amount to the carrying on of a business. Sam is also an equal shareholder and a director of Seaview Pty Ltd, which carries on a water taxi business. The other shareholder in Seaview Pty Ltd is unrelated to Sam and Sandra. Seaview Pty Ltd is considering whether to sell its business in December 2015.

18 S 328-125(2)(a) ITAA97.

19 [2009] FCA 880.

Because Sam and Sandra jointly receive assessable income (rent) but are not carrying on a business, they are a tax law partnership (see ¶18-100). There is an issue of whether such a partnership may be controlled by another entity for the purposes of the CGT small business relief provisions (see ¶18-110). If a tax law partnership cannot be a connected entity, only the value of Sam's interest in the rental property would be taken into account when calculating the net value of Sam's CGT assets for the purpose of applying the maximum net asset value test to Seaview Pty Ltd.

On the other hand, if a tax law partnership can be a connected entity, the tax law partnership in this example would be controlled by both Sam and Sandra. Accordingly, as Sam also controls Seaview Pty Ltd, both the partnership and Seaview Pty Ltd are connected, and the net value of the assets of the partnership would be taken into account when applying the maximum net asset value test to Seaview Pty Ltd. When calculating the net value of Sam's CGT assets, his interest in the tax law partnership would be disregarded under s 152-20(2)(a) ITAA97 (see ¶6-115) to prevent double counting.

The small business entity test is an alternative to the maximum net asset value test (see ¶4-100). For the purposes of determining whether Seaview Pty Ltd is a small business entity, even if the partnership and Seaview Pty Ltd are connected entities, the partnership cannot be grouped when calculating the aggregated turnover of Seaview Pty Ltd as it is assumed that the partnership is not carrying on a business. (Whether a business is carried on is a question of fact, but the mere letting out of a property by individuals would not ordinarily constitute the carrying on of a business (see ¶7-115 and ¶7-140).)

Case study 2

Mildred acquired office premises on 10 November 2010. After refurbishing the premises, she leased them to a partnership from 10 February 2012 on an arm's length basis. The partnership uses the premises to carry on an accounting business. The partnership has six equal partners, including Mildred's spouse (Matthew). Mildred does not engage in any other income-producing activities.

The office premises are used by Matthew for the purposes of carrying on a business (because he is a partner) (see ¶18-125). The special spouse/child under 18 affiliate rule will have the effect that Matthew is Mildred's affiliate (see ¶9-135) and, accordingly, the premises are an active asset of Mildred. This is so even though Matthew does not control the partnership.

Mildred and Matthew subsequently separate and are finally divorced on 10 January 2015. The partnership continues to rent the premises from Mildred and, on 10 June 2016, the partners exercise an option in the lease to purchase the premises from Mildred.

Matthew would cease to be Mildred's affiliate (for active asset purposes) on 10 January 2015 and the premises would then cease to be an active asset of Mildred.

There are:

(1) 67 months in the period from Mildred's acquisition of the premises (10 November 2010) to her disposal of them (10 June 2016); and

(2) 35 months during the period when the premises are an active asset of Mildred (10 February 2012 to 10 January 2015).

As the period in (2) above is more than one-half of the period in (1) above, the premises would meet the active asset test (see ¶8-150).

However, if the option in respect of the premises is exercised by the partnership on 10 April 2017, the period in (1) would be 77 months. As the period in (2) would then be less than one-half of the period in (1), the premises would not meet the active asset test.

Case study 3

Mandy is one of five equal partners in a partnership that carries on a retail footwear business in a shop acquired in 2005. The shop is a partnership asset and owned by the partners equally. None of the partners is related to any other partner, and each partner has an equal vote.

Due to rezoning, the value of the shop has risen dramatically, and it is now worth \$6.5m. In October 2015, the partners agree to sell the shop, and it is sold for its estimated value (ie \$6.5m). Mandy's share of the proceeds is \$1.3m, and her cost base is \$250,000.

For the purposes of determining whether Mandy satisfies the maximum net asset value test, the market value of her interest in the shop and the market value of her interest in the other CGT assets of the partnership are taken into account (less relevant liabilities). The balance of the market value of the CGT assets and of the liabilities of the partnership is not relevant (see ¶18-135).

Alternatively, as the shop is a partnership asset, if the partnership is a small business entity for the 2015-16 income year, Mandy would not need to satisfy the maximum net asset value test (see ¶4-105).

Case study 4

In case study 3, if, instead of the partners all being unrelated, Mandy's spouse (Michael) was an equal one-fifth partner, this may change the position. While Mandy and Michael, without more, would not be affiliates of each other within the primary definition of that term, it is arguable that the special spouse/child under 18 affiliate rule (see ¶9-135) could apply to make each an affiliate of the other. This would be on the basis that Mandy's interest in the shop is a CGT asset which is used by Michael and, conversely, that Michael's interest in the shop is used by Mandy. If this is correct, it would mean that Mandy and Michael would both control the partnership. Accordingly, the net value of the CGT assets of the partnership would be taken into account when applying the maximum net asset value test to Michael or to Mandy.

This would not be so if there were circumstances that would permit the Commissioner to disregard the control threshold of 40% and treat neither Michael nor Mandy as not controlling the partnership (see ¶10-135). On the facts given, because the partners other than Michael and Mandy are unrelated, it would be unlikely that there would be circumstances that would enable the Commissioner to exercise this discretion.

Case study 5

Assume the facts in case studies 3 and 4, except that, instead of the shop being a partnership asset, it is owned by Mandy and Michael as tenants in common in equal shares, and is rented to the partnership as part of the carrying on of a business by Mandy and Michael (ie Mandy and Michael are themselves carrying on business as partners in a general law partnership). The special spouse/child under 18 affiliate rule would apply, and Mandy and Michael would be treated as being affiliates of each other. This would mean that:

(1) Mandy and the partnership would be connected entities;

(2) Michael and the partnership would be connected entities; and

(3) the partnership of Michael and Mandy and the lessee partnership would be connected entities.

Case study 6

Barry and his three sons are partners in a wholesale coffee supply business. Barry is the controlling partner and has a 50% interest in the partnership. The business is carried on in premises owned by a discretionary family trust, the Brown Family Trust, under which Barry and his family are the primary beneficiaries. For the last three income years, Barry has received at least 45% of all distributions made by the trustee.

The premises will qualify as an active asset of the discretionary trust if the trust and the partnership are connected entities. In practical terms, this will mean that Barry must control both the discretionary trust and the partnership. On the facts, Barry would control the partnership. The control rules that apply in the case of a discretionary trust are explained at ¶10-160. On the basis of the facts given, Barry would control the discretionary trust under the pattern of distributions control rule (see ¶10-170).

Case study 7

David owns a trade mark that is a post-CGT asset. He licenses the use of the trade mark to a partnership in which the partners are three companies (One Pty Ltd, Two Pty Ltd and Three Pty Ltd). The companies have equal interests in the partnership, and each is a single director/shareholder company. David is the director/shareholder of One Pty Ltd, and the directors/shareholders of each of the other two companies are unrelated to David.

Since David controls One Pty Ltd (see ¶10-130), he and the company are connected entities. As the trade mark is used by One Pty Ltd while carrying on a business (see ¶18-125), the trade mark will be an active asset, provided its main use in the partnership business is not to derive royalties. David does not control the partnership.

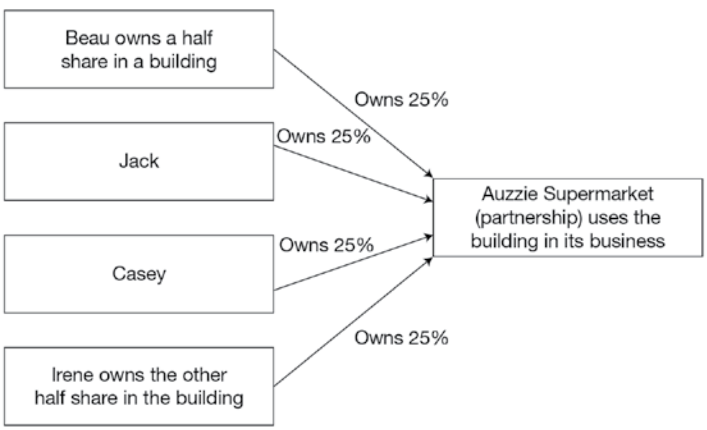
Case study 8

Tim is a partner in a partnership that carries on a recycling business, and he does not carry on business on his own account. The four other partners are unrelated. Tim owns the business premises that have been used by the partnership to carry on the business. He proposes to sell the premises to the partnership in November 2015. This will mean that the premises will become a partnership asset, and Tim will retain a one-fifth interest in the premises. Because of an inheritance, Tim cannot meet the maximum net asset value test. However, if the partnership is a small business entity for the 2015-16 income year, Tim would be able to claim the CGT small business reliefs in respect of the capital gain he makes from the disposal of the four-fifths interest in the premises, provided the premises satisfy the active asset test (they will have been an active asset while they have been used in the partnership business).

Case study 9

This case study (which is adapted from an example in the explanatory memorandum to the amending Bill that became the *Tax Laws Amendment (2009 Measures No. 2) Act 2009*) illustrates the effect of the provision that permits a partner to access the CGT small business reliefs via the small business entity test where a CGT asset owned by the partner is used in the partnership business.[20]

Beau and Irene each own 50% of a supermarket building, which is used in the business of a partnership carried on by Beau, Jack, Casey and Irene. The partnership trades under the name "Auzzie Supermarket". Beau and Irene do not carry on a business otherwise than as partners in the partnership.



Beau and Irene may be able to access the CGT small business reliefs in relation to their respective shares of the building via the small business entity test, depending on the aggregated turnover of the partnership calculated respectively for Beau and Irene. The aggregated turnover of Auzzie Supermarket must be calculated separately for Beau and Irene, taking into account any entities that are affiliates of, or connected with, each of them respectively.

Beau and Irene could, of course, potentially access the CGT small business reliefs via the maximum net asset value test.

20 S 152-10(1B) ITAA97; see ¶18-115. The example is also included in the ATO Guide.

Chapter 19

Deceased estates

¶19-100 Context

The usual CGT position is that the death of an individual does not give rise to a capital gain or capital loss. The deceased's legal personal representative and the beneficiaries of his or her estate are new CGT taxpayers who take over the CGT assets of the deceased, as at the date of death, at an appropriate cost base and reduced cost base. However, there are exceptions to this; for example, when a CGT asset owned by a deceased passes to an exempt entity (CGT event K3 would happen immediately before death).

