The Tax Institute

Private Business Tax Retreat

Unlocking the small business CGT concessions – restructuring your business

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1. Introduction

There are a number of issues which need to be considered when advising clients on an appropriate structure which should be used for operating businesses. These include:

- Whether there are unrelated parties who will be investing in the business or assets and what type of entities will the 'investors' be?
- Whether new investors are likely to be brought into the business in the future?
- Will a future buyer be willing to acquire shares/units rather than business assets?
- Protecting valuable assets (such as IP) from claims against the operating business risks.
- Protecting non-business assets and accumulated profits.
- Taxation benefits.
- Flexibility.
- Simplicity.
- Whether Division 7A will be a major issue.
- The type of assets being held.

Each of these factors should be considered when advising clients on the most appropriate structure to use when establishing a business as the cost of restructuring a mature business can be substantial.

This can be problematic as it requires clients to anticipate how successful their business may be, whether they will bring in new investors and who may be a potential buyer of the business.

This means that advisers should regularly review their client's structures taking into consideration the above issues. As is quite often the case circumstances change which means that the structure that the client started out with is no longer appropriate. For example, the client's business assets may be structured as a sole trader, partnership or trust and that entity is no longer appropriate.

In addition, whenever considering a restructure there are a number of issues which need to be considered such as:

- What is the client trying to achieve?

  For example:

  - The structure does not provide sufficient asset protection and the client is looking to separate:
    - non-business assets from the trading activities;

    - valuable business assets such as IP, real estate or plant and equipment from the trading activities; or
    - two independent trading activities.
  - The client may be looking at bringing investors into the business.
  - Taxation issues (such as Division 7A issues).
- What are the income tax, GST and duty issues relating to the transfer of assets?

  This will include the use of concessions and roll-overs such as:

  - Subdivision 122-A (individual or trustee to a company);
  - Subdivision 122-B (partnership to a company);
  - Subdivision 124-N (unit trust to a company);
  - Inserting a holding company between shareholders and another company using Division 615;
  - Subdivision 328-G (small business restructure roll-over);
  - Division 152 (small business CGT concessions); and
  - (in Queensland,)the small business restructure duty exemption.
- Commercial issues such as:
  - External financiers.
  - Third party consents (for example landlords).
  - Transfers of employees.
- Does the restructure impact on the estate planning issues?
- What is the impact of the restructure when the client looks to sell to a third party?

  Restructuring to separate passive assets in separate entities and/or inserting holding companies may impact on the client's ability to satisfy the small business CGT concessions (in particular the 'active asset' test). This should be considered and advice provided to the client when choosing how to or whether to implement the restructure.

This paper will focus on the issues to consider when restructuring and the use of the small business CGT concessions, small business restructure roll-over and the Queensland small business restructure duty exemption. This paper will not deal with the general CGT roll-overs as this topic is dealt with in the next session.

In this paper, a reference to:

- 1997 Tax Act means the *Income Tax Assessment Act 1997* (Cth);
- 1936 Tax Act means the *Income Tax Assessment Act 1936* (Cth); and
- Duties Act means the *Duties Act 2001* (Qld).

Unless states otherwise, a reference to legislation will be in relation to the 1997 Tax Act.

2. Taxation implications relating to the transfer of various types assets

When considering how to structure sale or restructure of a business it will be important to identify the taxation implications relating to the various assets which are being transferred.

2.1 Depreciating assets which are deductible under Subdivision 40-B of the 1997 Tax Act

- What is a 'depreciating asset'?
    - Depreciating assets are those assets that have a limited effective life and can reasonably be expected to decline in value over the time it is used, except:
        - land; or
        - an item of trading stock; or
        - intangible assets except:
        - mining, quarrying or prospecting rights;
        - mining, quarrying or prospecting information;
        - items of intellectual property;
        - in-house software;
        - spectrum licences;
        - datacasting transmitter licences;
        - telecommunication site access rights.[1]
    - An item of intellectual property consists of the rights (including equitable rights) that an entity has under a Commonwealth law as:
        - the patentee, or a licensee, of a patent;
        - the owner, or a licensee, of a registered design; or
        - the owner, or a licensee of a copyright;
        - or of equivalent rights under a foreign law.[2]
    - It is often overlooked by advisers that patents, registered and copyright (including software) are depreciating assets.

[1] Sections40-30(1) and 40-30(2) of the 1997 Tax Act
[2] Section 995-(1) of the 1997 Tax Act

- This will be particularly relevant when the entity ceases to hold these items as they will generally be taxed under Division 40 of the 1997 Tax Act not the capital gains provisions.

- Taxation implications under Division 40
  - Generally, the decline in value (depreciation) for depreciating assets is deductible using the methods provided for in Subdivision 40-B of the 1997 Tax Act (such a prime cost or diminishing value) and based on the effective life of the assets.
  - A balancing adjustment event occurs when a taxpayer ceases to hold, to use or have installed ready for use a depreciating asset which is deductible under Subdivision 40-B.
  - The balancing adjustment (profit on sale) is calculated under Subdivision 40-D and is equal to the amount by which the termination value is higher than its adjustable value (written down value).[3]

    The termination value will be:

    - the market value of the asset if:
    - the asset is sold; and
    - the parties are not dealing at arm's length; and
    - the amount received is less than market value[4]; or
    - the amount received if the parties are dealing at arm's length[5].

- Note:
  - Some of the intangible assets may have a high value but low cost, especially patents, copyright and mining rights.
  - Some plant and equipment retains its value, for example, helicopters and planes may have a much higher value than their depreciated value.
  - If the profit is assessable under Division 40 of the 1997 Tax Act, the capital gain provisions (including the general 50% discount and small business CGT concessions) will not apply.

2.2 Trading stock (Division 70)

- If an item of trading stock is disposed of outside the ordinary course of a business (for example, the disposal of all stock as part of the transfer of a business), then the taxpayer includes in their assessable income the market value of the item of trading stock.[6]
- Trading stock includes standing or growing crops (such as fruit), crop-stools and trees planted and tended for sale[7].

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[3] Section 40-285(1) of the 1997 Tax Act
[4] Item 6 of Section 40-300(2) of the 1997 Tax Act (see below for comments on apportionment issues)
[5] Item 1 of Section 40-305(1) of the 1997 Tax Act
[6] Section 70-90(1) of the 1997 Tax Act
[7] Section 70-85 of the 1997 Tax Act

This means that where the sale of a farming business includes fruit on the trees or standing crops (such as sugar cane), then the market value of these items of trading stock will need to be included in the assessable income of the vendor.

2.3 Capital gain provisions re transfer of business assets

- Assets which may be subject to the capital gain provisions include real estate, goodwill and other intangible assets (except for those which are defined to be depreciating assets) such as trademarks, rights to business names, domain names, and facebook pages.
- In relation to any capital gain on post-CGT assets, a company will not be entitled to apply the 50% general discount under Division 115 of the 1997 Tax Act (a discount of 50% for those assets which are held at least 12 months).

  This is because a company is not a type of entity which can apply the 50% general discount.
- A company may be able to reduce any capital gain under the small business CGT concessions contained in Division 152 of the 1997 Act, provided that:
  - either:
    - the net market value of the assets of the company and any connected entities just before entering into the sale agreement are less than $6 million; or
    - the company was a CGT small business entity (that is, it carried on business in either the current and had a turnover of less than $2 million in the current year or previous year [provided it carried on business in the previous year]); and
  - the CGT asset was used by the company (or a connected entity) in carrying on a business for at least half the time the company owned the asset.
- Under the small CGT concessions, the company may choose to reduce the capital gain:
  - by 50% under the small business 50% reduction under Subdivision 152-C; and/or
  - by applying the small business retirement exemption for its CGT concession stakeholders (Subdivision 152-D); and/or
  - by applying the small business roll-over (Subdivision 152-E).

  However, there may be tax implications for the shareholders in distributing the amount relating to the small business 50% reduction.
- Retained profits

  Any profit on the sale of the business assets will form part of the retained profits which will need to be paid out of the company.
- In relation to the assets of the company which were acquired pre-CGT, the company will be able to disregard any capital gain, subject to Division 149 of the 1997 Tax Act having been triggered.

- Division 149
  - Although a CGT asset may have been acquired by a company or trustee pre-CGT, it will be taken to be a post-CGT asset of Division 149 is triggered.
  - If Division 149 is triggered then the CGT asset:
    - ceases to be a 'pre-CGT asset' on the date the first Division 149 event is triggered (Division 149 Date); and
    - is taken to be acquired by the company or trustee for market value on the Division 149 Date.

    This means that the market value of the CGT asset on the Division 149 Date will form part of the first element of the CGT asset's cost base in calculating the capital gain or capital loss on any future CGT events.
  - Division 149 is triggered at the earliest time when the majority underlying interests in the asset were not held by the ultimate owners who had majority underlying interests in the asset immediately before 20 September 1985.
  - Majority underlying interests in the asset consist of:
    - more than 50% of the beneficial interests that ultimate owners have (whether directly or indirectly) in the asset (that is, capital rights); and
    - more than 50% of the beneficial interests that ultimate owners have (whether directly or indirectly) in any ordinary income that may be derived from the asset (that is, income rights).
  - A beneficiary in a discretionary trust does not have a beneficial interest in the assets of the trust. Therefore it would not be possible to trace through to individuals who have more than 50% of the beneficial interests in the income and capital of the trust. That is, any trust or company in which at least 50% of its shareholders have been trusts since pre-CGT could not have any pre-CGT assets. This is because Division 149 would have been triggered on 20 September 1985.

    However in *Taxation Ruling* IT 2340 (about section 160ZZS of the 1936 Tax Act which is the predecessor section to Division 149) the Commissioner makes the following comments at paragraphs 5 to 8:

    > In relation to what are generally referred to as discretionary trusts, i.e., family trusts, the trustees of which have discretionary powers as to the distribution of trust income or property to beneficiaries, in considering the question of whether majority underlying interests have been maintained in the assets of the trust it will be relevant to take into account the way in which the discretionary powers of the trustees are in fact exercised.
    >
    > Where a trustee continues to administer a trust for the benefit of members of a particular family, for example, it will not bring section 160ZZS into application merely because distributions to family members who are beneficiaries are made in such amounts and to such of those beneficiaries as the trustee determines in the exercise of his discretion.
    >
    > In such a case the Commissioner would, in terms of sub-section 160ZZS(1), find it reasonable to assume that for all practical purposes the majority underlying interests in the trust assets

> have not changed. That is consistent with the role of the section to close potential avenues for avoidance of tax in cases where there is a substantial change in underlying ownership of assets and the legislative guidance contained in Subdivision G of Division 3 of Part III of the Act. On that basis, trust assets acquired by the trustee before 20 September 1985 would remain outside the scope of the capital gains and losses provisions of the Act.
>
> On the other hand where, by the exercise of a trustee's discretionary powers to appoint beneficiaries or by amendment of the trust deed, there is in practical effect a change of 50% or more in the underlying interests in the trust assets - such as where the members of a new family are substituted as recipients of distributions from the trust in place of persons who were formerly the object of such distributions - the section would have its intended application as described.

Therefore provided that the trustee does not distribute to members of a new family, Division 149 should not be triggered.

2.4 Capital gain provisions re transfer of shares

- If the shareholders sell their shares in the company, there will be capital gains implications on the sale of the shares, however the shareholders may be able to reduce any capital gain as follows:
  - If the shareholder is an individual or trust, they will reduce their capital gain by 50% under the 50% general discount (Division 115) provided that they have held the shares at least 12 months and section 115-45 does not apply.

    Section 115-45 will apply if:
    - the shareholder owns at least 10% of the shares; and
    - the cost base of the assets acquired by the company in the last 12 months represented more than 50% of the cost bases of all assets; and
    - all the assets were sold at market value, the net capital gain from the assets acquired by the company in the last 12 months would represent more than 50% of the net capital gains from all assets.
  - The shareholders may also be able to choose some or all of the small business CGT concessions under Division 152 provided that they satisfy the basic conditions, being:
    - The shareholder satisfies the $6 million net asset test or CGT small business entity test.
    - The company satisfies the $6 million net asset test or CGT small business entity test (using modified rules).
    - The shares satisfy the active asset test (that is, using modified rules, 80% of the assets of the company have been active assets for at least half the time the shareholder has owned the shares).
    - The shareholder is either a CGT concession stakeholder, or if the shareholder is not an individual, CGT concession stakeholders in the company have a 90% small business participation percentage in the shareholder.