There are also special CGT main residence exemption rules that can apply when a dwelling owned by a deceased at death is disposed of within two years[1] of death by the deceased's legal personal representative or a beneficiary.

As originally enacted, the CGT small business reliefs had no special rules that applied where an individual owned a CGT asset that would potentially qualify for the reliefs, and the individual dies. The position was that the legal personal representative (as a new taxpayer) or a beneficiary (also a new taxpayer) would have to satisfy all of the CGT small business relief basic conditions if the reliefs were to be available.

Amendments made by the *Tax Laws Amendment (2006 Measures No. 7) Act 2007* and the *Tax Laws Amendment (2009 Measures No. 2) Act 2009* fundamentally altered the way in which the CGT small business reliefs can operate after the death of an individual, where the CGT event happens to a CGT asset of the deceased in the 2006-07 or a later income year.

In broad terms, under the concession introduced by these amendments, a disposal of a CGT asset (owned by a deceased at the date of his or her death) by the deceased's legal personal representative, by a beneficiary of his or her estate or by the trustee of a testamentary trust (or by a beneficiary of such a trust) may qualify for the CGT small business reliefs if the disposal occurs within two years[2] of the deceased's death, regardless of whether the legal personal representative or the beneficiary has used the asset in a relevant business. Provision is made for the position where a CGT asset is a joint tenant interest that has been acquired by survivorship. As explained at ¶19-105, the concession can apply where a CGT event other than CGT event A1 happens.

The concession can conveniently be referred to as "the CGT event within two years of death rule".

Roll-over relief

For a discussion of the consequences where an individual dies after claiming CGT small business roll-over relief, see ¶15-150 and ¶15-160.

1 The Commissioner has a discretion to extend this two-year period.

2 The Commissioner has a discretion to extend this two-year period.

¶19-105 CGT event within two years of death rule

The following outlines the features of the CGT event within two years of death rule.

When can the rule operate?

The CGT event within two years of death rule applies where:

(1) a CGT asset forms part of the estate of the deceased individual or was owned by joint tenants, one of whom has died;

(2) one of the following applies:

 (a) the asset devolves to the deceased's legal personal representative or to a trustee of a trust established by the deceased's will (a testamentary trust);

 (b) the asset passes to a beneficiary in the deceased individual's estate; or

 (c) (in the case of a deceased joint tenant) an interest in the CGT asset is acquired by the surviving joint tenant(s);

(3) the deceased individual or the deceased joint tenant would have been entitled to reduce or disregard a capital gain under the CGT small business reliefs if a CGT event had happened in relation to the CGT asset immediately before his or her death; and

(4) a CGT event happens in relation to the CGT asset within two years of the deceased individual's or the deceased joint tenant's death (or a longer period allowed by the Commissioner).[3]

How the rule operates

Where the conditions set out above are met for the CGT event within two years of death rule to operate:

- the legal personal representative;
- the beneficiary to whom the asset passes;
- the trustee of the testamentary trust or a beneficiary of that trust; or
- the surviving joint tenant or tenants (as the case may be),

is entitled to reduce or disregard a capital gain under the CGT small business reliefs in the same way as the deceased individual would have been entitled to.[4]

For the purpose of determining what the deceased's entitlement under the CGT small business reliefs would have been, the following assumptions are made:

(1) when applying the CGT 15-year small business exemption, the deceased individual need only be 55 years of age or over, or be permanently incapacitated, immediately before his or her death (ie the requirement that the CGT event happened in connection with the individual's retirement is ignored); and

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3 S 152-80(1) and (3) ITAA97.

4 S 152-80(2) and (2A) ITAA97.

(2) when applying the CGT small business retirement exemption, the requirement for individuals under 55 years of age to contribute the CGT-exempt amount to a complying superannuation fund or an RSA is ignored.[5]

Making choices

For a capital gain to be reduced or disregarded under the CGT event within two years of death rule, the relevant entity (legal personal representative, beneficiary, etc) will need to make any necessary CGT small business relief choices. For the general CGT choice-making rule, see ¶2-135.

Devolution to legal personal representative

The CGT event within two years of death rule can operate in relation to a capital gain made by a deceased individual's legal personal representative to whom the relevant CGT asset devolves.

The expression "legal personal representative" in s 152-80 ITAA97 is asterisked, and the expression is defined in the dictionary (so far as is relevant) as an executor or administrator of an estate of a person who has died.[6]

Passing to a beneficiary

The words used in s 152-80(1) ITAA97 in relation to a beneficiary are, in fact, "*passes to a beneficiary of the individual". The dictionary defines "passes" by reference to a CGT asset passing to a beneficiary in an individual's estate in the way described in s 128-20 ITAA97. It is presumed that this is what is intended.

A CGT asset passes to a beneficiary in the way described in s 128-20 ITAA97 if the beneficiary becomes the owner of the asset (broadly):

- under the deceased's will;
- by operation of an intestacy law;
- because it is appropriated to the beneficiary in satisfaction of an interest in the estate; or
- under a deed of arrangement (as defined).

The asset may be transmitted directly to the beneficiary or transferred by the legal personal representative. A transfer by the legal personal representative under a power of sale is expressly excluded.

Testamentary trust

The CGT event within two years of death rule can apply where executorial duties have been completed and a CGT asset devolves to a trustee of a trust established by the deceased's will. In this kind of case, the rule operates to reduce or disregard a capital gain that is made:

5 S 152-80(2) ITAA97.

6 S 995-1(1) ITAA97.

- by the trustee of the testamentary trust; or
- by a beneficiary of the trust,

from a CGT event happening in relation to the CGT asset.

Joint tenants

For a discussion of the position where a CGT asset is owned by joint tenants, and one of the joint tenants dies, see ¶19-110.

What CGT events?

There is no restriction on the CGT events that may attract the operation of the CGT event within two years of death rule. While CGT event A1 (disposal of a CGT asset) is the most typical CGT event that will happen, other CGT events will potentially be relevant (eg CGT event C2 (see ¶2-125), which could happen on the liquidation of a company or the redemption of a unit in a unit trust).

CGT event within two years

Whether a CGT event happens in relation to a CGT asset within two years of the death of an individual (or a longer period allowed by the Commissioner) will depend on the CGT event timing rule that applies to the particular CGT event. For example, in the case of a disposal of a CGT asset under a contract, the date on which the contract is entered into would usually be relevant. For the rules that govern the timing of the more common CGT events that may be encountered, see ¶2-125.

Discretion to extend two-year period

A discretion is conferred on the Commissioner to extend the two-year period for the operation of the CGT event within two years of death rule.[7]

Some situations in which it could be envisaged that the Commissioner's discretion would be exercised favourably include where the administration of the estate has been delayed because of a dispute over the validity, or the meaning of the terms, of the deceased's will, which takes time to resolve, or where a family provision claim is made that is not settled or adjudicated on for some time.

Situations where an asset does not pass under will

There will be cases where, by some contractual or some other legally binding inter vivos obligation, a CGT asset owned by an individual who dies is acquired by an entity otherwise than under the deceased's will (or by operation of an intestacy law).

For example, a partnership agreement may provide for a deceased partner's interest in the partnership to be acquired by the surviving partners on the terms and conditions specified in the partnership agreement. By way of further example, the constitution of a private company may provide that, in the

7 S 150-80(3) ITAA97.

event of the death of a shareholder, the other shareholder or shareholders have the right to acquire the deceased's shares.

In cases of this kind, it would seem that usually the deceased's asset (the interest in the partnership or the shares in the company) would initially devolve to the deceased's legal personal representative. If that is so, the CGT event within two years of death rule would be potentially available to the deceased's estate, were the surviving partners or shareholders to acquire the deceased's interest in the partnership or shares from the deceased's legal personal representative.

What reliefs?

If the conditions are met for the CGT event within two years of death rule to apply, all of the CGT small business reliefs (including roll-over relief) are potentially available to the legal personal representative, trustee, beneficiary or surviving joint tenant in the same way as the deceased would have been entitled to claim them (see above).

The CGT small business retirement exemption could only be chosen up to the amount of the deceased's CGT retirement exemption limit remaining immediately before his or her death.

If CGT small business roll-over relief is chosen, there is no express indication of whether the CGT roll-over relief events (CGT events J2, J5 and J6) could have any operation; but presumably they would not, as the operation of the choice by the legal personal representative or beneficiary is to be determined by what the deceased would have been entitled to do immediately before his or her death.

Deceased's position immediately before death

The CGT event within two years of death rule can only apply if the deceased individual or the deceased joint tenant would have qualified for the CGT small business reliefs if a CGT event had happened in relation to the CGT asset immediately before his or her death. This presumably would require that:

(1) the deceased satisfied the maximum net asset value test immediately before his or her death (see ¶6-100), or the small business entity requirements were met (see ¶4-100); for example, if the deceased was a small business entity for the income year comprising the period commencing on 1 July before his or her death and ending at his or her death (see ¶7-100); and

(2) the asset satisfied the active asset test immediately before the deceased's death (see ¶8-145).

Ordinary CGT small business relief rules

The CGT small business reliefs will be available in the normal way to a deceased individual's legal personal representative, a beneficiary of the deceased's estate or a surviving joint tenant if the conditions are met for the reliefs to apply according to the facts as they exist after the deceased's death. This will be so even if the CGT event happens within two years of the deceased's death. For an explanation of how the CGT small business reliefs operate in this regard, see ¶19-115.

Indeed, there will be cases where it will be necessary to rely on the CGT small business relief rules being met after the deceased's death, to enable the reliefs to apply where a CGT event happens within two years of death. For example, the deceased may not have been a small business entity and may have had substantial personal assets that would have resulted in the deceased failing to meet the maximum net asset value test immediately before death, but the small business entity test or the maximum net asset value test may be able to be met by the deceased's legal personal representative or a beneficiary of his or her estate (eg in the case of the legal personal representative, the maximum net asset value test may be able to be met because the deceased's other assets (or the amount received on their realisation) have been distributed to beneficiaries).