- If the shareholder acquired the shares pre-CGT, they will need to consider whether CGT event K6 is triggered
    - CGT event K6 applies if a shareholder acquired their shares in a company pre-CGT but just before the shares were transferred, the market value:
        - of property of the company (that is not its trading stock) that was acquired on or after 20 September 1985; or
        - of interests the company owned through interposed companies in property (except trading stock) that was acquired on or after 20 September 1985;

      were at least 75% of the net value of the company.[8]
    - If CGT event K6 occurs, the capital gain will be equal to that part of the capital proceeds on the shares which is reasonably attributable to the amount by which the market value of the post-CGT assets exceeds the cost base of those assets.[9]

2.5 Valuation and apportionment issues

When are valuations important in the context of a restructure or transfer to a third party?

- The concept of 'market value' will be important when restructuring or transferring to a third party in the following circumstances:
    - Trading Stock
        - If an item of trading stock is disposed of outside the ordinary course of a business, then the taxpayer includes in their assessable income the market value of the item of trading stock (regardless of whether or not the transferor and transferee are dealing with each other at arm's length).[10]
        - In the context of a retail business, where all or most of the business assets are being transferred (including all of the stock) the market value of the stock in that context is likely to be the cost of the stock.

          This is because a purchaser in that circumstance is not going to pay retail price when they can acquire the items from a wholesaler.
        - However, there may be circumstances where the cost of the stock is substantially lower than its market value even where all of the trading stock on hand is transferred.

          A common example of this is the transfer of livestock. This is because the stock on hand will generally consist of cattle which have been bred by the transferor and therefore the cost of those cattle will be recognised at a lower value.

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[8] Section 104-230(2) of the 1997 Tax Act
[9] Taxation Ruling TR 2004/18 provides guidance as to how the 75% test and capital gain is calculated
[10] Section 70-90(1) of the 1997 Tax Act

- Depreciating assets

  The market value of the asset is used in determining the balancing adjustment if the parties are not dealing at arm's length and the amount received is less than market.11

- Capital gains provisions:
  - The capital proceeds are taken to be market value if:
    - no consideration is received;
    - the capital proceeds cannot be valued; or
    - the consideration is more or less than market value if the parties are not dealing at arm's length.[12]
  - In calculating the $6 million net asset test, the sum of the market value of the assets needs to be ascertained just before the CGT event.

    Issues in relation to the small business CGT concessions and the net market value test are discussed later in this paper.

Valuation issues

- What is market value?

  In *Spencer v The Commonwealth* (1907) 5 CLR 418:

  Griffith CJ [at 432] stated:

  > In my judgment 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, i.e., 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?"

  and Isaacs J [at 441] stated:

  > To arrive at the value of the land at that date, we have, as I conceive, to suppose it sold then, not by means of a forced sale, but by voluntary bargaining between the plaintiff and a purchaser, willing to trade, but neither of them so anxious to do so that he would overlook any ordinary business consideration. We must further suppose both to be perfectly acquainted with the land, and cognizant of all circumstances which might affect its value, either advantageously or prejudicially, including its situation, character, quality, proximity to conveniences or inconveniences, its surrounding features, the then present demand for land, and the likelihood, as then appearing to persons best capable of forming an opinion, of a rise or fall for what reason soever in the amount which one would otherwise be willing to fix as the value of the property.

[11] Item 6 of Section 40-300(2) of the 1997 Tax Act
[12] Sections 116-30(1) and 116-30(2) of the 1997 Tax Act

- Valuers typically adopt the following definition of 'market value'

  The price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller acting at arm's length.

- For taxation purposes, the market value of an asset is reduced by the amount of any input tax credit to which an entity would be entitled assuming that the acquisition had been solely for a creditable purpose.[13]

- In the publication "Market valuation for tax purposes", the ATO has outlined a number of accepted principals of valuation for taxation purposes.

  These include the following:

  - Valuation fundamentals for tax compliance

    1. A valuation should be specific to the tax and superannuation provision that it is being applied to and consider any requirements of the relevant provisions, having considered case law and relevant ATO guidance.

    2. Market value is conceptually distinct from historical cost (the original price that is paid for goods or a service, or the amount paid to produce the goods or services by the relevant entity).

    3. The nature and source of the valuation inputs must be consistent with the bases of value (relevant facts and assumptions) and the valuation purpose (tax or superannuation provision).

    4. The valuer should adopt the most relevant and appropriate valuation methodology based on industry standards and practice. This may be influenced by:

    • the data available

    • the circumstances relating to the market, and

    • industry practice and standards for the asset being valued.

    5. International valuation standards recommend that valuers consider using more than one approach. For tax purposes, we recommend that (where possible) a secondary or cross-check methodology should be applied to provide additional support for an estimated value from the primary methodology.

    6. The process of valuation requires the valuer to make impartial judgments as to the reliability of inputs and assumptions. For a valuation to be credible, it is important that those judgments are made in a way that promote transparency (for example, state the inputs and any assumptions made) and minimise the influence of any subjective factors on the process.

    7. The valuer should assemble and record evidence by means such as inspection (as required), enquiry, computation and analysis to ensure that the valuation is properly supported.

    8. An estimate provided for a future date (prospective value) is frequently sought in connection with projects that are proposed, under construction or under conversion to a new use. Market value for tax purposes requires valuation for a date specified by the legislation and a prospective assessment will not be considered reasonable or acceptable.

    Bases of value

    International Valuation Standard IVS 104 defines 'bases of value' (sometimes called 'standards of value') as 'the fundamental premises on which the reported *values* will be based'.

    The bases (or basis) of value selected are critical and may influence the valuer's choice of methods, inputs and assumptions that will determine the valuation outcome.

[13] Section 960-405(1) of the 1997 Tax Act

Important facts and assumptions include the relevant transaction, the date used for valuation and the relevant parties and party characteristics. Further assumptions may include the circumstances of exchange.

The bases of valuation must be reasonable under the circumstances, supported by evidence, suitable for tax purposes, well-documented and not include buyer or seller transaction costs.

Where a valuer does not have all the required information to prepare a valuation, the outstanding information should be identified in the valuation report.

Valuation approach

A valuation approach is the methodology chosen to determine the value of an asset. The 3 internationally-defined valuation approaches are:

- **The market approach** – relies on applying market transactions for comparable valuation assets at the valuation date. This approach estimates market value by reference to market prices in actual transactions and asking prices of assets currently available for sale. The valuation process is essentially that of comparison and correlation between the asset to be valued and other similar assets.

- **The income approach** – refers to estimating the risk and return parameters of the valuation asset at the valuation date. This approach estimates the market value of an asset based on the income or cashflows that the asset can be expected to generate in the future.

- **The cost approach** – refers to estimating the market cost of replicating the valuation asset in a similar condition as at the valuation date as a suitable indicator of market value. It is often used when the plant and equipment is a component part of a larger transaction to allocate value to the plant and equipment as a proportion of the enterprise value.

The primary valuation methodology selected should be the most suitable approach for the valuation asset, with reference to the reliability and relevance of information available at the valuation date. The valuation report should include an explanation of why the chosen methodology is the most suitable. For tax purposes, it is highly recommended that a secondary or cross-check methodology is provided where possible to support the primary methodology estimate.

The valuation approach must be:

- reasonable given the valuation asset and information available

- supported by evidence

- suitable for tax purposes; depending on the circumstances and facts, a valuation that adopts and follows professional standards can add credibility to an estimate

- replicable, and

- well-documented.

- ### Who can determine market value?

For tax purposes, the acceptability of a valuation usually depends on the valuation process undertaken rather than who conducted it. However, there are some exceptions. For example, only a 'professional valuer' may undertake a market valuation for GST margin scheme purposes and only an 'approved valuer' may undertake a market valuation for the Cultural Gifts Program.

A reasonable estimate of market value requires skill, knowledge and experience. Several valuation and accounting professional bodies and institutes provide certification and standards for valuers. It is prudent to ensure that your valuer has obtained all certifications necessary for, and has previous experience and knowledge of, the asset class being valued.

A valuation report carried out by a suitably qualified professional following commonly-accepted industry standards and professional codes of conduct generally contains sufficient evidence and reasoning to allow for testing or replication and is considered more reliable by the Commissioner.

Apportionment issues

- Where there is a transfer of business assets, the apportionment of the purchase price between the different types of assets is one area where the interests of the seller and purchaser are often opposed.
    - Generally, the seller wants to ensure that the amount apportioned to depreciating assets and trading stock is kept to a minimum whereas the purchaser wants to maximise the amount apportionment to these deductible items.
    - If the parties are too far apart on this issue, you do not have to insert an apportionment in the contract. This leaves it open to the parties to adopt their own apportionment.
    - If the parties have not adopted an apportionment, the ATO has the power to apply a market value apportionment in most cases (sections 40-300 and 40-310 (depreciating assets), section 70-90 (trading stock) and sections 116-30 and s116-40 (CGT assets)).
    - The mere fact the parties insert an apportionment in the contract does not mean that the ATO is bound by that apportionment.

      For example, a disposal of trading stock other than in the ordinary course of business will be deemed to have been made at market value (section 70-90).

      A sale of all of the trading stock on the sale of the business will clearly be a sale other than in the ordinary course of business.

      There is no provision in section 70-90 which requires the Commissioner to adopt a value apportioned by the parties. Therefore, market value can be imposed irrespective of whether the parties have agreed on a value.
- With plant and equipment and other CGT assets, there are express provisions which require the ATO to accept the values agreed by the parties provided they are dealing at arm's length.

  However, the mere fact that the parties to a contract may be at arm's length does not mean they are dealing at arm's length.

  Collis v FCT (96 ATC 4831) provides a good example of the difference between "being" at arm's length and "dealing" at arm's length in relation to the apportionment of purchase price. In that case the taxpayer sold two blocks of land to an arm's length purchaser. The profit on the sale of one of the lots was exempt from tax whereas any profit on the sale of a second block would be taxable under the former section 26AAA.

  Because the purchaser was acquiring and amalgamating two blocks it was indifferent as to how the purchase price was apportioned between the two blocks. The purchaser therefore agreed with the vendor to apportion the bulk of the price to the "exempt" block.

  The ATO successfully argued that it could apply a market value apportionment because the parties were not dealing at arm's length in relation to fixing the apportionment.

3. Small business CGT concessions

3.1 Introduction

- Provided that clients satisfy the basic tests to access the small business CGT concessions, they may choose to reduce any capital gain happening in relation to their CGT assets (after applying the 50% general discount if applicable) by:
  - 50% under the small business 50% reduction (Subdivision 152-C); and/or
  - applying the small business retirement exemption for its CGT concession stakeholders (Subdivision 152-D); and/or
  - applying the small business roll-over (Subdivision 152-E).
- Alternatively, provided that the basic tests to access the small business CGT concessions as well as the requirements for the 15-year exemption (under Subdivision 152-B) are satisfied any capital gain will be disregarded.
- The small business CGT concessions are extremely generous however the rules relating to them can be quite complex and there are a lot of traps, particularly in determining whether the requirements to access the concessions are satisfied.
- The rules relating to CGT events occurring in relation to shares in companies and units in unit trusts which apply to CGT events happening on or after 8 February 2018 have added further complexity, not only when determining whether the basic requirements are satisfied but also when providing structuring advice.
- Although the eligibility to access the concessions is determined when a CGT event occurs, it is important that advisors are aware of the impact of these rules when advising clients on:
  - how to structure their operations, in particular:
    - where CGT assets are owned in a separate entity to the business operations – as this can impact on the client's ability to satisfy the 'active asset test'; and
    - the impact of the February 2018 rules relating to CGT events happening in relation to shares and units;
  - the ownership of companies (including the use of discretionary dividend shares); and
  - how distributions from trusts are made – as this may determine who will 'control' the trust and who are the 'CGT concession stakeholders'.
- The challenge for advisors will be:
  - to consider the concessions when advising on structuring issues;
  - review existing structures to identify issues which may impact on claiming the small business CGT concessions; and

- before the client triggers the CGT event advising client whether they satisfy the requirements to be eligible to access the particular concessions; and
- when claiming the concessions to:
  - correctly determine whether clients satisfy the requirements to be eligible to access the particular concessions;
  - make sure that the concessions are applied correctly (including making any required choices in writing); and
  - make sure that all of the documentation showing that all requirements are satisfied are in place before claiming the concessions.

3.1.1 Basic conditions for accessing the small business concessions

- To access any of the small business CGT concessions, the taxpayer must meet the basic requirements of Subdivision 152-A. These are (section 152-10):
  - One of the following applies:
    - The taxpayer and its connected entities and affiliates have $6,000,000 or less in net value of assets just before the CGT event (NAT).
    - The taxpayer is a CGT small business entity for the income year.
    - The asset is used by an affiliate or connected entity which is a CGT small business entity for the income year.
    - The taxpayer is a partner in a partnership, the partnership is a CGT small business entity for the income year and the CGT asset is an asset of the partnership.
    - The asset is owned by the taxpayer which is a partner and used by a CGT small business entity partnership in carrying on a business.
  - The CGT asset must meet the active asset test (see below).
  - If the CGT asset is a share in a company or interest in a trust the following additional tests must be satisfied (see below):
    - Modified rules for applying the active asset test for shares (that is, the 80% look-through test).
    - If the taxpayer did not satisfy the net asset test, that is, they are relying on the small business entity test – the taxpayer must be carrying on a business just before the CGT event.
    - The company or trust in which the shares (or units) are held (Object Entity) would be a CGT small business entity for the income year or satisfy the net asset test if the assets of each entity which the Object Entity controlled (assuming the control percentage is 20%) were included.

- CGT concession stakeholder test:
  - there must be a significant individual just before the CGT event and the shareholder or unitholder claiming the concession must be a CGT concession stakeholder in the company or trust; or
  - CGT concession stakeholders have a 90% interest in the entity which owns the shares or interest in the trust.

3.1.2 Applying the small business concessions

Small business 15-year exemption (subdivision 152-B)

- To claim the small business 15-year exemption it is necessary that:
  - the taxpayer satisfies the basic conditions;
  - the taxpayer must have owned the CGT asset for at least 15 years;
  - if:
    - the asset is owned by a company or trust; or
    - the asset is a share in a company or interest in a trust, then

    that company or trust:

    - must have had a significant individual for at least 15 years (subject to some exceptions about trusts with losses); and
    - must have a CGT concession stakeholder just before the CGT event; and
  - the taxpayer who owns the asset or the CGT concession stakeholder just before the CGT event if the Taxpayer is a company or trust must be:
    - 55 years or over just before the CGT event and the CGT event happens ‘in connection with their retirement’; or
    - permanently incapacitated.
- If the requirements for the small business 15-year exemption are satisfied, the taxpayer disregards the capital gain.

Small business 50% reduction (subdivision 152-C)

- If the taxpayer satisfies the basic tests, it may choose to apply the small business 50% reduction (section 152-30).
- This is applied after the general discount in Division 115 is applied.
- Provided the requirements of Division 115 are satisfied, the general discount applies automatically after applying capital losses.
- The taxpayer has the choice not to apply the small business 50% reduction.
- However, if the small business 50% reduction is applied, it must be applied after the general discount in Division 115 is applied.

Small Business Retirement Exemption (subdivision 152-D)

- Individuals:
    - The individual must not exceed their lifetime limit of $500,000.
    - If the individual is under 55 years of age when making the choice, the retirement exemption amount must be paid to a complying superannuation fund by the time the choice is made.
    - The choice must be made in writing by the time of the lodgement of the tax return for the year in which the CGT cent occurs.
    - A CGT Cap Election Form must be given to the superannuation at or before the contribution is made to the superannuation fund, otherwise the contribution is treated as a non-concessional contribution (section 292-100).
- Companies and trusts
    - To access the retirement exemption, a company or trust must have a significant individual just before the CGT event (section 152-305(2)).
    - The small business retirement exemption allows the taxpayer to pay up to $500,000 to or for the benefit of its CGT concession stakeholders (section 152-315(5)).
    - However, the individual must not exceed their lifetime limit of $500,000.
    - The taxpayer must make the choice to use the retirement exemption in writing by the time it lodges its income tax return for the year in which the CGT event occurs (section 103-25 and 152-315(4)).
    - It must nominate who its CGT concession stakeholders are and what percentage of the small business retirement exemption it is applying to each.
    - It must make the payment no later than within seven days of making the choice (section 152-325(4)).
    - If the CGT concession stakeholder to whom the retirement exemption is applied is at least 55 years when the choice is made, the payment does not need to be paid into superannuation.

- If the CGT concession stakeholder to whom the retirement exemption is applied is not at least 55 years when the choice is made, the payment does need to be paid into a complying superannuation fund (section 152-325(7)).
- A CGT Cap Election Form must be given to the superannuation at or before the contribution is made to the superannuation fund, otherwise the contribution is treated as a non-concessional contribution (section 292-100).

Small business roll-over (subdivision 152-E)

- By applying the small business roll-over, the taxpayer can defer the remaining capital gain (section 152-410). There is no requirement that the taxpayer is actually contemplating acquiring a replacement asset.
- However, the deferred amount will be included in the taxpayer's assessable income in a later year if certain things happen. For example, if:
  - by the end of two years after the CGT event, it has not acquired a replacement asset (CGT event J5);
  - the cost of the replacement asset is less than the amount of the capital gain that is rolled over (CGT event J6); or
  - the replacement asset ceases to be an active asset (CGT event J2).

CGT event J5

CGT event J5 will occur if Subdivision 152-E is chosen, but by the end of the replacement asset period (which is generally two years after the date of the CGT event):

- the taxpayer who choose the small business roll-over has not acquired a replacement asset or incurred fourth element expenditure (about improving a CGT asset) in relation to a CGT asset (replacement asset); or
- the following conditions are not satisfied in relation to the replacement asset:
  - the replacement asset must be an active asset of the taxpayer by the end of the replacement period; and
  - if the replacement asset is a share in a company or an interest in a trust:
    - the taxpayer or an entity connected with the taxpayer must be a CGT concession stakeholder in the company or trust; or
    - CGT concession stakeholders in the company or trust must have a small business participation percentage in the taxpayer of at least 90%.

If CGT event J5 is triggered, the time of the CGT event is at the end of the replacement asset period. The capital gain is equal to the amount of the capital gain disregarded under Subdivision 152-E.

CGT event J6

CGT event J6 will occur if Subdivision 152-E is chosen, but by the end of the replacement asset period (which is generally two years after the date of the CGT event):

- the taxpayer who choose the small business roll-over has acquired a replacement asset and/or incurred fourth element expenditure (about improving a CGT asset) in relation to a CGT asset (replacement asset);
- the replacement asset is an active asset of the taxpayer at the end of the replacement period; and
- if the replacement asset is a share in a company or an interest in a trust at the end of the replacement period:
    - the taxpayer or an entity connected with the taxpayer is a CGT concession stakeholder in the company or trust; or
    - CGT concession stakeholders in the company or trust must have a small business participation percentage in the taxpayer of at least 90%; and
- the total amount incurred in relation to the replacement asset (first element and incidental costs) and/or fourth element expenditure is less than the amount disregarded under Subdivision 152-E.

If CGT event J6 is triggered, the time of the CGT event is at the end of the replacement asset period. The capital gain is equal to the difference between the amount of the capital gain disregarded under Subdivision 152-E and the amount incurred.

CGT event J2

<u>When does CGT event J2 occur?</u>

CGT event J2 will occur if Subdivision 152-E is chosen and:

- the taxpayer acquires a replacement asset and/or incurred fourth element expenditure (about improving a CGT asset) in relation to a CGT asset (replacement asset) by the end of the replacement asset period;
- the replacement asset is an active asset of the taxpayer at the end of the replacement period; and
- if the replacement asset is a share in a company or an interest in a trust at the end of the replacement period:
    - the taxpayer or an entity connected with the taxpayer is a CGT concession stakeholder in the company or trust; or
    - CGT concession stakeholders in the company or trust must have a small business participation percentage in the taxpayer of at least 90%; and

- any of the following changes occur:
    - the replacement asset stops being the taxpayer's active asset;
    - the asset becomes the taxpayer's trading stock;
    - for a share a company or an interest in a trust:
        - CGT event G3 (about capital payments for shares) or CGT event I1 (about an individual ceases to be an Australian resident); or
        - One of the following is not satisfied:
            - the taxpayer or an entity connected with the taxpayer is a CGT concession stakeholder in the company or trust; or
            - CGT concession stakeholders in the company or trust must have a small business participation percentage in the taxpayer of at least 90%.

<u>When does CGT event J2 occur?</u>

If CGT event J2 is triggered, the time of the CGT event is the date the change happens.

<u>How much is the capital gain?</u>

The capital gain is equal to:

- If there is only one replacement asset – the amount of the capital gain disregarded under Subdivision 152-E (**Subdivision 152-E Amount**).
- If there is more than one replacement asset and changes happened to all of them – the **Subdivision 152-E Amount**.
- If there is more than one replacement asset and changes happened to some but not all of them – so much of the **Subdivision 152-E Amount** which exceeds the sum of the following for the assets to which a change did not occur:
    - the cost base of the replacement assets acquired;
    - incidental costs incurred to acquire those replacement assets;
    - the fourth element expenditure incurred in relation to those replacement assets.

However, if CGT event J6 has happened in relation to the small business roll-over under Subdivision 152-5, the capital gain applies to the **Subdivision 152-E Amount** is reduced by the amount of the capital gain under that event.

If CGT event J2 happens again in a later year in relation to small business roll-over under Subdivision 152-E, the capital gain applies to any remaining part of the **Subdivision 152-E Amount** reduced by the amount of the capital gain under the earlier event.

3.2 Maximum net asset value test (NAT)

How is NAT satisfied?

- To satisfy NAT, the sum of the net value of the CGT assets of the following entities (NAT Entities) must not exceed $6 million:
  - The entity that has the CGT event (Taxpayer).
  - Entities ‘connected’ with the Taxpayer.
  - Entities who are ‘affiliates’ of the Taxpayer.
  - Entities connected with the affiliates.[14]
- The net value of the CGT assets of an entity is the amount obtained by subtracting from the sum of the market values of the assets of NAT Entities, the sum of:
  - the liabilities of the NAT Entities that are related to the assets; and
  - provisions made by the NAT Entities for annual leave, long service leave, unearned income and tax liabilities.[15]
- In calculating NAT, if the NAT Entity is **an individual**, then the following assets are disregarded:
  - Assets being used solely for the personal use and enjoyment of the individual or the individual’s affiliate (except a dwelling that is the individual’s main residence).
  - The main residence of the individual unless the dwelling has been used during the ownership period to derive assessable income, in which case a reasonable amount of the market value of the residence must be included having regard to the extent that interest has been or would have been deductible.
  - A right to, or to any part of, any allowance, annuity or capital amount payable out of a superannuation fund or an approved deposit fund.
  - A right to, or to any part of, an asset of a superannuation fund or an approved deposit fund.
  - A policy of insurance on the life of an individual.[16]

[14] Section 152-15 of the 1997 Tax Act
[15] Section 152-20(1) of the 1997 Tax Act
[16] Section 152-20(2) of the 1997 Tax Act

- In calculating NAT, if the entity is an 'affiliate' or an entity which is connected with the taxpayer because of the 'affiliate', the only assets which are used or held ready for use in the carrying on of a business by the taxpayer or an entity connected with the taxpayer are included.[17]

- Issues and traps with calculating NAT

  - NAT is a 'snap shot test determined just before the CGT event.

    Be careful about when the "CGT event" has occurred. If the client enters into a binding heads of agreement, the CGT event may have occurred at that time and not at the time the formal agreement is entered into.

  - The taxpayer needs to identify 'connected entities' and 'affiliates'.

    - Quite commonly we find that not all of the entities who are connected with the taxpayer who has had the CGT event have been identified or that only the taxpayer's ownership interest in the connected entity's assets has been taken into account.