Conversely, there may be situations in which the operation of the CGT event within two years of death rule will mean that the CGT small business reliefs will be available where the reliefs would not be available, even though the particular CGT asset continues to be used in the same business the asset was used in before the deceased died. This could be the case, for example, if the status of a particular CGT asset as an active asset depended on the use of the asset in a particular business carried on by another entity that was connected with the deceased, and the deceased's death resulted in the "connected" status of the other entity (ie the entity that carries on the business in which the asset is used) not being maintained.

¶19-110 Asset owned by joint tenants

Although the CGT event within two years of death rule extends to cover the case where a joint tenant dies, it is nevertheless important to note that there may be circumstances where the legal title to a partnership asset passes by survivorship, but the equitable interest passes under the deceased's will. This is an important point, because it determines the entity who or which may be entitled to the CGT event within two years of death rule.

The kind of case envisaged is illustrated by the decision in *Spence v FCT*.[8] In that case, a husband and wife were carrying on a land dealing business in partnership. The land was owned by them as joint tenants, and the husband's will left all of his estate to his wife (the taxpayer). The partnership was solvent and Windeyer J held that the wife acquired the husband's interest in the land as a beneficiary of his estate. His Honour said:

> "I think that it is a mistaken approach to the present question to ask what would have happened had the deceased not died. He did die and the land was unsold when he died. The taxpayer became the landowner. She could sell the land as and when she wished, or not at all. When she sold any part of it she was simply selling what had become hers. Her interest in it has as to a half come to her by way of testamentary gift from her husband. She could use that gift, turn it to account, in any way she wished. It is I repeat a mistake to say she got it simply by virtue of her joint tenancy. The legal estate devolved in accordance with the joint tenancy. To that extent the maxim which was mentioned – *ius accrescendi inter mercatores locum non habet* – does not apply; see *Lindley on Partnership*, 11th ed, p 428. But it is applicable in equity; partners who hold as joint tenants in law hold beneficially as tenants in common. That is an old rule. It is more exactly stated today in terms of the Partnership Acts – the relevant provisions are s 30 and 32 in the Western Australian Act: the legal estate devolves according to its nature and tenure but

8 [1967] HCA 32.

> in trust so far as necessary for the persons beneficially interested; and as between partners land which is partnership property is to be treated as personal estate."

In such a case, the surviving joint tenant would become the owner of the deceased joint tenant's interest in an asset under the deceased's will. The decision in the *Spence* case involved "revenue" assets of the partnership, but there seems to be no reason why the position would not be the same if a partnership asset was a capital asset (eg the premises in which the partnership business is carried on).

¶19-115 Applying ordinary CGT small business relief rules to deceased estates

The ordinary CGT small business relief rules will only apply to a CGT event that happens in relation to an asset owned by an individual at the time of his or her death if the conditions for the reliefs to apply are met by the entity that owns the asset at the time the CGT event happens (typically, the deceased's legal personal representative or a beneficiary of the deceased's estate).

The operation of the ordinary CGT small business relief rules in the case of a deceased estate can be illustrated by ID 2004/531. The facts considered in that interpretative decision involved a farming property that was owned by an individual who died. Under the terms of the deceased's will, the property was held in trust for the taxpayer and the taxpayer's children until the youngest child turned 25 years of age. Several years later, when the youngest child turned 25, the property vested in the taxpayer and the children and, soon after, the title was transferred to her and the children.

Although, under the CGT deceased estate rules in Div 128 ITAA97, a CGT asset owned by a deceased at death that passes to a beneficiary is taken to be acquired by the beneficiary on the day on which the deceased died, the interpretative decision concluded that, for the purposes of applying the CGT small business active asset test, the interest was acquired by the taxpayer when it was transferred. The time of transfer, not of vesting, was relevant in this case, because the taxpayer was not the sole beneficiary and, therefore, could not be said to be absolutely entitled at the time of vesting.

Subsequent to the release of ID 2004/531, a definition of "acquire" was inserted into the dictionary to the ITAA97 (s 995-1 ITAA97). The definition of acquire is to the effect that a taxpayer acquires a CGT asset when the taxpayer becomes its owner, and the time when the taxpayer acquires the asset is when the taxpayer becomes its owner. ID 2004/531 was withdrawn and the withdrawal notice states that the statutory definition produces the same result as that stated in the interpretative decision.

In ID 2004/121, the executor of a deceased's will continued to carry on the business operated by the deceased. The deceased's spouse was the sole beneficiary, and became absolutely entitled to the assets of the estate when the executorial duties were completed. The spouse was not able to operate the business and requested that it be sold. It was concluded that, providing the maximum net asset value test was met, the spouse could choose the CGT small business retirement exemption in respect of the capital gain on the disposal of the business. (If the deceased died after 30 June 2007, the small business entity test would be potentially available as an alternative to the maximum net asset value test.)

The underlying proposition that supported this conclusion was that the assets of the deceased estate passed to the spouse when she became absolutely entitled and, thereafter, anything done by the trustee (including the carrying on of the business and its sale) was taken to have been done by the spouse.[9]

For the special deceased estate provision that applies for CGT event J2, see ¶15-150.

¶19-120 Some other consequences of death for CGT small business reliefs

If an individual dies, there may be other CGT small business relief consequences; for example:

(1) if the deceased is survived by a spouse, the deemed affiliate relationship that can exist under the rule discussed at ¶9-135 would end (this may mean, for example, that a CGT asset ceases to be an active asset); and

(2) if the deceased was a significant individual of a company or trust, significant individual and, therefore, CGT concession stakeholder status would cease on death. This may have a flow-on consequence that a surviving spouse of the deceased loses his or her CGT concession stakeholder status (see ¶11-115).

¶19-125 Case studies

Case study 1

Brian owns commercial premises that he acquired in September 1995. He has leased these premises since December 1995 to a company (Able Engineering Pty Ltd) that carries on a machining business in the premises. That company was incorporated in November 1995 and all of the issued shares of the company are of the one class. Brian has owned 60% of the issued shares since the company was incorporated. The remaining 40% of the shares in the company are owned by Brian's spouse (Beatrice).

Brian dies on 18 November 2014. His will appoints his two sons (Edward and Eric) as executors and trustees. Under Brian's will, the commercial premises are devised to his daughter (Jean), and his shares in Able Engineering Pty Ltd are gifted equally between Edward and Eric.

Immediately before his death, Brian satisfied the maximum net asset value test and, at that time, the commercial premises and the shares he owned in Able Engineering Pty Ltd satisfied the active asset test. Accordingly, if the premises were to be sold, either by Edward and Eric as executors or by Jean as a beneficiary, under a contract entered into within two years of Brian's death (or a longer period allowed by the Commissioner), the CGT event within two years of death rule (see ¶19-105) would apply.

The position would be the same in relation to the shares in Able Engineering Pty Ltd if they were disposed of by Edward and Eric within two years of Brian's death (or a longer period allowed by the

9 S 106-50 ITAA97.

Commissioner) or the company is fully wound up by 18 November 2016 (or a later time allowed by the Commissioner). CGT event C2 or G1 would happen if the company were to be wound up. For the time when these CGT events would happen, see ¶2-125.

Case study 2

The situation is the same as in case study 1, except that Jean sells the commercial premises to Edward and Eric's complying superannuation fund under a contract entered into on 10 March 2017. Since the date of Brian's death, Jean has been receiving commercial rent for the premises from Able Engineering Pty Ltd.

Assuming that the Commissioner does not allow a further period, the CGT event within two years of death rule will not apply, and Jean will only be entitled to the benefit of the CGT small business reliefs if the premises satisfy the active asset test for the period from when she becomes absolutely entitled to the premises, on the basis that she is the taxpayer.

Because the arrangements for the leasing of the premises are on a commercial basis, it would be unlikely that any relevant entity would be an affiliate of Jean and, if that were the case, the premises could not satisfy the active asset test.

Case study 3

Plumber Pty Ltd was incorporated in May 2010 and, from that time, carried on a plumbing supply business. The company is wholly owned by Graham who, in March 2010, acquired the premises in which the company carried on the business.

Plumber Pty Ltd sold the business in March 2013 to an unrelated party, and Graham leases the premises to the purchaser.

Graham dies on 21 February 2015 and the premises are sold by his executors in November 2015.

The premises would have met the active asset test just before Graham's death, because the premises were an active asset for more than half of the time from their acquisition by Graham until Graham's death. Accordingly, assuming that Graham satisfied either the maximum net asset value test or the small business entity requirements immediately before his death (eg he was a small business entity for the income year ending on the date of his death), the CGT event within two years of death rule would apply (see ¶19-105).

Case study 4

David and his spouse (Deidre) are equal shareholders in a company (Bright Lights Pty Ltd) that carries on a successful retail lighting business.

The company carries on the business on land acquired in 2004 by a family discretionary trust. Under the terms of the trust, David and Deidre, their children and their remoter issue are the primary beneficiaries, and the appointor is David during his lifetime and, after his death, the person nominated in his will or, failing such nomination, his legal personal representative. The trustee of the trust is a company, Igloo Pty Ltd, of which David is the sole shareholder and director. David dies on 7 November 2015, and under his will, his shares in Igloo Pty Ltd pass to his legal personal representative, who is one of his sons, and his shares in Bright Lights Pty Ltd pass to another of his sons. David makes no nomination of an appointor for the discretionary trust in his will.

Putting to one side the pattern of distributions control rule, before David's death, Bright Lights Pty Ltd and the discretionary trust may possibly be connected entities by virtue of the operation of the trustee reasonable to expect to act control rule (see ¶10-165). On David's death, even if this control rule would be met by David's legal personal representative, this would not make the discretionary trust and Bright Lights Pty Ltd connected entities. The position may, however, have been otherwise if David had nominated Deidre in his will to be the appointor for the purposes of the discretionary trust. The position would also have been otherwise if either Deidre or the son who inherited David's shares in Bright Lights Pty Ltd controlled the discretionary trust under the pattern of distributions control rule.

Case study 5

In July 2006, Clinton incorporated a company (Safety First Pty Ltd) that commenced to carry on a business selling safety equipment. The issued shares in the company are of one class and are held equally by Clinton and his spouse (Helen). In August 2008, Clinton acquired premises in his own name, which he leased to the company to carry on the business. The business was successful and the company sold the business in May 2014. Clinton died in November 2014 and, under his will, the premises were left on trust for Helen for life and after her death for his children equally, with the trustee having the power to dispose of the premises and reinvest the proceeds of sale to be held on the same trusts. Executorial duties in relation to Clinton's will are completed in October 2015. The trustee receives an extremely generous offer for the purchase of the premises and enters into a contract to sell the premises in January 2016.