    - Note: Where an entity is a 'connected' entity, 100% of the net assets of that entity are included in determining NAT.

  - All CGT assets (other than those specifically excluded) must be included.

    - CGT assets as defined in section 108-5(1) of the 1997 Tax Act includes any kind of property.

    - This means that CGT assets to which a capital gain would not normally apply must also be included (e.g. depreciating business assets, trading stock, bank accounts, cash, debtors and loans will need to be taken into account).

  - Assets owned by individuals and used solely for personal use and enjoyment by the individual or their affiliate are excluded.

    (ATO's view and AAT decision)

    - Interest earning bank accounts are not used solely for personal use and enjoyment (ATO ID 2009/33).

    - Vacant land on which the individual intends to construct a house in not used for any purpose, therefore is not used solely for personal use and enjoyment (ATO ID 2009/34).

    - The use of the asset over its ownership period is taken into account, not just the use 'just before the CGT event' (ATO ID 2011/37). Holiday home which has been rented at some point is not used solely for personal use and enjoyment (ATO ID 2011/41). This is not consistent with the legislation nor the AAT decision of Altnot.

      Altnot Pty Ltd v FC of T [2013] AATA 140: Home had been rented out until 31 January 2007. In December 2006 the decision was made to use the home as a holiday home. ATO argued that you needed to look at the use of the property through-out the ownership period. AAT – only needed to look at the use of the property just before the CGT event, however although the

[17] Sections 152-20(3) and 152-20(4) of the 1997 Tax Act

home was not being rented and was available for use as a holiday home, it was not being used for that purpose just before the time of the CGT event (which occurred in March 2007).

- Holiday home (which had never been rented) used for the personal use and enjoyment of the individual, their spouse and children under 18 years of age will be considered to be for personal use and enjoyment (ATO ID 20011/39).

- Holiday home (which had never been rented) used for the personal use and enjoyment of the individual's relatives and friends will be considered to be for personal use and enjoyment (ATO ID 20011/40).

- Where the CGT asset is currently an individual's main residence, that home is only excluded to the extent that it has never been used to derived assessable income.

  Therefore, it is important to ask the client about the history of the use of the home.

- How to determine the market value of the assets?

  Note: The market value of the assets will need to be independently verified. It is not necessarily what the client thinks is the market value of the assets.

- Identifying the liabilities which relate to the assets which are included. For example liabilities can only be counted if they relate to assets which are included. For example, if the main residence is excluded, then the liability related to that main residence is excluded.

- Identifying 'connected' entities

  Discretionary trust distributions and control

  - Trust distributions are important in determining who controls the trust which is relevant for the $6 million net asset test, CGT small business entity tests and active asset test.

  Distributions and control

  - An entity controls a discretionary trust if for any of the four income years prior to the year in which the CGT event occurs, the trustee paid to or applied for the benefit for:

    - the entity; or

    - the entity's affiliates; or

    - the entity together with its affiliates

    at least 40% of the **income or capital** of the trust (section 328-125(4)).

  - An exempt entity or deductible gift recipient will not control a trust if it receives at least 40% of the income or capital of the trust (section 328-125(5)).

  - An entity also controls are trust if, that entity controls another trust which controls the trust.

    That is, if

    - Entity A controls Entity B; and

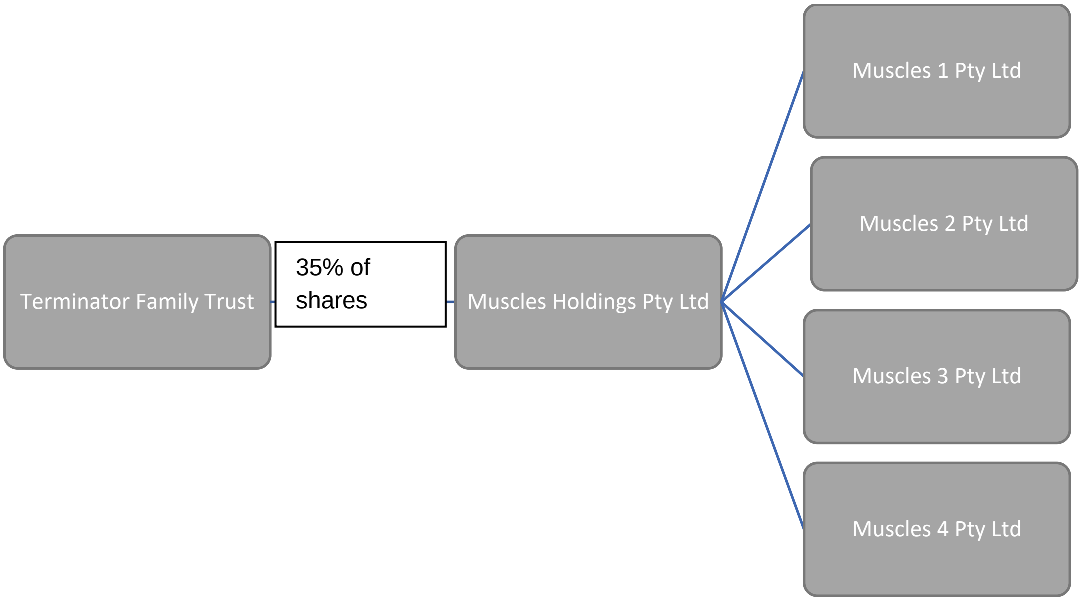
- Entity B controls Entity C etc; then
- Entity A will be taken to control Entity C (section 328-125(7)).

- Be careful when distributing to children as this may bring the children and their respective entities in as ‘connected entities’ for the purpose of the $6 million net asset test and CGT SBE tests.

- *Example: Distributions and net asset test*

  Facts

  - Maria and Arnie approached their advisor in June 2023 advising them that they were looking at selling their business which was operated by the trustee of the Terminator Family Trust and would be signing a contract on 30 June 2023.
  - The adviser considered whether the Terminator Family Trust could satisfy the $6 million net asset test to access the small business CGT concessions.
  - For the years 2019 to 2022 the trustee for the Terminator Family Trust had distributed all income and capital equally to Maria and Arnie.
  - The net assets of Terminator Family Trust consist of:
    - the net business assets which have a market value of $4 million;
    - the 35% shareholding in Muscles Holdings Pty Ltd.
  - The net value of the assets of Muscles Holdings Pty Ltd are $5 million. (35% of $5 million is $1.75 million)
  - Muscles Holdings Pty Ltd owns 100% of the shares in various subsidiaries.



- The advisor identifies that based on the past distributions of the trust, the assets of the following entities need to be included:
  - Terminator Family Trust; and
  - Arnie; and
  - Maria.
- The advisor calculates the net market value of the assets to be included as follows:
  - Terminator Family Trust:
    - Business Assets -$4 million;
    - Shares in Muscles Holdings Pty Ltd - $1.75 million (based on 35% of $5 million); and
  - Arnie and Maria – nil (on the basis that they only have excluded assets).
- The advisor prepares the resolution for the Terminator Family Trust for the 2023 year on the basis that the trust income and capital are distributed as follows:
  - Arnie – 20% of income and 50% of capital;
  - Maria – 20% of income and 50% of capital;
  - Muscles 1 Pty Ltd – 60% of income (as it has losses that year) and 0% of capital.
- Arnie and Maria as the directors of the trustee company sign the resolution on 28 June 2023.

  The advisor does not hear anything further from Arnie and Maria until October 2023 when they send in their 2023 tax work.

- What happens next?

  The advisor finds out the trustee for the Terminator Family Trust did not enter into the agreement to sell the business assets until 1 August 2023.

  CGT event happened in the 2024 year.

- Who controls Terminator Family Trust?

  - Arnie – received at least 40% of distributions of income or capital in the years 2019 to 2023.

  - Maria – received at least 40% of distributions of income or capital in in the years 2019 to 2023.

  - Muscles 1 Pty Ltd – received at least 40% of distributions of income in 2023.

  - Muscles Holdings Pty Ltd – because it controls Muscles 1 Pty Ltd who in turn controls Terminator Family Trust.

- Net asset test – $9 million:

  - Terminator Family Trust – net business assets - $4 million;

  - Muscles Holdings Pty Ltd – net assets - $5 million.

3.3 CGT Small Business Entity

What is a CGT small business entity?

- An entity is a CGT small business entity (CGT SBE)[18] for an income year if it:

  - carries on business in the income year; and

  - at least one of the following applies:

    - it has an aggregated turnover of less than $2 million for the income year (worked out at the end of the year);

    - it carried on business in the previous year and had an aggregated turnover of less than $2 million for the previous income year; and/or

    - its aggregated turnover for the current year is likely to be less than $2 million (provided that if it carried on business for the previous two years its aggregated turnover for those two years was not $2 million or more).

[18] as defined in section 328-110 of the *1997 Tax Act*

- ‘Aggregated’ turnover requires that the ordinary income derived from carrying on a business of the taxpayer’s group must be less than $2 million.

- If an entity is winding up a business, it will be taken to be a small business entity if it were a CGT SBE in the year it stopped carrying on a business.

Carrying on a business

- The activities of the entity must be sufficient to be carrying on a business.

- There has been some confusion as to the Commissioner’s view as to when a company will be carrying on a business. For the purpose of determining whether a company is carrying on a business for section 328-110 (about small business entities) the Commissioner has provided some guidance and examples in Taxation Ruling TR 2019/1. The examples have been reproduced below.

> *Example 1 - inactive company with retained profits*
>
> 62. InactiveCo is a company incorporated in Australia. InactiveCo carried on a trading business that was wound up in the 2015-16 income year. InactiveCo has $400,000 of retained earnings which it holds in a bank account.
>
> 63. In the 2016-17 and later income years, the company's income has consisted solely of interest of $12,000 a year. InactiveCo has no intention of resuming its trading business. InactiveCo pays an annual company review fee of $254 to ASIC. The company's income is consistently greater than its expenses. As a result, the company has made a profit in each income year from 2016-17.
>
> 64. InactiveCo's activities have both a purpose and prospect of profit. InactiveCo is carrying on a business.
>
> *Example 2 - company is engaged in preliminary activities invests its assets in producing income*
>
> 65. Future Co is a newly incorporated company. Its activities consist of investigating whether it would be viable to carry on a particular business in the future and investing its $300,000 in share capital in income producing bank accounts. No decision has been made to carry on the business under investigation. However, it derives $9,000 a year in interest from its bank accounts. While Future Co's activities of investigating the potential business may be preliminary in nature and not a business, it nonetheless carries on a business as a result of its activity of investing for profit.
>
> *Example 3 - property investment company*
>
> 66. InveproCo is a company incorporated in Australia. InveproCo owns a commercial property, which it rents to a third party at a market rate on normal commercial terms. InveproCo provides no other services in relation to the property and conducts no other activities. InveproCo has produced a profit in each of the income years it has rented out the property. InveproCo is engaged in ongoing activities that have a purpose and prospect of profit, including letting out the property.
>
> *Possibility A*
>
> 67. InveproCo engages a professional property manager to manage the property, find tenants and do all the maintenance and ongoing inspections in relation to the property.
>
> 68. InveproCo carries on a business.
>
> *Possibility B*

69. InveproCo does not engage a professional property manager to manage the rental property and its directors find tenants. All maintenance and inspections are carried out by its directors.

70. InveproCo carries on a business.

Example 4 - share investment company

71. ShareCo is a company incorporated in Australia. ShareCo holds a portfolio of listed shares worth $400,000. The shares generate $20,000 in income a year, after expenses.

72. ShareCo was formed for the purpose of investing in shares with the intention of earning income from dividends. Its share portfolio was selected with this in mind.

73. ShareCo has applied its assets in ongoing activities that have both a purpose and a prospect of profit. ShareCo has also invested a substantial amount of capital, and the dividend income is received by way of periodic payments.

Possibility A

74. ShareCo does not engage a third party to manage its portfolio of shares. ShareCo carries on a business.

Possibility B

75. Share Co engages a professional investment advisor and manager to manage its investment portfolio. ShareCo carries on a business.

Example 5 - Company leases multiple boats to unrelated party

76. CharterCo owns three passenger boats which it previously used to operate charter services. Following the loss of its operator's licence, the company sought to and leased its boats to an independent third party under a commercial lease agreement.