CGT event A1 happens in relation to the premises within two years of Clinton's death. The CGT event within two years of death rule can apply because the disposal of the premises is by the trustee of Clinton's estate.

Case study 6

Mary acquired a strata title office unit in 2011. She leases the unit to Abacus Pty Ltd, a company that carries on an accountancy practice. The issued shares in Abacus Pty Ltd are of one class and are beneficially held as to 50% by Andrew (Mary's spouse) and as to 50% by Gregory (who is unrelated to either Mary or Andrew). If these are the only relevant facts, the effect of s 152-47 ITAA97 (see ¶9-135) is that Andrew will be treated as Mary's affiliate for the purposes of determining whether Abacus Pty Ltd is connected with Mary. This will mean that Abacus Pty Ltd is connected with Mary.

Andrew dies on 10 October 2015 and the shares that he holds in Abacus Pty Ltd pass under his will to Sam (Andrew's son, who is over 18 years of age). This would mean that Mary and Abacus Pty Ltd would cease to be connected entities (unless Sam is otherwise Mary's affiliate). Accordingly, assuming that Sam is not Mary's affiliate, when determining whether the office unit meets the active asset test for the purposes of applying the CGT small business reliefs to a capital gain made by Mary, the office unit would not be an active asset for the period after 10 October 2015.

Chapter 20

Superannuation funds and members

¶20-100 Superannuation funds and CGT small business relief

Because a superannuation fund would not typically be carrying on business itself, the main CGT small business relief issue that arises when a superannuation fund is involved is whether the superannuation fund can be "connected" with another entity. This issue is important for the purposes of determining whether:

- a CGT asset (eg business real property) owned by the superannuation fund and used by the other entity in its business can be an active asset; and
- the net value of the CGT assets (or the annual turnover) of the superannuation fund is relevant when applying the maximum net asset value test (or the small business entity test) to the other entity.

TD 2006/68 states that neither the trustees nor the members of a complying superannuation fund "control" the superannuation fund for the purposes of the CGT small business reliefs.

The determination states that the members of a complying superannuation fund do not beneficially own, or have the right to acquire beneficial ownership of, interests in the fund carrying the right to distributions of income or capital. Further, a complying superannuation fund does not distribute income or capital as such, but rather pays benefits in the form of pensions or lump sums on the occurrence of certain events, such as retirement, death while in employment, or the attainment of a stated age.

The determination goes on to state that, similarly, the trustee of a complying superannuation fund does not beneficially own, or have the right to acquire beneficial ownership of, interests in the fund carrying the right to receive distributions of income or capital.

The determination further points out that neither the members nor the trustees of a complying superannuation fund are affiliates (see ¶9-110) of the fund. Accordingly, a complying superannuation fund does not control another entity under the CGT small business relief control rules (via aggregation of its affiliates' interests), even if the fund's members or trustees control that other entity.

It should be noted that TD 2006/68 was issued before the amendments to s 328-125 ITAA97 (made by the *Tax Laws Amendment (2013 Measures No. 1) Act 2013*) and has not been revised following those amendments. The amendments substituted the concept of "own" for the concept of "beneficially owned" in the direct control rules provided for by s 328-125(2) ITAA97 (see ¶10-130). The explanatory memorandum to the amending Bill stated that, as a result of the amendments, the connected entity and stakeholder tests would apply to interests held by life insurance companies, superannuation funds and trusts in the same way that they apply to other types of entities. However, while a superannuation fund may, as a result of the amendments, control and, therefore, be connected with (say) a unit trust, it is difficult to see how a CGT asset of a superannuation fund could be an active asset as a result of its use by another entity. Further, a superannuation fund could not access the CGT small business reliefs in respect of a capital gain that arises in respect of a unit in a unit trust or a share in a company as the superannuation fund could not be a CGT concession stakeholder.

This is the view taken in the ATO Guide which states:

> "The small business concessions will not be available for any capital gain a complying superannuation fund makes on the sale of an asset used in a 'related' entity's business.
>
> It may be common for a complying superannuation fund to own premises used in the business of a 'related' entity, for example, business real property. However, as the members or trustees of the fund (who typically also control the 'related' entity) do not control the fund in the manner required, the related entity is not a connected entity and, therefore, the business real property is not an active asset."

The determination refers to the situation of a complying superannuation fund, but there is no apparent reason why the position would not be the same in the case of a non-complying superannuation fund that has a similar structure to a complying superannuation fund.

Reference may also be made to the decision of Lindgren J in *Kafataris v DCT*.[1]

Interaction of retirement exemption with superannuation

The CGT small business retirement exemption requires amounts to be immediately contributed into a complying superannuation fund or a retirement savings account if the recipient is younger than 55 years old when they make a choice to use the retirement exemption. This is an important requirement: failure to immediately pay the amount to a complying superannuation fund or retirement savings account will mean that the conditions are not satisfied and the retirement exemption will not be available. See further ¶14-145 and ¶14-180.

¶20-105 Exclusion from net value of CGT assets

In the case of an individual:

- a right to, or to any part of, any allowance, annuity or capital amount payable out of a superannuation fund (whether a complying or non-complying fund) or of an approved deposit fund; and
- a right to, or to any part of, an asset of a superannuation fund or of an approved deposit fund,

are disregarded for the purposes of calculating the net value of the CGT assets of the individual.[2] See further ¶6-120.

¶20-110 Case study

George and his spouse (Gladys) are equal shareholders in a company (G&G Decorating Pty Ltd) that carries on an interior decorating business. The business has been carried on in rented premises, but it is decided that the time has come for premises to be acquired.

1 [2008] FCA 1454.

2 S 152-20(2)(b) ITAA97.

Instead of the company or the shareholders buying the premises, George and Gladys's superannuation fund (the G&G Superannuation Fund) acquires the premises. The fund is a complying superannuation fund, and George and Gladys are the only members. The premises are leased by the fund to the company on an arm's length basis.

Several years later, G&G Decorating Pty Ltd disposes of a business asset that it has owned and that qualifies as an active asset. For the purposes of applying the maximum net asset value test to G&G Decorating Pty Ltd, the net value of the CGT assets (including the business premises) of the G&G Superannuation Fund is ignored.

Later still, the premises owned by the G&G Superannuation Fund are sold. The premises do not qualify as an active asset because G&G Decorating Pty Ltd and the superannuation fund are not connected entities. Accordingly, the G&G Superannuation Fund cannot obtain the benefit of the CGT small business reliefs.

Chapter 21

Tips and traps

¶21-100 Context

The CGT small business reliefs are generous concessions and are potentially available to individuals, companies and trusts. Care should be taken to ensure that they are, if possible, applicable to a capital gain and, if applicable, can be utilised to the greatest extent.

This will, of course, require consideration being given to the potential operation of the CGT small business reliefs at the earliest possible time; for example, when deciding how a business or a business asset is to be owned, and also on a continuing basis.

A number of practical planning considerations are considered in the earlier chapters of this handbook. This chapter seeks to illustrate some of the more important features of the CGT small business reliefs that need to be kept in mind to ensure that the reliefs apply. It must be emphasised, however, that this chapter is not in any way exhaustive in its coverage of the planning considerations that may arise.

¶21-105 Impact of recent changes

The CGT small business relief provisions have been subject to considerable legislative change over the years and there is a growing body of relevant case law and ATO rulings, determinations and interpretative decisions.

There is one recent tangential legislative change that should be noted. This change was made by the *Tax Laws Amendment (Small Business Restructure Roll-over) Act 2016* and provides for optional CGT, depreciating asset and trading stock roll-over relief for small business entities where there is a restructure without a change in the ultimate economic ownership of the assets. This roll-over applies to transactions that occur on or after 1 July 2016. From a CGT perspective, it may be somewhat doubtful what advantage this roll-over relief would provide in some cases. This is because, usually, the CGT small business reliefs would be available and, if they were available, the transferee entity would receive a stepped-up cost base for the CGT assets involved. The CGT small business reliefs would, of course, be available because the new roll-over relief applies in relation to small business entities, and the fact that an entity is a small business entity means that the small business reliefs may be accessed. The new roll-over relief may, however, provide an advantage where CGT small business roll-over relief would need to be chosen to reduce the capital gain to nil.

¶21-110 Existing arrangements must be monitored

It is necessary to keep a close watch on the way existing arrangements operate in the context of the CGT small business reliefs, having regard to developments that may occur. The developments include not only legislative developments, but also government-announced changes, any decisions of the courts and the AAT that may be relevant, and interpretative views expressed by the Commissioner; (for example, in taxation determinations and rulings).

Also, it may be prudent to consider whether events that may occur may take an entity out of the scope of the CGT small business reliefs. For example, assuming that the small business entity tests are not relevant, if the entity is likely to reach the point where the maximum net asset value test will not be met, a transfer of assets or a business to a new entity controlled by the taxpayer may be able to be effected without a CGT liability but with an uplifted CGT cost base for the assets concerned. Other implications would, of course, have to be considered, including, in the case of some assets, the possibility of a stamp duty liability.

¶21-115 General anti-avoidance provisions (Pt IVA)

In cases where deliberate steps are taken so that the CGT small business reliefs can be used, the potential operation of the general anti-avoidance provisions of Pt IVA ITAA36 (with the attendant possibility of penalties) may need to be considered.

It would seem that there is considerable potential for the operation of Pt IVA ITAA36 where steps are taken to satisfy the conditions for the CGT small business reliefs to apply. Nevertheless, it is submitted that, if what is done is moderate and if what is achieved is within the spirit of the concessions, it would be somewhat unlikely that the Commissioner would attempt to apply the Part.