77. The rental income derived from letting the boats is CharterCo's only source of income, which greatly exceeds the outgoings associated with holding the boats for lease.

Possibility A: CharterCo self manages its leasing activity

78. CharterCo's directors directly manage the leasing of the boats, including finding lessees and personally carrying out minor repairs to the boats. The leasing activities include obtaining insurance, maintaining and registering the boats.

79. CharterCo's ongoing activities are carried on in a business-like manner and have both a purpose and prospect of profit. CharterCo carries on a business.

Possibility B: CharterCo engages a management company

80. CharterCo engages a management company to manage its chartering activities and maintenance of its boats. CharterCo's ongoing activities are carried on in a business-like manner and have both a purpose and prospect of profit. Charter Co carries on a business.

Example 6 - holding company

81. HoldCo is a company incorporated in Australia. HoldCo owns all the shares in SBE Co, which carries on a profitable trading business in Australia.

Possibility A: holding company only holds shares in subsidiary

82. HoldCo's only asset is its shares in SBE Co. HoldCo's activities consist of investing in shares in SBE Co and managing the company group. HoldCo's activities are carried on with a purpose and prospect of profit and reflect a normal commercial business structure. HoldCo carries on a business.

Possibility B: holding company holds shares in, and provides loan to, subsidiary

83. In addition to owning all the shares in SBE Co, HoldCo provides an interest-free loan to SBE Co and provides plant and capital equipment that SBE Co uses in its business rent free.

84. HoldCo's income consists of dividend income derived from the shares it holds in SBE Co. While it does not derive a direct return on the loan or provision of equipment, these enhance SBE Co's

profitability and improve the return on Holdco's shares in SBE Co. The profits are distributed by HoldCo to its shareholders.

85. HoldCo's activities consist of investing in shares in SBE Co, managing the group, providing a loan to SBE Co and deriving interest income from the loan. HoldCo carries on a business.

Who must be the CGT SBE?

- CGT SBE Test 1

  The taxpayer who has the capital gain is the CGT SBE.

- CGT SBE Test 2

  All of the following occur:

  - the taxpayer is a partner in a partnership; and
  - the partnership is a CGT SBE; and
  - the CGT asset is an asset of the partnership.

- CGT SBE Test 3

  All of the following occur:

  - the taxpayer’s affiliate or an entity connected with the taxpayer is a CGT SBE for the income year; and
  - the taxpayer does not carry on a business in the income year (other than in partnership); and
  - if the taxpayer does carry on business in partnership – the CGT asset is not an interest in an asset of the partnership; and
  - the SBE referred to above is the entity that at a time in the income year uses the asset or holds it ready for use in the course of carrying on a business.

- CGT SBE Test 4

  All of the following occur:

  - the taxpayer is a partner in a partnership in the income year; and
  - the partnership is a CGT SBE for the income year; and
  - the taxpayer does not carry on a business in the income year (other than in partnership); and
  - the CGT asset is not an interest in an asset of the partnership; and
  - the business the taxpayer carried on as a partner in the partnership referred to above is the business that at a time in the income year uses the asset or holds it ready for use in the course of carrying on a business.

What is Aggregated Turnover[19]

- Aggregated Turnover is the sum of the annual turnover for the income year:
    - of the entity; and
    - an entity which was a connected entity at any time during the income year; and
    - an entity which was an affiliate at any time during the income year.
- However, any amounts derived in the income year:
    - between the entity, the connected entity and the affiliate whilst they are ‘connected’ or affiliates are excluded;
    - by the connected entity or affiliate whilst it is not connected with or an affiliate of the entity are excluded.
- ‘Annual Turnover’ is the total ordinary income that the entity derives in the income year in the ordinary course of carrying on a business.[20]
    - ‘Ordinary income’ is income as defined by section 6-5 of the 1997 Tax Act.
    - ‘Annual Turnover’ only includes ordinary income derived in the ordinary course of carrying on a business.
        - Items of income which are statutory income, such as net capital gains and dividends will not be included.
        - Income from assets which form part of the sale of the business will not be included. For example, sale of stock or depreciating assets.
    - The GST component is not included in annual turnover.
    - Any income derived from an associate of an entity must be included as the amount the entity would have derived if they were dealing at arm’s length.
    - Meaning of ‘in the ordinary course of carrying on a business’

The Explanatory Memorandum to the *Tax Laws Amendment (Small Business) Bill 2007* provides the following guidance on the meaning of ‘in the ordinary course of carrying on a business at paragraphs 2.14 to 2.16

> 2.14 The phrase `in the ordinary course of carrying on a business' is not defined in income tax law. It must therefore be interpreted according to its ordinary meaning.
>
> 2.15 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 event. Similarly, the income is derived in the ordinary

[19] Section 328-115 of the 1997 Tax Act
[20] Section 328-120 of the 1997 Tax Act

course of carrying on a business if the income although not regularly derived, is a direct result of the normal activities of the business.

2.16 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.

Where trading stock is sold as part of the sale of a business, it would not be made in the ordinary course of business (Private Binding Ruling PBR 1013036077107).

- If a business did not carry on a business for the whole of the income year, the entity's annual turnover is calculated using a reasonable estimate of what the entity's turnover would have been if it had carried on business for the whole year.

  ATO ID 2009/49

  The taxpayer operated two businesses during the year:

  - one for the whole year; and
  - the other for part of the year.

  Although the taxpayer carried on one of the businesses for the whole of the year, the ATO's view is that section 328-120(5) 'refers to a taxpayer that does not carry on a business for the whole of an income year rather than to a taxpayer that does not carry on any business for the whole of an income year'.

  This means that the taxpayer was required to annualise the turnover of the business which ceased during the year.

  Is this view correct??

3.4 Active Asset Test

- When does an asset satisfy the active asset test?
  - There are two parts to the active asset test:
    - the asset must be an active asset; and
    - the asset must meet the active asset test.
- A CGT asset satisfies the active asset test if the asset was an active asset of the taxpayer for the following periods (section 152-35):
  - if the asset is owned 15 years or less, then half the period:
    - beginning when the asset was acquired (which is the generally the date of the contract for the acquisition of the asset); and
    - ending at the time of the CGT event (or at the time of the cessation of the business if the business ceased in the last 12 months (or a longer period that the Commissioner allows));
  - if the asset is owned more than 15 years, then the asset must be active for a total of at least 7.5 years of the period:
    - beginning when the asset was acquired; and
    - ending at the time of the CGT event (or at the time of the cessation of the business if the business ceased in the last 12 months (or a longer period that the Commissioner allows)).
- An asset is an active asset at a given time if, at that time the taxpayer owns it; and the asset (section 152-40):
  - is used, or held ready for use, in the course of carrying on the taxpayer's business; or
  - it is an intangible asset that is inherently connected with a business that the taxpayer carries on (for example, goodwill or the benefit of a restrictive covenant); or
  - it is used, or held ready for use, in the course of carrying on a business by:
    - the taxpayer's affiliate; or
    - an entity connected with the taxpayer.
- Assets which cannot be 'active assets'[21]
  - Shares or units unless they are covered by section 152-40(3), (3A) or (3B) (sections 152-40(4)(a), (b) and (c)).
  - 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) (section 152-40(d)).

[21] Section 152-40(4) of the 1997 Tax Act.

- An asset whose main use is to derive interest, an annuity, rent, royalties or foreign exchange gains cannot be an 'active asset' unless:
  - the asset is an intangible asset and has been substantially developed, altered or improved by the taxpayer so that its market value has been substantially enhanced; or
  - its main use for deriving rent was only temporary.[22]
- Royalties (*Law Companion Ruling* LCR 2019/5):
  - Ordinary meaning (cases):
    - It is a payment made in return for the right to exercise a beneficial privilege or right (e.g. to remove minerals or natural resources such as timber, to use a copyright, or to produce a play).
    - The payment is made to the person who owns the right to confer that beneficial privilege or right.
    - The consideration payable is determined on the basis of the amount of use made of the right acquire.
  - Ordinary meaning of royalties expanded under the definition in section 6(1) of the 1936 Tax Act.

    The definition includes as royalties amounts paid or credited for:

    (a) 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;

    (b) the use of, or the right to use, any industrial, commercial or scientific equipment;

    (c) the supply of scientific, technical, industrial or commercial knowledge or information (e.g. know-how payments);

    (d) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in paragraph (a), any such equipment as is mentioned in paragraph (b), or any such knowledge or information as is mentioned in paragraph (c);

    (e) the use of, or the right to use, motion picture films, films or video tapes for use in connection with television, or tapes for use in connection with radio broadcasting; or

    (f) a total or partial forbearance in respect of the use of, or the granting of the right to use property of any of the kinds referred to in paragraphs (a), (b) or (e), or the supply of knowledge, information or assistance of any of the kinds referred to in paragraphs (c) or (d).
  - An intangible asset owned by a company whose main use is to derive royalties will not be an active asset of the company unless it has been substantially developed, altered or improved by the taxpayer so that its market value has been substantially enhanced.

[22] Section 152-40(4)(e) of the 1997 Tax Act

- Is income from hire equipment royalties?
    - Ordinary meaning of royalties expanded to include specified payments such as the right to use industrial, commercial or scientific equipment (section 6(1) of the 1936 Tax Act).

    > Payments for the use of or the right to use industrial, commercial or scientific equipment form the second category of amounts that will be royalties. In this context 'equipment' does not have a narrow meaning and includes such things as machinery and apparatus. A payment for the rental of confectionary wrapping plant would be a royalty under this head, as would a payment for the hire of a computer.
    >
    > [paragraph 18 of IT 2660]

    - PBR No 1051573620646 – company in business of leasing equipment which is of an industrial or commercial nature. Hire income was a royalty and therefore BREPI.
- Although a company may be considered to be carrying on a business in a general sense as described in *Taxation Ruling* TR 2019/1, if an asset's main use is to derive rent or interest (unless the asset is used by a 'connected' entity or affiliate in carrying on a business) the asset will not be an active asset (*Taxation Determination* TD 2021/2).

    > Example: property investment company (from Taxation Determination TD 2021/2)
    >
    > *2. InveproCo is a company incorporated in Australia. InveproCo owns a commercial property, which it has rented to third parties at market rates on normal commercial terms since its inception. InveproCo provides no other services in relation to the property and conducts no other activities. InveproCo has produced a profit in each of the income years it has rented out the property. InveproCo is engaged in ongoing activities that have a purpose and prospect of profit, including letting out the property.*
    >
    > *3. In this situation, the company has derived rental income from the leasing of a property. Accordingly, the company carries on a business in a general sense described in TR 2019/1. However, the main (only) use of the property is to derive rent and it is therefore excluded from being an active asset under paragraph 152-40(4)(e) regardless of whether the activities constitute the carrying on of a business in a general sense. Therefore, the investment property would not satisfy the active asset test in section 152-35 and InveproCo would not meet the requirement in paragraph 152-10(1)(d) to be eligible for the CGT small business concessions in Division 152 in relation to the disposal of the investment property.*

- AAT decision *Del Castillo and Commissioner of* Taxation (Taxation) [2022] AATA 4233 which was handed down in December 2022:
    - The taxpayer argued that the exception in section 152-40(4)(e) about assets where the main use was to derive rent should only apply in relation to passive assets and not where the activities of the taxpayer amounted to a business (that is, a rental property business).
    - The Tribunal held that section 152-40(4)(e) was clear and applied to assets whose main use was to derive rent regardless of whether the activity of deriving the rent was considered to be a business. Deputy President McCabe at paragraph 28:

    > There is no contextual basis for concluding the parliament intended the words 'main use …to derive .. rent' in s 152-40(4)(e) to comprehend anything other than a reference to real estate assets used to drive payments under a lease – a description which neatly captures what the application was doing, whether as part of a small business or not. She clearly does not fall

within the scope of the exception to the exception. If parliament had intended to provide a more named treatment of leased assets, it presumably would have done so in express terms.

- What does 'main use' for deriving rent mean?

  The issue is where premises that are used partly for carrying on a business and partly to derive rent from entities which are not connected or affiliated, will the asset be an active asset.

  Taxation Determination TD 2006/78 provides guidance on the circumstances in which premises used in the business and to derive rent can be active assets.