Where steps are taken which mean that the CGT small business reliefs will be available where they would not otherwise have applied and the Commissioner relies on the general anti-avoidance provisions of the income tax law (Pt IVA ITAA36) to cancel a tax benefit, then, on an appeal or a review, the evidence of a professional adviser who oversaw the arrangements that were implemented may in some cases be relevant. In *Track Bros and FCT*,[1] where steps were taken to seek to ensure that the maximum net asset value test was met, the AAT said:

> "Before considering the various factors listed in s 177D(b) of the 1936 Act it is as well to make some general observations regarding the evidence adduced by the applicants.
>
> First, it is pertinent to note that none of the principals, nor indeed Mr Accountant, was able to give any detailed explanation of the purpose of the particular steps in the scheme nor the way in which those steps contributed to the asserted motive of 'asset protection'. In particular, there was no evidence from Mr Festa, the solicitor from Cleary Hoare who appears to have designed the structure, that explained the relevance of particular steps. As the Commissioner submits, if the arrangements were motivated by a desire to protect assets, it may be wondered how that purpose was served when the proceeds of sale were deposited to, and largely stayed in, a deposit account of Track Bros 1 Trust. I need not go so far as to draw an adverse inference from the failure to call Mr Festa; it is enough to say that his absence makes it more difficult to accept that asset protection played any role in the design or implementation of the scheme.
>
> Additionally, I found the evidence of a need for asset protection unconvincing."

Making choices

The CGT small business reliefs operate in some important respects by the making of a choice or choices. The making of a choice and the disregarding of a capital gain in whole or in part could, particularly having regard to the wide definition of "scheme", give rise to the obtaining of a tax benefit

1 [2015] AATA 45.

in connection with a scheme for the purposes of Pt IVA. However, it is provided that the obtaining by a taxpayer of a tax benefit in connection with a scheme does not include a tax benefit that is attributable to the making of (*inter alia*) a choice that is expressly provided for by the ITAA36 or the ITAA97, provided the scheme was not entered into or carried out by any person for the sole or dominant purpose of creating any circumstance or state of affairs, the existence of which is necessary to enable the choice to be made.[2] What is meant by a tax benefit being "attributable to" a choice etc was considered in *Walters v FCT*.[3]

This should mean that, provided there is no wider scheme that can attract Pt IVA, the making of a choice under the CGT small business relief provisions would not result in the Commissioner being able to apply Pt IVA. For example, as pointed out at ¶15-170, the mere making of a choice for roll-over relief so as to defer the making of a capital gain until a subsequent income year should not be caught.

¶21-120 CGT merits of different kinds of entities

The following chart sets out, in a very broad way, the basic CGT small business relief implications for various kinds of entities. The CGT 15-year small business exemption is not covered. (N/R means not relevant.)

		Discount concession		Small business reliefs		
Kind of entity[1]	Tax rate	Available?	Distribution tax-free?	Available?	Distribute reduction concession tax-free?	Can interest in entity be active asset?
Individual	Marginal rate	✓	N/R	✓	N/R	N/R
Discretionary trust	Beneficiary's marginal rate; trustee – 46.5% if s 99A ITAA36	✓[2]	✓	✓[2]	✓[3]	N/R
Unit trust	Unitholder's marginal rate; trustee – 46.5% if s 99A ITAA36	✓[2]	✓	✓[2]	✗[4]	✓
Company	30%[5]	✗	N/R	✓	✗[4]	✓

1. For CGT purposes, the relevant taxpayers in a partnership are the individual partners, although the fact that a partnership is an entity can have significant CGT small business relief implications (see ¶18-105).
2. The CGT discount capital gain concession and the CGT small business 50% reduction are reversed if the trustee is assessed under s 99A ITAA36 (see ¶17-125).
3. See ¶17-105 and ¶17-115.

2 S 177C(2) ITAA36.

3 [2007] FCA 1270. See also *Taxpayer and FCT* [2010] AATA 497; *Case* 3/2010, 2010 ATC ¶1-022.

4. See ¶17-115 (unit trusts) and ¶16-105 (companies). In some circumstances, it may be better for a choice to be made for the CGT small business 50% reduction not to apply and for the CGT small business retirement exemption to be taken instead, if available.
5. On distribution, imputation will apply. For 2015-16, a company that is a small business entity is taxed at 28.5%.

¶21-125 Active asset test

"Just before"

The active asset test will be met (where the CGT asset has been owned for 15 years or less) if the asset satisfies the definition of active asset for a total of at least one-half of (broadly) the period of ownership. For a CGT asset that has been owned for more than 15 years, it must be an active asset for a total of at least 7½ years (see ¶8-150).

This means that the fact that a CGT asset may, for any reason, cease to qualify as an active asset before the CGT event will not of itself prevent the active asset test from being met. For example, there would not necessarily be a failure to satisfy the active asset test where a CGT asset is an active asset of an entity because it is used in a business carried on by a connected entity, and the connected entity status ceases.

"Use or holding ready for use"

Putting to one side a share or trust interest, a CGT asset will be an active asset at a particular time if, at that time, it is used in (or is held ready for use in or is inherently connected with) the carrying on of a relevant business, unless it is excluded from being an active asset (see ¶8-110 and ¶8-125 to ¶8-135).

According to the NTLG Losses and CGT Subcommittee draft minutes of the meeting of 14 November 2007, there is no requirement for the use to be the sole or exclusive use, so if a CGT asset is only used partly in the relevant business, the asset may still qualify as an active asset (provided it is not an excluded asset). Presumably, however, the use would need to be a substantive use and not merely a de minimis use.

The factual situation considered in the draft minutes was of a property owned as tenants in common by three discretionary trusts, each of which was connected with a doctor. The property was used by the doctors (who were not in partnership) as their practice rooms. The response by the ATO in the draft minutes stated that each discretionary trust (as a tenant in common) had a separate interest in the whole asset, one-third of which was being used in the business of a connected entity, and two-thirds in the businesses of unrelated entities.

Accordingly, one-third of each discretionary trust's asset (being its separate interest in the whole asset) was being used in the business of a connected entity, and two-thirds in the business of unrelated entities. While this in itself would not stop a particular discretionary trust's interest in the whole asset from being an active asset, where the discretionary trusts rent the rooms to the doctors, it would be necessary to determine whether the main use is to derive rent. The draft minutes do not comment on this question, the answer to which would require an analysis of the legal position of a tenant in common and the facts (eg what the position would be if one doctor's practice rooms were substantially larger in area than the other doctors' practice rooms). The part of the premises used as a common area (eg as a waiting room) may also be relevant.

Period of time

As indicated above, the active asset test requires the asset to be an active asset for at least:

(1) 50% of (broadly) the period it is owned; or

(2) 7½ years if the asset has been owned for more than 15 years (see ¶8-150).

When a CGT asset is acquired, it is always prudent to ensure that it becomes an active asset in some way as soon as possible. If, for some reason, a CGT asset ceases to be an active asset, the time periods will need to be carefully monitored to ensure that the active asset test remains satisfied.

Connected entity

If the status of an asset owned by an entity as an active asset depends on the asset being used, or held ready for use, in the course of carrying on a business by an entity connected with the owner of the asset, it is vital that "connected" status is maintained for a sufficient period to satisfy the active asset test. For other connected entity issues, see ¶21-145.

Affiliate

A CGT asset can qualify as an active asset if it is used (or held ready for use) in the carrying on of a business by a connected entity or an affiliate. Further, whether entities are connected entities can, in some cases, depend on whether an individual is another individual's affiliate. It should be kept in mind that there is a special provision that (in effect) treats a spouse or a child under 18 years of age of an individual as being the individual's affiliate for the purpose of determining affiliate status, or whether one entity is connected with another entity, in passive asset situations (see ¶9-135).

Rent-producing use

If the main use of a CGT asset in a business is to derive rent and this is not merely temporary, the asset will not be an active asset (see ¶8-135). Because "rent" requires the existence of a lease, the distinction between a "lease" and a "licence" of real property can be crucial in some circumstances. Whether the main use of an asset is to derive rent can raise issues of fact. It would be prudent to have an appropriate agreement to support the existence of a licence, rather than a lease, and it would be necessary, of course, for the parties to adhere to the terms of the agreement in practice.

For the purposes of determining whether the main use of an asset is to derive rent, any personal use or enjoyment of the asset by the taxpayer is ignored and any use by an affiliate of, or an entity connected with, the taxpayer is treated as the taxpayer's use.

¶21-130 Maximum net asset value test

Alternative tests

It needs to be kept in mind that there are tests which turn on small business entity status that are alternatives to the maximum net asset value test for the purposes of accessing the CGT small business reliefs (see ¶21-135).

The small business entity tests are alternatives to the maximum net asset value test where the CGT event happens in the 2007-08 or a later income year (see ¶21-135).

Threshold

The maximum net asset value test threshold is currently $6m (see ¶6-105). It needs to be kept in mind that, in the event of any dispute with the Commissioner, the taxpayer would need to establish the net values of the CGT assets of any relevant entities. This will usually involve obtaining valuations from professional persons of the CGT assets of all relevant entities. In some circumstances, market valuation issues can, of course, be problematic.

"Just before"

The time when the maximum net asset value test is applied is "just before" the CGT event happens. For example, in the case of CGT event A1, if the CGT asset is disposed of under a contract, the relevant time for applying the test will be just before the contract is entered into (see ¶2-135).

Effect of what has been done in the past

What has been done in past income years may affect the application of the maximum net asset value test. For example, in the case of a discretionary trust, if a distribution has been made in any of the preceding four income years that makes a particular beneficiary control the trust by virtue of the pattern of distributions control rule (see ¶10-170), that beneficiary will be connected with the trust for the current income year, and the net value of that beneficiary's CGT assets will be taken into account when determining whether the trust satisfies the maximum net asset value test.

Conversely, if the maximum net asset value test is being applied to such a beneficiary, the net value of the CGT assets of the trust would be taken into account.

Connected entities

The maximum net asset value test requires the net value of the CGT assets of connected entities to be taken into account. It may be possible, in some circumstances, to break a connection before the CGT event happens. Note that even if the status of the relevant CGT asset as an active asset depends on it being used, or held ready for use, in a business carried on by the particular connected entity, breaking the connection before the CGT event (even some time before the CGT event) will not necessarily mean that the active asset test cannot be met. This is because it is not necessary for an asset to be an active asset just before the CGT event (or the cessation of the business, if that occurred in the 12 months preceding the CGT event happening).

Of course, in some circumstances it may simply not be possible to break a connection, in others there may be practical difficulties, and in others advance planning may be required. To illustrate the last point, in the case of a discretionary trust, if a controlling percentage (40% or more) distribution is made to a particular beneficiary for an income year, that beneficiary would control the discretionary trust (and therefore the beneficiary and the trust would be connected entities) for each of the four income years following the income year for which the distribution was made, even if no distribution is made to the beneficiary for any of those four income years (see ¶10-200).