  Example 5 in TD 2006/78 provides that the Commissioner's view is that in determining if the main use of land is to derive rent, it is appropriate to consider a range of factors.

  26. If an asset is used partly for business and partly to derive rent at any given time, it will be a question of fact dependent on all the circumstances as to whether the main use of the asset at that time is to derive rent. No one single factor will necessarily be determinative, 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 deriving rent and other uses); and
  - the comparative levels of income derived from the different uses of the asset.

  Example 5: mixed use

  > 15. Mick owns land on which there are a number of industrial sheds. He uses one shed (45% of the land by area) to conduct a motor cycle repair business. He leases the other sheds (55% of the land by area) to unrelated third parties. The income derived from the motor cycle repair business is 80% of the total income (business plus rentals) derived from the use of the land and buildings.
  >
  > 16. In determining if the main use of the land is to derive rent, it is appropriate to consider a range of factors. In this case, a substantial (although nevertheless not a majority) proportion by area of the land is used for business purposes. As well, the business proportion of the land derives the vast majority (80%) of the total income. In all the circumstances, the Tax Office considers the main use of the land in this case is not to derive rent and accordingly the land is not excluded from being an active asset by paragraph 152-40(4)(e) of the ITAA 1997.

- TD 2006/78 also outlines the Commissioner's view as to the circumstances the premises used in a business of providing accommodation for reward will satisfy the active asset test.

  > 22. Whether an asset's main use is to derive rent will depend on the particular circumstances of each case. The term 'rent' has been described as follows:
  >
  > - the amount payable by a tenant to a landlord for the use of the leased premises (*C.H. Bailey Ltd v. Memorial Enterprises Ltd* [1974] 1 All ER 1003 at 1010, *United Scientific Holdings Ltd v. Burnley Borough Council* [1977] 2 All ER 62 at 76, 86, 93, 99);
  > - a tenant's periodical payment to an owner or landlord for the use of land or premises (*The Australian Oxford Dictionary*, 1999, Oxford University Press, Melbourne); and
  > - recompense paid by the tenant to the landlord for the exclusive possession of corporeal hereditaments. .... The modern conception of rent is a payment which a tenant is bound by contract to make to his landlord for the use of the property let (Halsbury's *Laws of*

England 4th Edition Reissue, Butterworths, London 1994, Vol 27(1) 'Landlord and Tenant', paragraph 212).

23. 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; *Tingari Village North Pty Ltd v. Commissioner of Taxation* [2010] AATA 233 at paragraphs 44-46, 2010 ATC 10-131, 78 ATR 693 and associated Decision Impact Statement 2008/4646 & 2008/4647). 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.

24. 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.

25. 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).

Example 1: rental properties

2. Commercial Property Co owns 5 commercial rental properties. The properties have been leased for several years under formal lease agreements to various commercial tenants which have used them for office and warehouse purposes. The terms of the leases have ranged from 1 year to 3 years with a 3 year option and provide for exclusive possession. The company has not engaged a real estate agent to act on its behalf and manages the leasing of the properties itself.

3. In this situation, the company has derived rental income from the leasing of a number of properties. Accordingly, the main (only) use of the properties is to derive rent and they are therefore excluded from being active assets under paragraph 152-40(4)(e) of the ITAA 1997 regardless of whether the activities constitute the carrying on of a business.

Example 2: commercial storage

4. Christine carries on a business of providing commercial storage space. The storage facility comprises 50 storage sheds which are available for hire for periods of 1 week to 2 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.

5. 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.

6. 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.

7. Having regard to all the circumstances, the Tax Office considers a tenant/landlord relationship does not exist between the parties in this example and therefore the amounts received are not rent. Accordingly, the storage facility is not excluded by paragraph 152-40(4)(e) of the ITAA 1997 and is therefore an active asset.

Example 3: boarding house

8. David owns an 8 bedroom property which 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 4-6 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, kitchen, bathrooms, laundry and a recreation area.

9. In this example, 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 through 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.

10. 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 therefore the paragraph 152-40(4)(e) exclusion does not apply. If David's activities amount to the carrying on of a business, the boarding house will be an active asset under section 152-40 of the ITAA 1997.

Example 4: holiday apartments

11. Linda owns a complex of 6 holiday apartments. The apartments are advertised collectively as a motel and are booked for periods ranging from 1 night to 1 month. The majority of bookings are from 1 to 7 nights.

12. Linda is responsible for bookings, checking guests in and out and cleaning the apartments. She also provides clean linen and meal facilities to guests. Linda does not enter into any lease agreements with guests staying at the apartments.

13. In this example, the apartments are operated similar to a motel. The guests do not have exclusive possession of the apartment they are staying in but rather only a right to occupy the apartment on certain conditions. The usual length of stay by guests is very short term and room cleaning, linen and meals are also provided to guests.

14. These facts indicate that the relationship between Linda and the guests is not that of landlord/tenant under a lease agreement. Accordingly, the income derived is not 'rent'. If Linda's activities amount to the carrying on of a business, the paragraph 152-40(4)(e) of the ITAA 1997 exclusion would not apply and the apartments would be active assets under section 152-40 of the ITAA 1997.

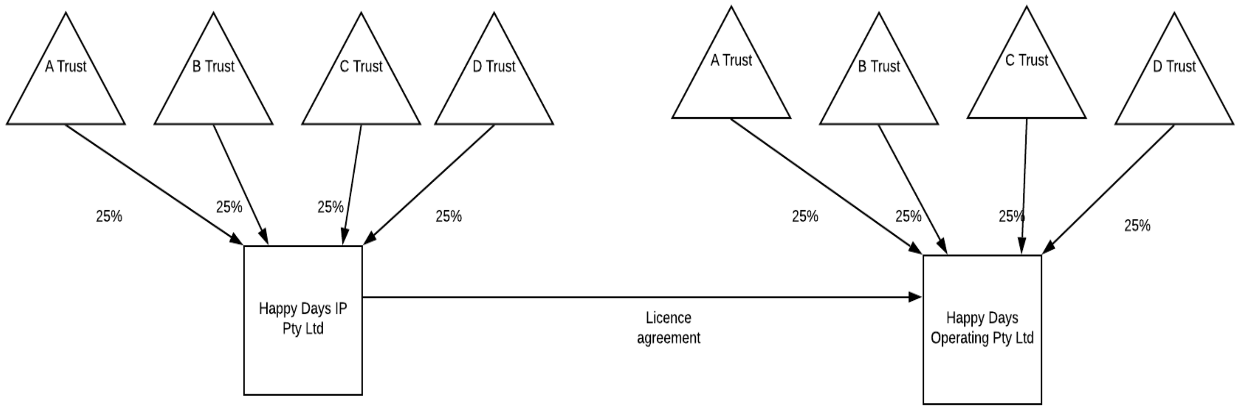
- "Connection" issues with a trust which has a tax loss or no taxable income
  - If the trust has a tax loss or no taxable income for a year, then the trustee may nominate not more than four beneficiaries as being the controllers of the trust for those years for the purpose of determining 'control'.
  - These nominated beneficiaries will be the controllers for those years (section 152-78(3)).
  - The nomination must be in writing and signed by the trustee and by each nominated beneficiary (section 152-78(4)).
  - Section 152-78 does not state when the nomination must be made by. The Commissioner's view (as expressed in relation to the legislation pre 1 July 2007) is that the nomination should be made by the time the entity chooses to apply the small business concessions for a particular capital gain. (ATO ID 2004/970).
- Spouse or children taken to be affiliates for passively held CGT assets
  - Section 152-47 applies if:
    - one entity (the asset owner) owns a CGT asset (whether a tangible or intangible asset); and
    - either:
      - the asset is used or held ready for use in the course of carrying on a business in an income year by another entity (the business entity); or
      - the asset is inherently connected with a business that is carried on in an income year by another entity (the business entity); and
      - the business entity is not (apart from this section) an affiliate of, or connected with, the asset owner.
  - For the purposes of Subdivision 152-A (basic conditions), in determining whether a business entity is an affiliate of, or is connected with, the asset owner, the following are taken to be affiliates of an individual:
    - a spouse of the individual; and
    - a child of the individual who is under 18 years (section 152-47(2)).
  - If an entity is an affiliate of, or connected with, another entity as a result of section 152-47(2), then the spouse or child mentioned in that section is taken to be an affiliate of the individual for the purpose of:
    - Subdivision 152-A – maximum net asset test and small business entity test;
    - sections 328-110 and section 328-115 (calculating aggregated turnover for determining whether an entity is a small business entity); and
    - section 328-125 (determining whether an entity is a 'connected entity').

- Structuring issues in relation to 'active asset test'

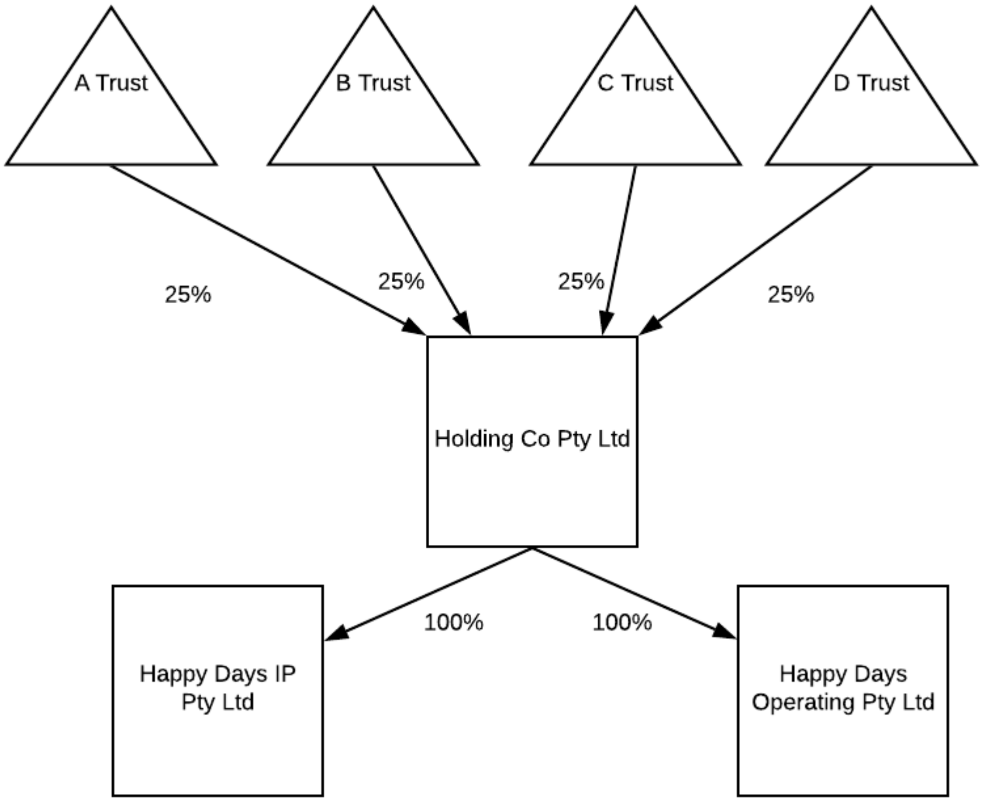
  Where one entity owns an asset and another uses that asset to carry on business, the asset owning entity and business entity will need to be 'connected' or affiliates for at least half of the relevant period or 7½ years (whichever is the lower).

  Below are examples of common structuring issues

  - Example 1: Happy Days IP Pty Ltd and Happy Days Operating Pty Ltd may not be 'connected' entities. Trusts cannot be 'affiliates' of each other. No one shareholder has at least 40% of voting, capital and dividend rights. Question: Can Happy Days IP Pty Ltd and Happy Days Operating Pty Ltd be affiliates??



- Example 2: Happy Days IP Pty Ltd and Happy Days Operating Pty Ltd owned by a Holding Company. They will be connected entities as they are both controlled by Holding Co Pty Ltd.



3.5 CGT Concession Stakeholders

3.5.1 When is a CGT Concession Stakeholder required?

- In the context of the small business CGT concessions, a CGT Concession stakeholder is important for the application of the following small business CGT concessions:
  - Where a CGT event occurs in relation to shares in a company (or units in a trust), just before the CGT event the shareholder must either be a CGT concession stakeholder or CGT

concession stakeholders in the company must have a small business participation percentage of at least 90% in the shareholder.[23]

- To access the small business 15-year exemption (Subdivision 152-B):
  - a company must have a significant individual for at least 15 years and just before the CGT event the company must have a CGT concession stakeholder:
    - who is at least 55 years of age at that time: and the CGT event happens in connection with their retirement; or
    - is permanently incapacitated at that time[24]; or
  - if the asset is a share in a company, the company must have had a significant individual for at least 15 years and at the time of the event the shareholder was a CGT concession stakeholder:
    - who is at least 55 years of age at that time: and the CGT event happens in connection with their retirement; or
    - is permanently incapacitated at that time.[25]
- To choose to apply the small business retirement exemption (Subdivision 152-D), a company must have a significant individual just before the CGT event and can only choose to apply the retirement exemption in relation to individuals who were CGT concession stakeholders just before the CGT event.[26]

3.5.2 Who is a CGT Concession Stakeholder?

- A CGT concession stakeholder is:
  - a significant individual; or
  - a spouse of a significant individual in the company or trust provided the spouse has a small business participation percentage (small business participation percentage) in the company or trust at that time that is greater than zero.[27]
- A significant individual of a trust is an individual who has a small business participation percentage in the company or trust of at least 20%.[28]
- An entity's small business participation percentage is the total of:
  - the entities direct small business participation percentage; and
  - the entities indirect small business participation percentage.

  This means that a significant individual is an individual with at least 20% of the direct and indirect small business participation percentages in a company or trust.

[23] Section 152-10(2) of the *1997 Tax Act*
[24] Section 152-110 of the *1997 Tax Act*
[25] Section 152-105 of the *1997 Tax Act*
[26] Sections 152-305(2), 152-315(2) and 152-325 of the *1997 Tax Act*
[27] Section 152-60 of the *1997 Tax Act*
[28] Section 152-55 of the *1997 Tax Act*

3.5.3 Legislation: Direct small business participation percentage

Section 152-70 of the 1997 Tax Act

An entity's *direct small business participation percentage*

In this entity:	Is:
Item 1 A company	This percentage that the entity has because of holding the legal and equitable interests in *shares in the company: (a) the percentage of the voting power in the company; or (b) the percentage of any *dividend that the company may pay; or (c) the percentage of any distribution of capital that the company may make; of, if they are different, the smaller or smallest.
Item 2 A trust (where entities have entitlements to all the income and capital of the trust)	This percentage: (a) the percentage of any distribution of income that the trustee may make to which the entity would be beneficially entitled; or (b) the percentage of any distribution of capital that the trustee may make to which the entity would be beneficially entitled; or, if they are different, the smaller.
Item 3 A trust (where entities do not have entitlements to all the income and capital of the trust)	This percentage: (c) if the trustee makes distributions of income during the income year (the current year) in which that time occurs – the percentage of the distributions to which the entity was beneficially entitled; or (d) if the trustee makes distributions of capital during the current year – the percentage of the distributions to which the entity was beneficially entitled; or, if 2 different percentages are applicable, the smaller.

Section 152-70(2) provides that for item1, ignore redeemable shares

3.5.4 Legislation: Indirect small business participation percentage

Section 152-75 of the 1997 Tax Act

(1) Work out the ***indirect small business participation percentage*** that an entity (the ***holding entity***) holds at a particular time in another entity (the ***test entity***) by multiplying:

(a) the holding entity's *direct small business participation percentage (if any) in another entity (the ***immediate entity***) at that time; by

(b) the sum of:

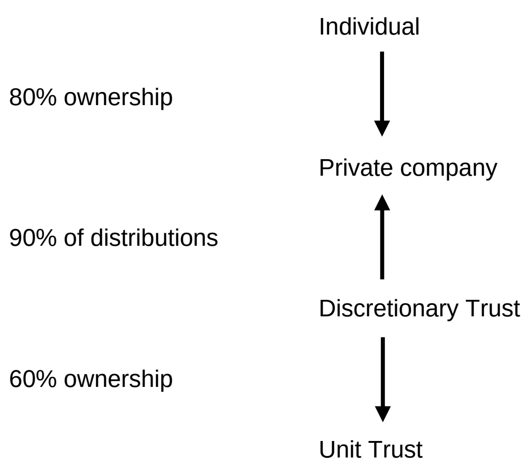
(i) the intermediate entity's direct small business participation percentage (if any) in the test entity at that time; and

(ii) the intermediate entity's indirect small business participation percentage (if any) in the test entity at that time (as worked out under one ore more other applications of this section).

Note: When testing an intermediate entity's indirect small business participation percentage in another entity, the intermediate entity becomes the holding entity.

(2) If there is more than one intermediate entity to which paragraph (1)(a) applies at that time, the holding entity's ***indirect small business participation percentage*** is the sum of the percentages worked out under subsection (1) in relation to each of those intermediate entities.

Example: The individual mentioned in the diagram has an indirect small business participation percentage in the unit trust.



Multiplying the percentages as mentioned in subsection (1) produces small business participation percentage of 43.2%.

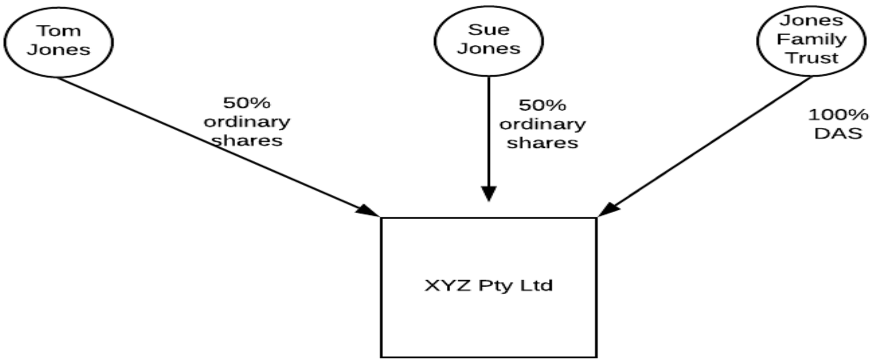
If the individual had a direct small business participation percentage of 10% in the unit trust, that would be added to the individual's indirect small business participation percentage to produce a small business participation percentage in the trust of 53.2%

That is, an entity can trace through other entities by multiplying its direct small business participation percentage in the interposed entity by the interposed entity's direct small business participation percentage in the next entity etc.

3.5.5 CGT concession stakeholders and companies

Can an entity have a small business participation percentage if a company has dividend access shares on issue?

- Generally, when dividend access shares are issued in a company:
  - the only rights attaching to a dividend access share are dividend rights (that is, they do not have voting rights or rights to surplus assets on the winding up of the company);
  - the ordinary shares have the voting and capital rights; and
  - the directors have the power to declare dividends in respect of one class of shares to the exclusion of the other classes.
- This means that where dividend access shares are on issue, a company may not have a CGT concession stakeholder as none of the shareholders may have a small business participation percentage. For example



Shareholder	Voting Rights	Capital Rights	Dividend Rights
Tom Jones	50%	50%	0%
Sue Jones	50%	50%	0%
Jones Family Trust	0%	0%	0%

In the above example, each of the shareholders has a small business participation percentage of 0%. This is because the shareholder's small business participation percentage is the lowest of its percentage of voting, capital and dividends rights.

Devuba's case

- To determine an entity's small business participation percentage, the rights attaching to the shares is determined just before the CGT event. The issue of whether a dividend access share on issue prevents the CGT concession stakeholder requirement being satisfied was considered by the Full Federal Court in *FC of T v Devuba Pty Ltd* [2015] FCAFC 168.

  Devuba Pty Ltd sold shares in a company during the 2010 year resulting in a capital gain. As the CGT event happened in relation to shares in a company, for Devuba to access the small business CGT concessions, CGT concession stakeholders of the company in which the shares were sold needed to have a small business participation percentage of at least 90% in Devuba (90% Test). The 90% Test must have been satisfied just before the CGT event.

- At the time of the CGT event the issued capital of Devuba comprised of:
  - one ordinary share held by Mr Van der Vegt (Mr V);
  - one ordinary share held by the trustee for the Van der Vegt Family Trust; and
  - one dividend access share held by Mr V's wife (Mrs V).
  - Rights attaching to the dividend access shares
  - When the dividend access share was issued to Mrs V on 1 May 2007 it did not carry any voting rights and could not participate in a distribution of any surplus assets remaining after payment of the amount paid up on all shares but was entitled to receive such dividends, capital or other distributions other than on winding up as the directors may from time to time determine to pay.
  - On 1 September 2008, the rights attached to Mrs V's shares were varied so that the holders of the dividend access shares had no right to payment of a dividend until such time as the directors of the company resolved that the holders of the dividend access shares had a right to a payment of a dividend.
- Issue
  - To determine whether the 90% Test was satisfied the issue which needed to be determined was as follows:
    - If Devuba had paid a dividend to its shareholders just before the CGT event what percentage of that dividend may Devuba pay to the dividend access shares (Item 1(b) of section 152-70(1))?
    - If, just before the CGT event, dividends could be paid to either the ordinary shares or to the dividend access share, then each of the shareholders would have a small business participation percentage of zero. This is because the percentage of dividends which any of the shareholders may receive would be zero.
  - Therefore, the Court had to determine whether the dividend access shares had any rights to dividends just before the CGT event.
- The resolution on 1 May 2007 creating the dividend access share was as follows:
  - It was resolved that the following class of shares be inserted into the Memorandum and Articles of Association pursuant to Paragraph 4.
  - The new share class is to be known as Dividend Access Shares (DIVV ACC) and will have the following rights:

The holders of 'DIVV ACC' class of shares shall not be entitled to:

- any vote in respect of any such shares held by them at any meetings of the Company but shall be entitled to receive notice of such meetings and to attend thereat; or
- participate in a distribution of surplus assets (if any) remaining after payment of the amount paid up on all shares in the capital of the Company but shall be entitled to receive in respect of any such shares, such dividends, capital or other distributions (if any) other than on a winding-up as in respect of each class the Directors may from time to time determine to pay. The Directors may determine a dividend be paid on any one or more of such shares and any such declaration, payment or distribution shall be binding upon all members of the Company.

- On 1 September 2008 a resolution was passed varying the rights of the holders of the dividend access shares as follows

  Resolved: that pursuant to Article 83 of the company's constitution, the rights attached to Dividend Access Shares are varied so that the holders of the Dividend Access Shares have no right to payment of a dividend until such time as the directors of the company resolve that the holders of the Dividend Access Shares have a right to payment of a dividend.

- Article 129 of the Memorandum and Articles of Association allowed for dividends to be declared on one or more classes of shares to the exclusion of other classes of shares.
- The Full Court held that:
  - the dividend access shares had been created in 2007 with an entitlement to receive 'such dividends, capital or other distributions (if any) other than on a winding-up as in respect of each class the Directors may from time to time determine to pay'; however
  - the 2008 resolution took away that right and deprived the company of an ability to declare a dividend on the dividend access shares unless and until the directors first resolved that the holders of the Dividend Access Share had a right to payment of a dividend.
- The Full Court stated:[29]

> The 2008 resolution expressly limited Devuba's ability to pay a dividend to the holder of the Dividend Access Share by excluding from the holder of the Dividend Access Share any right to a dividend "until such time as the directors of the company resolve[d] that the holders of the dividend access shares have a right to payment of a dividend". Devuba's ability "to pay" any dividend to the dividend access shareholder was made dependent upon the prior determination by the directors. Devuba's ability to declare a dividend was correspondingly restricted. The determination of the directors contemplated by the 2008 resolution was not that the dividend be declared by the directors, but that the holder of the Dividend Access Share should be determined to become entitled to the future exercise of a discretion which had otherwise been removed. No such determination had been made by the directors in respect of the Dividend Access Share and, therefore, as at 19 May 2010 the company could not declare a dividend to the holder of that share.

[29] At paragraph 10

What are the implications of Devuba?