For other connected entity issues, see ¶21-145.

Excluded assets

For the purpose of calculating the net value of the CGT assets of an individual, there are CGT assets that are excluded from the net value calculation, and these may be able to be maximised – for example, by making a superannuation contribution before the CGT event happens (see ¶6-120). A bona fide outright gift of, say, cash (but not necessarily if made to a connected entity or an affiliate) would, of course, reduce the net value of assets, as would the expenditure of money on hand to improve an excluded asset.

Dividend

In the case of a company, there may be a reduction in the net value of the CGT assets of the company if a dividend were to be paid or a final dividend declared in circumstances such that a debt owing by the company arises[4] before the time when the net value of the CGT assets of the company are being determined (see ¶6-105). If a borrowing were to be made to pay a dividend, this should be a liability that is taken into account when calculating the net value of the company's CGT assets. Of course, a dividend paid or payable to a shareholder will be reflected in that shareholder's assets, unless a dividend that has been paid is no longer represented by a CGT asset (eg it has been gifted) or has been applied to an exempt asset.

Incurring of liability

Liabilities incurred by an entity should be incurred in such a way that they are, to the greatest extent possible, clearly related to CGT assets that are taken into account in the calculation of the net value of the CGT assets of the entity. A borrowing by an individual on the security of a non-excluded asset to acquire an excluded asset is not likely to be effective in reducing the net value of the individual's CGT assets. For more information, see ¶6-150.

4 Cf *Bluebottle UK Ltd v DCT* [2007] HCA 54.

Entity connected because of affiliate

It needs to be kept in mind that an entity (X) may be connected with another entity (say, Company Z) if Company Z is controlled in the relevant sense by Y, who is an affiliate of X. In certain circumstances, however, the assets (or some of the assets) of Y and Company Z will be excluded when determining whether X satisfies the maximum net asset value test (see ¶6-135). For this exclusion to apply in the case of assets of Company Z, X's connection with Company Z must be "only because" of Y. If X were to beneficially own some shares in Company Z, it is not clear whether the exclusion would apply (see ¶6-135).

Timing issues involved

The time when a CGT event happens needs to be watched in some circumstances. For example, if the incurring of a liability that would be taken into account when determining the net value of the CGT assets of an entity is imminent, deferring the time when the CGT event occurs (eg in the case of CGT event A1, deferring the time when the contract is entered into) may mean that the liability will be able to be taken into account.

¶21-135 Small business entity tests

Alternative test

The small business entity tests are alternative tests to the maximum net asset value test. The small business entity tests require (broadly) that either:

- the entity that makes the capital gain being tested for CGT small business relief is a small business entity for the income year in which the CGT event happened;
- the CGT asset is an interest in an asset of a partnership that is a small business entity for the income year, and the entity making the capital gain is a partner in the partnership; or
- the entity that makes the capital gain being tested for CGT small business relief does not carry on a business in the income year (otherwise than as a partner), and that the asset is used in (or is held ready for use in or is inherently connected with) a business carried on either by an affiliate or connected entity that is a small business entity for the income year, or by a partnership (in which the entity is a partner) that is a small business entity for the income year (see ¶4-110 and ¶4-105).

Small business entity

To qualify as a small business entity for an income year (called the "current year"), an entity must carry on a business in the current year (or, in some circumstances, may be winding up a business that was previously carried on), and the entity's aggregated turnover must be less than $2m (see ¶7-100 and ¶7-105). The aggregated turnover of an entity requires the annual turnovers of entities connected with the particular entity and of affiliates of the particular entity to be combined (which can be subject to some limitations). The aggregated turnover can be that of the current year (calculated on an actual basis or, subject to certain limitations, on a "likely" basis) or of the preceding income year (see ¶7-110). There are provisions that apply in relation to dealings between connected entities or between an entity and an affiliate. For connected entity issues, see ¶21-145.

The fact that an entity must be carrying on a business during the current year (or fall within the winding-up provision) to be a small business entity makes it important to ascertain whether a business is being carried on by the entity. It means (for example) that if an entity simply sells the business (that it has been carrying on) on a going concern basis, the entity cannot qualify as a small business entity for the income year following the income year in which the sale occurs, unless a new business commences to be carried on. Whether a business is carried on in a particular case will depend on all the facts (see ¶7-115). A partner in a general law partnership cannot, by that circumstance, be a small business entity (see ¶7-110).

Note that the renting out of a property without more may not constitute the carrying on of a business, at least in the case of an individual. Also, if there is a partnership for taxation purposes only because of the statutory definition of partnership, the partnership will not be able to qualify as a small business entity, because it will not be carrying on a business (see ¶7-115).

Annual turnover

An entity's annual turnover for an income year is the total ordinary income (calculated on a GST-exclusive basis) that the entity derives in the income year in the ordinary course of carrying on a business (see ¶7-140). If the business is carried on for only part of an income year, the annual turnover is extrapolated to what it would be on a full year basis (see ¶7-160). A special provision applies where ordinary income is derived from dealings with associates (see ¶7-165).

While, in many instances, it will be clear whether an amount derived by an entity is ordinary income derived in the ordinary course of carrying on a business, there will be difficulty in some cases. Ordinary income will be derived in the ordinary course of carrying on a business if the income is a direct result of the normal activities of the business. This will be so even if it is not regularly derived and even if it is not the main type of ordinary income derived by the entity. Further, the income does not need to account for a significant part of the entity's overall receipts. For further discussion, see ¶7-145.

Use of small business entity test

The introduction of the small business entity test enables an entity that is "asset rich" but has a relatively low turnover to access CGT small business relief.

Significantly, however, the small business entity test may be able to be used to achieve positive outcomes in a range of other situations. For example, assume that Sam is a CGT concession stakeholder (with 20% of the shares) in a company (Artistic Pty Ltd) that has net assets of, say, $40m and is neither controlled by, nor an affiliate of, Sam. Sam has no relevant liabilities. If Sam were to sell the shares that he owns in Artistic Pty Ltd, he could not satisfy the maximum net asset value test. However, if Sam carried on a small business on his own account in the income year in which he sells the shares and for that income year the business has an aggregated turnover of less than $2m, Sam would be a small business entity, and the capital gain made on the sale of the shares in Artistic Pty Ltd could, therefore, potentially qualify for CGT small business relief if the shares satisfy the active asset test.

¶21-140 Affiliate issues

Relevance of affiliate status

Whether an entity is an affiliate of another entity is relevant for the purposes of:

- determining whether the other entity is connected with a company, trust or partnership (see ¶10-120);
- determining what entities are relevant when applying the maximum net asset value test and the small business entity test (see ¶6-100 and ¶7-100);
- determining whether a CGT asset is an active asset; and
- determining whether a personal use asset of an individual is excluded when applying the maximum net asset value test (see ¶6-120).

Definition of affiliate

Whether an individual or a company is an affiliate of an entity (under the primary definition of affiliate) depends on whether the individual or company acts, or could reasonably be expected to act, in accordance with the entity's directions or wishes, or in concert with the entity, in relation to the affairs of the business of the individual or company (see ¶9-110). Only a company or an individual may be an affiliate of another entity under this definition.

Spouse/child under 18 years of age

An individual's spouse or child under 18 years of age who is not an affiliate of the individual under the definition noted above will be taken to be the individual's affiliate in certain circumstances. This will be so where one entity (entity B) uses (or holds ready for use) in its business a CGT asset owned by another entity (entity A), and it is necessary to determine, for the purposes of the CGT small business relief basic conditions, whether entity B is an affiliate of, or is connected with, entity A (see ¶9-135). This is referred to as the special spouse/child under 18 affiliate rule in this handbook. The rule also applies for the purposes of determining small business entity status as it is relevant to the CGT small business reliefs.

To take a simple example, assume that Marilyn owns a CGT asset that is used by a company (Banjo Pty Ltd) in its business, and that all of the issued shares in Banjo Pty Ltd are beneficially owned by Marilyn's spouse (Peter). Peter will be treated as Marilyn's affiliate under the special spouse/child under 18 affiliate rule and, therefore, Banjo Pty Ltd will be connected with Marilyn. However, on these facts, Marilyn will not be treated as Peter's affiliate.

There may, however, be factual situations in which each spouse will be an affiliate of the other spouse under the special spouse/child under 18 affiliate rule. For example, assume that Lyn beneficially holds

70% and Murray (Lyn's spouse) holds 30% of the issued shares (all of one class) in Tiger Pty Ltd, and that Lyn beneficially holds 20% and Murray beneficially holds 80% of the issued shares (all of one class) in Zebra Pty Ltd. If Tiger Pty Ltd uses a CGT asset owned by Zebra Pty Ltd in its business, it would seem that the special spouse/child under 18 affiliate rule would operate to treat Lyn as an affiliate of Murray and Murray as an affiliate of Lyn (see ¶9-135).

The operation of the special spouse/child under 18 affiliate rule can have some unwelcome results – for example, by bringing the net value of the CGT assets of entities into the maximum net asset value test calculation where those entities would not otherwise be relevant for the purposes of applying the test. Because the maximum net asset value test is applied just before the happening of the CGT event that gives rise to the capital gain being tested for CGT small business relief, the possible operation of the rule at that time could be avoided by having the relevant CGT asset that is owned by an entity ceasing to be used (or held ready for use) in the business of the other entity. Whether this can be done as a practical matter will depend on the facts, and it is suggested that, to be effective, there would, at the least, have to be a real (and not a nominal) cessation of use (or holding ready for use) for a reasonable period of time.

¶21-145 "Connected" entity issues

Relevance of connected entity rules

The rules that govern whether two entities are connected are relevant when determining:

- whether the entities are grouped for the purposes of applying the maximum net asset value test or the small business entity test to one of the entities (see ¶6-105 and ¶7-135); and
- whether a CGT asset is an active asset of one of the entities (see ¶8-110).

Control percentage less than 50%

It is important to remember that the fact that an entity has a controlling percentage in another entity of 40% will not, in some circumstances, mean that it controls the other entity. There are circumstances in which the Commissioner has a discretion to treat an entity that has a controlling percentage in another entity of at least 40%, but less than 50%, as not controlling that other entity (see ¶10-135, ¶10-140, ¶10-155 and ¶10-175). The terms of this discretion are unsatisfactory and the Commissioner has not clearly articulated his approach to its exercise.

Right to distribution control rule

The right to distribution control rule can operate to determine control of a company, a partnership or a non-discretionary trust. The right to distribution control rule makes it clear that there can be control under the rule by reference, either to rights in respect of distributions of income or rights in respect of distributions of capital. There is arguably some doubt whether a tax law partnership may be connected with another entity (see ¶18-110). The right to distribution control rule was amended by the *Tax Laws Amendment (2013 Measures No. 1) Act 2013* (with effect for CGT events that happen after 7.30 pm AEST on 10 May 2011) to ensure that trusts may be treated as connected entities for the purpose of testing eligibility for the concessions even though they do not own assets for their own benefit (see ¶10-130 and ¶10-155).

Discretionary trusts

It is important to note that, under the pattern of distributions control rule, an entity that receives a distribution from a discretionary trust for an income year that would be sufficient to establish control does not control the trust, by virtue of that distribution, until the following income year. However, even if no further distributions are made to that beneficiary, the beneficiary will control the discretionary trust under the rule not only for that following income year, but also for the next three income years, that is, for four income years (see ¶10-200).

Control because of affiliates

An entity's control percentage in another entity under the connected entity control rules includes the control percentage of affiliates of the entity (see ¶10-120). It is important to keep in mind that the definition of "affiliate" is not as wide as may have been thought. While the fact that the definition is somewhat narrow could have positive consequences for the application of the maximum net asset value test or the small business entity test, it could have adverse consequences when determining whether an asset is an active asset.

These consequences, however, are ameliorated by the provision which applies where an entity (entity A) owns a CGT asset that is used in (or is held ready for use in or is inherently connected with) a business carried on by another entity (entity B), and has the effect that an individual's spouse or child under 18 years of age will be treated as being the individual's affiliate for the purposes of determining whether entity B is an affiliate of, or is connected with, entity A (see ¶9-135).

By way of illustration, assume that Paint-tech Pty Ltd carries on a business of importing and wholesaling equipment used by painters. The issued shares of the company (all of one class) are beneficially held in equal numbers by Harry, Sandra (Harry's spouse), Trevor (Harry and Sandra's son) and Veronica (Trevor's spouse). None of the shareholders carries on business on his or her own account, and the company carries on its business in premises leased from Sandra.

Harry will be treated as Sandra's affiliate and, accordingly, Sandra and Paint-tech Pty Ltd will be connected entities (because Sandra would have a control percentage of 50%). Accordingly, while these facts continue, the premises owned by Sandra would qualify as an active asset.

Income and capital

The application of the pattern of distributions control rule that applies in the case of a discretionary trust requires that it be determined whether a distribution is income or capital, or partly income and partly capital (and, if so, the amounts of income and capital). Practitioners need to be aware that what is meant by income in the context of the general trust provisions of Div 6 ITAA36 was considered by the High Court in *FCT v Bamford*.[5]

In that case, the High Court held that the income of a trust estate for the purposes of s 97 ITAA36 is determined by reference to ordinary trust principles and the terms of the trust deed. There seems no apparent reason why this would not also be the position when determining what “income” is for the purposes of the pattern of distributions control rule. The Commissioner takes the view that the decision in the *Bamford* case is relevant to the pattern of distributions control rule.[6] For more information, see ¶10-195.

¶21-150 Significant individual issues

Trusts and small business participation percentage

Because an entity can only have a direct small business participation percentage in a company if the entity holds the legal and equitable interests in shares in the company, there is an issue of whether (and, if so, in what circumstances) a trust can have a direct small business participation percentage in a company and, hence, whether an indirect small business participation percentage in a company can be traced through a trust (see ¶11-125). There are also issues as to whether a trust can have a direct small business participation percentage in another trust, given that this depends on a beneficiary being beneficially entitled to distributions (see ¶11-130 and ¶11-135).

Discretionary trusts

No entity can have a direct small business participation percentage in a discretionary trust if the trustee does not make a distribution during the income year and, if a distribution of income and a distribution of capital are made, the entity must receive some part of each distribution (if the percentages of each distribution are different, the entity’s direct small business participation percentage is the lesser percentage) (see ¶11-135). Note that taxpayers can have a non-zero direct small business participation percentage where a discretionary trust has not made a distribution in an income year for which the trust had a tax loss or no net tax income (see ¶10-135).

Income and capital

Whether an entity has a direct small business participation percentage in a trust depends on correctly determining whether a distribution is income or capital of the trust or partly income and partly capital. For more information, see ¶10-195.

5 [2010] HCA 10.

6 ID 2012/99.

Companies and dividend access shares

There is an issue as to whether any shareholders of a company may hold a direct small business participation percentage in the company where the company has one or more dividend access shares on issue. This situation was considered in relation to particular facts by the Full Federal Court in *FCT v Devuba Pty Ltd*.[7]

An important point to note is that, when determining an entity's direct small business participation percentage in a company, redeemable shares are ignored (s 152-70(2) ITAA97). This opens the possibility that, if a dividend access share was issued as a redeemable preference share, it would be ignored. Where steps are taken to utilise this possibility, issues relating to the Commissioner's powers to make a determination under the general anti-avoidance provisions of the income tax law (Pt IVA ITAA36) would need to be considered.

¶21-155 CGT 15-year small business exemption

Company or trust

If a company or trust is entitled to the CGT 15-year small business exemption in respect of a capital gain, the distribution of the exempt amount to CGT concession stakeholders can be tax-free where the distribution occurs within two years (or a longer period allowed by the Commissioner) of the relevant CGT event happening (see ¶12-150). However, the distribution should be made as soon as possible because, if a stakeholder were to die, the potential exemption for that stakeholder's share of the exempt amount would be lost (see ¶12-180).

A distribution that is made indirectly to a CGT concession stakeholder can be tax-free, but care needs to be taken (see ¶12-170). Note that it would seem that this tax-free distribution rule is possibly of limited practical relevance in the case of trusts (see ¶12-162 and ¶12-165).

¶21-160 CGT small business 50% reduction

Choice for reduction not to apply

It is open to a taxpayer to make a choice for the CGT small business 50% reduction not to apply (see ¶13-110). This choice must be made in relation to the whole amount of the capital gain that is potentially subject to the CGT small business 50% reduction. In some cases, a company or unit trust may find the making of this choice attractive in order to maximise the CGT small business retirement exemption, if the conditions for that exemption to apply are all met.

7 [2015] FCAFC 168.

Individual and discretionary trust

An individual or discretionary trust would rarely (if at all) make the choice for the CGT small business 50% reduction not to apply. The amount of the capital gain freed from tax by the reduction is simply tax-free in the hands of an individual and effectively tax-free if distributed from a discretionary trust (see ¶13-125).

Consequence of choice

If a choice is made for the CGT small business 50% reduction not to apply so as to maximise the making of a choice for the CGT small business retirement exemption, it needs to be kept in mind that this would reduce the recipient's CGT retirement exemption limit (see ¶14-135).

¶21-165 CGT small business retirement exemption

Actual proceeds not necessary

In order for the CGT small business retirement exemption to be able to be chosen, it is not a requirement that actual (ie not deemed) capital proceeds be received of an amount that is at least equal to the amount for which the retirement exemption is being claimed. This means that a CGT asset may be gifted or disposed of for an inadequate consideration without affecting the claiming of the CGT small business retirement exemption, if (as would usually be the case) the market value substitution rule applied to determine the capital proceeds from the happening of the CGT event.

No actual retirement required

Although the ITAA97 refers to the CGT small business "retirement exemption", there is no need for any retirement. There is, however, a requirement to make a contribution to a complying superannuation fund or an RSA if the particular individual is under 55 years of age (see below). A company or trust may only claim the CGT small business retirement exemption in respect of a CGT concession stakeholder (see ¶14-165).

Under 55 years of age

An individual who is claiming the CGT small business retirement exemption and who is under 55 years of age at the relevant time must contribute the amount claimed for retirement relief to a complying superannuation fund or an RSA (immediately) at the time when the choice for retirement exemption is made (there is an exception to the contribution timing rule if the capital proceeds have not been received by the time the choice for retirement exemption is made) (see ¶14-145).

If a company or trust chooses the CGT small business retirement exemption, the payment to a CGT concession stakeholder must be made (generally) by the later of seven days after the company or trust makes the choice and seven days after the company or trust receives an amount of capital proceeds from the CGT event (see ¶14-155). Where the payment is made by the company or trust, it may be made to a CGT concession stakeholder either directly or indirectly through one or more interposed entities.

If the stakeholder is under 55 years of age at the relevant time, the payment must be made by the company or trust making a contribution to a complying superannuation fund or an RSA within a specified time, and the company or trust must, at the time when the contribution is made, notify the trustee of the fund or the RSA provider that the contribution is made in accordance with the CGT retirement exemption provisions (see ¶14-180).

If the stakeholder is approaching 55 years of age at the CGT event date, it is often advantageous to consider utilising the Div 152-E asset roll-over and defer the gain until after the stakeholder is over 55 and then apply the Div 152-D retirement concession to the resulting CGT event J5 gain.

Division 7A ITAA36

Any possible operation of Div 7A ITAA36 in relation to a payment by a private company is expressly excluded by s 152-325(11) ITAA97.

¶21-170 CGT small business roll-over relief

Automatic disregarding of capital gain

Where CGT small business roll-over relief is chosen, the amount of the capital gain for which the relief is chosen is simply disregarded, regardless of whether it is intended that a replacement active asset will be acquired or relevant fourth element expenditure will be incurred (see ¶15-110 and ¶15-170). This means that CGT small business roll-over relief can be used simply as a tax deferral mechanism. The capital gain will, however, be remade later by the happening of CGT event J5, J6 or J2 (see below).

Replacement asset: kind

A replacement asset need not have the same function as the CGT asset that gave rise to the capital gain for which the roll-over relief is chosen (see ¶15-135).

Replacement asset: share or trust interest

If the replacement asset is a share in a company or an interest in a trust, not only must the share or trust interest be an active asset, but the taxpayer (or an entity connected with the taxpayer) must also be a CGT concession stakeholder in the company or trust, or (if the taxpayer is a company or a trust) a 90% test must be met (see ¶15-130).

Improvements

Capital expenditure that falls within the fourth element of the cost base of a CGT asset (called "fourth element expenditure") that is or becomes an active asset may be taken into account for the purposes of CGT small business roll-over relief (see ¶15-125 and ¶15-130).

Rolled-over gain remade

CGT small business roll-over relief works by disregarding the capital gain chosen, but this capital gain will again be made when CGT event J5 or J6 happens at the end of the replacement asset period, or when CGT event J2 happens after the end of the replacement asset period (see ¶15-115).

If no replacement active asset or fourth element expenditure is incurred on an active asset within the replacement asset period, the capital gain will again arise at the end of the replacement asset period (CGT event J5). If only some of the amount of the roll-over has been utilised by the end of the replacement asset period as a result of acquiring a replacement asset or by way of fourth element expenditure, a capital gain equal to the unutilised amount will be made at the end of the replacement asset period (CGT event J6). A capital gain made from the happening of CGT event J5 or J6 can only qualify for the CGT small business retirement exemption, but can qualify for the exemption without satisfying the basic conditions for CGT small business relief to apply (see ¶15-155).

CGT event J2 may happen, for example, if a replacement asset that is an active asset at the end of the replacement asset period subsequently ceases to be an active asset. A capital gain that arises from the happening of CGT event J2 can qualify for either the CGT small business retirement exemption or CGT small business roll-over relief (see ¶15-155).

Retirement exemption or roll-over relief

CGT small business roll-over relief is an alternative to the CGT small business retirement exemption. Usually, if the CGT small business retirement exemption can be taken in respect of a capital gain, this would be taken. However, there may be circumstances in which roll-over relief would be taken (see ¶15-170).

Roll-over of part of gain

It should be kept in mind that it is possible to roll over part of a capital gain (see ¶15-110).

¶21-175 Deceased estates

CGT event within two years of death

If a deceased individual would have been eligible for the CGT small business reliefs if a CGT event had happened in relation to a CGT asset immediately before death, the reliefs can be claimed by the deceased's legal personal representative, a beneficiary (to whom or which the CGT asset passes) or the trustee (or a beneficiary) of a testamentary trust, providing the CGT event giving rise to the capital gain happens in relation to the CGT asset within two years of the deceased's death (or longer period permitted by the Commissioner) (see ¶19-105). The position is similar if an interest in a CGT asset held by joint tenants is acquired as a result of the death of a joint tenant (see below).

Ordinary CGT rules

The CGT small business reliefs are available in respect of a CGT asset owned by a deceased individual (whether the CGT event happens within or later than two years of the deceased's death) on the normal basis (ie if the legal personal representative or beneficiary satisfies the basic conditions for CGT small business relief), but there are some relevant points to consider (see ¶19-115).

Changes resulting from death

The death of an individual may have the consequence that a relevant link that renders a CGT asset an active asset ceases, or that the connected entity rules cease to have the effect that two entities are connected (see ¶19-120).

Joint tenants

The CGT small business concession that applies when an individual dies and a CGT event happens within two years of death (or longer period permitted by the Commissioner) applies where the interest of a deceased joint tenant in a CGT asset is acquired by the other joint tenant(s) by survivorship (see ¶19-110).

¶21-180 Company and trust structuring

When a company or unit trust is being established, attention needs to be paid to the possibility that the CGT small business reliefs will be relevant in the future, either to the company or trust itself or to a shareholder or unitholder. This will involve particular regard being had to the significant individual (see ¶11-105) and CGT concession stakeholder (see ¶11-115) tests.

It needs to be noted that the significant individual threshold interest is 20%, and that the significant individual test may be satisfied indirectly.

In the case of a discretionary trust, the potential operation of the trustee reasonable to expect to act control rule (see ¶10-165) will need to be considered when drafting the terms of the trust deed. While the operation of this control rule cannot be excluded by including provisions that, if their terms alone were relevant, would mean that the control rule would not apply (because what is relevant is the actual operation of the trust), there may be appropriate provisions that could assist in precluding the operation of the control rule, if that were desired. It should be noted that the Commissioner has abandoned the view that a person who has the power to remove and appoint a trustee of a discretionary trust will control the trust under this control rule.

The fact that spouses are not automatically affiliates of each other (even if one spouse (A) is an affiliate of the other (B) does not mean that B is an affiliate of A) needs to be taken into account if a spouse and a trust or company need to be connected entities to make a CGT asset an active asset (see ¶9-110). The possibility that the special spouse/child under 18 affiliate rule (see ¶9-135) may apply should not be overlooked.

In the case of a company, consideration should be given to the possibility of issuing redeemable shares (since these are excluded when determining an entity's direct small business participation percentage in a company and can, if necessary, be redeemed at any appropriate time).

Where a company has on issue dividend access shares, this may cause difficulty when applying the small business participation percentage test. However, as just noted, redeemable shares are disregarded when applying the test and consideration could be given to issuing redeemable shares that are dividend access shares. It must be kept in mind that, if connected entity status with another entity is needed, the fact that there are such shares on issue may prevent connected entity status being attained.

If an individual is a significant individual in a company with substantial net assets, and the shares owned by the individual are active assets but the individual will (or may be likely to) fail the maximum net asset value test, consideration should be given as to whether the individual could carry on a small business that has an aggregated turnover of less than $2m (so that the individual would be a small business entity). The individual would then not need to satisfy the maximum net asset value test to access the CGT small business reliefs in relation to a capital gain resulting from a CGT event that happens in relation to the shares.

If an existing company or unit trust structure is being examined with a view to making changes to take advantage of the maximum number of individuals who may benefit from the CGT small business reliefs being claimed by the company or trust, or from a CGT event happening in relation to their shares or trust interests, this should be approached with caution to ensure that all possible revenue implications from any change are taken into account.

¶21-185 Partnership structuring

It is important to keep in mind that if a CGT event happens in relation to a CGT asset of a partnership, the CGT small business reliefs will be potentially available to a partner in respect of a capital gain that is made in relation to the partner's interest in the partnership asset if that interest satisfies the active asset test and:

- the partner satisfies the maximum net asset value test;
- the partner carries on a business on his, her or its own account and is a small business entity; or
- the partnership is a small business entity (see ¶4-105, ¶4-110 and ¶4-115).

It should also be kept in mind that (broadly), if a partner who or which does not carry on business on his, her or its own account makes a capital gain as a result of a CGT event happening to a CGT asset that the partner owns and is used in (or is held ready for use in or is inherently connected with) the partnership business, the partner does not need to satisfy the maximum net asset value test if the partnership is a small business entity (see ¶4-105).

Where an entity other than a partner owns a CGT asset that is used in (or is held ready for use in or is inherently connected with) a business carried on by the partnership, the CGT small business reliefs will be potentially available to the entity (in relation to a capital gain that is made from a CGT event happening in relation to the asset) if a partner is connected with, or is an affiliate of, the entity, or if the entity and the partnership are connected entities.

¶21-190 Passive asset issues

Passive asset

A passive asset is used in this discussion to describe a CGT asset that is not a partnership asset and is owned by an entity but is used in (or is held ready for use in or is inherently connected with) a business carried on by another entity. For the CGT small business reliefs to be available for a capital gain made from the happening of a CGT event in relation to a passive asset, the asset must be used in (or held ready for use in or inherently connected with) a business carried on by:

- an affiliate of, or an entity that is connected with, the entity that owns the asset; or
- a partnership in which the entity that owns the CGT asset is a partner.

What tests need to be met

Both the maximum net asset value test and the small business entity test are potentially available for the purposes of applying the CGT small business reliefs in relation to a capital gain made from a CGT event happening in relation to a passive asset. The following table sets out the entity that must meet these tests in different circumstances:

Entity (M) that owns a CGT asset:	Asset is used (or held ready for use) in a business carried on by:	Maximum net asset value test to be met by:[1]	Small business entity test to be met by:[1]
Does not carry on a business on his/her/its own account[2]	an entity (Y) that is an affiliate of, or connected with, M	M	Y[3]
Does not carry on a business on his/her/its own account[2]	a partnership of which M is a partner	M	the partnership[3]
Carries on a business on his/her/its own account[4]	entity (Y) that is an affiliate of, or connected with, M	M	M
Carries on a business on his/her/its own account[4]	a partnership of which M is a partner	M	M

1. The maximum net asset value test and small business entity test are alternatives.
2. That is, the entity does not carry on business (otherwise than as a partner) in the income year in which the CGT event happens.
3. Note that when determining whether Y or the partnership (as the case may be) is a small business entity, affiliates of, or entities connected with, M are treated as being affiliates of, or entities that are connected with Y or the partnership (as the case may be) (see ¶7-135).
4. That is, the entity carries on business (otherwise than as a partner) in the income year in which the CGT event happens.

¶21-195 Deferring capital losses

As a capital loss is applied against a capital gain before the CGT discount capital gain concession and the CGT small business reliefs apply, deferring the making of a capital loss (that would otherwise have to be offset against a capital gain that will qualify for either the CGT discount capital gain concession or the CGT small business reliefs) to a subsequent income year may maximise the benefit of the capital loss. The particular circumstances would, of course, need to be considered. See the case study at ¶21-200.

¶21-200 Case study

Murray disposes of the following CGT assets during the 2015-16 income year:

- public company shares, realising a capital loss of $20,000; and
- a business asset, realising a capital gain of $110,000, which is eligible for the CGT discount capital gain concession, the CGT small business 50% reduction and the CGT small business retirement exemption, so that the capital gain will be reduced to nil.

During the 2016-17 income year, Murray disposes of a vacant block of residential land and realises a capital gain of $90,000. This capital gain potentially qualifies for the CGT discount capital gain concession but not for any other CGT concession. Murray makes no other capital gains or any capital losses during this income year, and has no net capital loss.

For 2015-16, Murray will have no net capital gain or net capital loss. The capital loss of $20,000 would be absorbed by the $110,000 capital gain before the CGT discount capital gain concession and the CGT small business reliefs were applied.

For 2016-17, Murray would have a net capital gain of $45,000 after applying the CGT discount capital gain concession.

If, however, Murray were to dispose of the public company shares in the 2016-17 income year, making the $20,000 capital loss in that income year rather than in the 2015-16 income year, the position would be as follows:

- for 2015-16, Murray would have a nil net capital gain; and
- for 2016-17, Murray would have a net capital gain of $35,000 after first applying the capital loss of $20,000 and then applying the CGT discount capital gain concession.

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