- Without the restriction placed on the dividend access shares by the 2008 resolution, the dividend access shares would have had dividend rights just before the CGT event. If this were the case, each shareholder would have had a small business participation percentage of zero and the 90% Test would not have been satisfied.
- Therefore, clients will need to review the terms of the rights attaching to any dividend access share to determine whether the company can pay dividends to the holders of those shares without any restriction.
- Clients could:
  - consider inserting a restriction on the rights attaching to the dividend access shares so that the holders of the shares do not have an automatic right to be paid a dividend; or
  - deal with the dividend access share prior to the CGT event.

  However, anything done close to or in contemplation of a CGT event occurring may be open to scrutiny by the Commissioner.
- An alternative would be to issue dividend access shares as redeemable preference shares.
  - Section 152-70(2) provides that for Item 1 of the table in section 152-70(1) redeemable shares are ignored. There are two views as to the interpretation of section 152-70(2). That is, either:
    - in determining an entity's small business participation percentage any redeemable shares which they hold are ignored; or
    - all redeemable shares issued in the company (regardless who they are issued to) are ignored.
  - The Commissioner's view as outlined in *Taxation Determination* TD 2006/77 appears to support the second view. TD 2006/77 relates to whether all classes of shares (other than redeemable shares) issued by a company are taken into account in determining if the company has a significant individual under section 152-55 of the 1997 Tax Act.

    Yes. All classes of shares (other than redeemable shares) issued by a company are taken into account in determining if the company has a significant individual under section 152-55 of the *Income Tax Assessment Act 1997* (ITAA 1997).[30]

    Example 4

    9. XYZ Co has 100 ordinary shares and 1 redeemable preference share on issue. Michelle and ABC Co each own 20 ordinary shares. Catherine owns the redeemable preference share.

    10. The redeemable preference share has voting rights equal to the ordinary shares, preferential dividend rights, 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.

    11. In this situation, the redeemable preference share is ignored for the purpose of determining if 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 the company may make (excluding redeemable shares), she is a significant individual of XYZ Co.

[30] At paragraph 1

- Recommendation: If appropriate, dividend access shares could be issued as redeemable preference shares and also contain a restriction similar to that in Devuba. That is, the directors (or shareholders) must first resolve that the holders of the dividend access shares have a right to payment of a dividend.

3.5.6 CGT concession stakeholders and trusts where entities have entitlements to all the income and capital of the trust (Fixed Trusts)

- In relation to a Fixed Trust, an entity's direct small business participation percentage in this type of trust is the lowest of the following percentages (determined just before the CGT event):
  - the percentage of any distribution of income that the trustee may make to which the entity would be beneficially entitled; or
  - the percentage of any distribution of capital that the trustee may make to which the entity would be beneficially entitled.
- Issues:
  - Where the percentages are different, use the lowest percentage.
  - The entity's interests are determined just before the CGT event.
  - Where income and capital unitholders are different, no unitholder will have a small business participation percentage in the Fixed Trust.
  - Even where the trustee has the power to accumulate trust income, a unitholder may still have a small business participation percentage.

ATO ID 2015/8

Issue: Is a trust, in relation to which a term of the trust deed gives the trustee the power to accumulate income or capital of the trust estate for a year of income, capable of being a trust where entities have entitlements to all the income and capital of the trust for the purposes of Item 2 of the table in subsection 152-70(1) of the *Income Tax Assessment Act 1997* (ITAA 1997)?

Decision: Yes. A trust, in relation to which a term of the trust deed gives the trustee the power to accumulate income or capital of the trust estate for a year of income, is capable of being a trust where entities have entitlements to all the income and capital of the trust for the purposes of Item 2 of the table in subsection 152-70(1) of the ITAA 1997.

Facts:

The XYZ Trust is a unit trust, in which two unit holders, U1 and U2, each hold 50% of the single class of units.

Under the XYZ Trust Deed, unit holders are entitled to each year's income of the trust estate in proportion to their unit holdings. Upon vesting, or at an earlier time determined by the trustee, unit holders are also entitled to the capital of the trust estate in proportion to their unit holdings.

The trustee has no discretion to allocate income or capital of the trust to unit holders other than in accordance with the share of income and capital represented by their units.

The XYZ Trust Deed gives the trustee discretion to accumulate some, or all, of the income of the trust estate for a year of income such that it forms part of the capital of the trust fund.

Each unit holder retains their interest in the share of accumulated income represented by their unit holdings.

Reasons for Decision: The small business Capital Gains Tax (CGT) concessions only apply to a capital gain if, amongst other things, the basic conditions in section 152-10 of the ITAA 1997 are met. Where that capital gain is made in respect of an interest in a trust or a share in a company, the additional basic condition in subsection 152-10(2) of the ITAA 1997 requires a determination of whether or not an individual is a CGT concession stakeholder and, in turn, a significant individual, in the trust or company just before the relevant CGT event (defined in sections 152-60 and 152-55 of the ITAA 1997, respectively).

An individual is a significant individual in a trust at a time if, at that time, the individual has a small business participation percentage in the trust of at least 20% (section 152-55 of the ITAA 1997). An entity's small business participation percentage in another entity at a time is the percentage that is the sum of the entity's direct small business participation percentage and indirect small business participation percentage in the other entity at that time (section 152-65 of the ITAA 1997).

An entity's direct small business participation percentage in a trust is calculated using the methodology in either item 2 or 3 of the table in subsection 152-70(1) of the ITAA 1997, depending on whether or not the trust is one in which entities have entitlements to all of the income and capital of the trust.

Items 2 and 3 of the table in subsection 152-70(1) of the ITAA 1997 state:

Although 'income' is not relevantly defined, in context, it has the meaning which it has for the purposes of the general law of trusts (ATO Interpretative Decision ATO ID 2012/99). Similarly, it is considered that 'capital' has the meaning which it has for the purposes of the general law of trusts.

Accordingly, a determination of whether a trust is an entity to which item 2 or item 3 of the table in subsection 152-70(1) of the ITAA 1997 applies, depends on whether or not, on a proper construction of the trust instrument, there is any amount of income or capital of the trust to which no beneficiary is entitled at the relevant time.

The 'relevant time' (as that phrase is used in subsection 152-70(1) of the ITAA 1997) for making the determination is, with respect to the additional basic conditions, 'just before the CGT event' (subsection 152-10(2) of the ITAA 1997).

Accordingly, a trust instrument which gives the trustee discretion to appoint or distribute income or capital to one or more of a class of beneficiaries is a trust where entities do not have entitlements to all the income and capital of the trust. Although entities may become entitled to the income and capital of the trust as a result of the exercise of the trustee's discretion, those entitlements do not exist prior to that time.

By contrast, whilst every case will turn on a proper construction of the trust instrument, the power in the trustee to accumulate income of the trust in the present case does not of itself cause the trust to be one in which beneficiaries do not have entitlements to all the income and capital of the trust. Generally, an accumulation clause gives the trustee a power to effectively cause part of the income of the trust estate to be capital of the trust estate.

Provided that, under the trust instrument, one or more beneficiaries has, at the relevant time, an entitlement to all of the income and capital of the trust, including any accumulated income or capital, the trust will be a trust to which item 2 of the table in subsection 152-70(1) of the ITAA 1997 applies. For the purposes of determining whether or not a trust is a trust to which item 2 or item 3 of the table in subsection 152-70(1) applies, it doesn't matter whether the same beneficiary or beneficiaries have an entitlement to the accumulated income or capital.

In the present case, the power in the trustee to accumulate some or all of the income of the trust estate in accordance with the terms of the trust deed does not change the fact that entities are, at all relevant times, entitled to all of the income and capital of the unit trust.

3.5.7 CGT concession stakeholders and trusts where entities do not have fixed entitlements to all the income and capital of the trust (Discretionary Trusts)

- In relation to a Discretionary Trust, an entity’s direct small business participation percentage is the lowest of the following percentages:
  - if the trustee makes a distribution of income during the year, the percentage of the distributions of income to which the entity was beneficially entitled; or
  - if the trustee makes a distribution of capital during the year, the percentage of the distributions of capital to which the entity was beneficially entitled.

Issues

- Where the percentages are different, use the lowest percentage.
- The entity's interests are determined based on the distributions made during the income year.
- Must make sure distributions are done on time – as it refers to distributions made during the year.
- What is 'income' of the trust for the purposes of determining an entities small business participation percentage?

What is 'income' of the trust for the purposes of determining an entities small business participation percentage?

- ATO ID 2012/99

  Issue: When determining an entity's direct small business participation percentage in a trust under items 2 or 3 of the table in subsection 152-70(1) of the *Income Tax Assessment Act 1997* (ITAA 1997), do the references to distributions of 'income' necessarily mean income according to ordinary concepts?

  Decision: No. The references to distributions of 'income' in the context of determining an entity's direct small business participation percentage in a trust mean the income of the trust, determined according to the general law of trusts, to which a beneficiary could be entitled. Depending on the deed and/or actions of the trustee, this may be an amount that differs from the ordinary income of the trust.

  Facts: In a particular income year the trustee of a discretionary trust makes a capital gain of $90,000 from the sale of shares in a company (the *object company*). Prior to the sale, the trustee owned 50% of the shares in that company.

  The trustee also derived ordinary income of $10,000 in that year.

  The trustee has a power to appoint income of the trust among a range of discretionary objects.

  The trust deed does not define 'income' although the trustee does have a power to determine whether receipts are on capital or revenue account.

  Pursuant to the deed, the trustee validly resolves to treat the capital gain as income of the trust and to distribute it to beneficiary A.

  The trustee resolves to appoint the ordinary income to beneficiary B.

  Reasons for Decision

  Background

  The small business Capital Gains Tax (CGT) concessions will only potentially apply to a capital gain if the basic conditions in section 152-10 of the ITAA 1997 are met. Where that capital gain is made by a trust in respect of a share in a company, those basic conditions include the requirement that CGT concession stakeholders in that company together hold a small business participation percentage in the trust of at least 90 percent (paragraph 152-10(2)(b) of the ITAA 1997).

  Which entities have a small business participation percentage in the discretionary trust?

  An individual's direct small business participation percentage in a trust is worked out under either item 2 or item 3 of the table in subsection 152-70(1) of the ITAA 1997 depending on whether beneficiaries have or do not have entitlements to all of the income and capital of the trust.

  In this case the trust is a discretionary trust (beneficiaries do not have entitlements to all the income and capital of the trust) and so the relevant percentage is worked out under item 3 as follows:

  (a) if the trustee makes distributions of income during the income year - the percentage of the distributions to which the entity was beneficially entitled; or

  (b) if the trustee makes distributions of capital during the current year - the percentage of the distributions to which the entity was beneficially entitled;

  or, if 2 different percentages are applicable, the smaller.

  To make the calculation it must first be ascertained whether the amount treated by the trustee as income of the trust estate is 'income' for the purpose of paragraph (a) of item 3.

Neither 'income' nor the expression 'distributions of income' is defined in that provision. However it is considered that when read in context income has the meaning which it has for the purposes of the general law of trusts.

This is consistent with the decision in *Commissioner of Taxation v. Bamford* [2010] FCAFC 6; 2010 ATC 20-163 (*Bamford*). In that case, the High Court held that the expression 'income of the trust estate' as used in section 97 of the ITAA 1936 had a content found in the general law of trusts upon which Division 6 (including section 97) then operates. Section 97 is concerned with ascertaining whether a beneficiary is 'presently entitled to a share of the income of the trust estate' as a step in the process of determining the share of the trust's net income (calculated pursuant to subsection 95(1) of the ITAA 1936) included in the assessable income of the beneficiary.

Item 3 of the table in subsection 152-70(1) provides a different legislative context. It is instead concerned with determining a beneficiary's entitlement to income distributions made by a trust for the purpose of determining the beneficiary's participation percentage in the trust. This is a step in the process of determining whether a capital gain made by the beneficiary on the disposal of its interest in the trust qualifies for any of the CGT small business concessions.

While item 3 of the table in subsection 152-70(1) concerns a legislative enquiry that is different from that required by section 97, it is nonetheless considered that the reference in item 3 to 'income' also has a content found in the general law of trusts - albeit a content upon which item 3 then operates (in a different fashion from the operation of section 97).

Accordingly, where a trust instrument, or the trustee acting in accordance with it, treats the whole or part of a receipt as income of a period and distributes that amount to a beneficiary entitled to income, that amount is a distribution of income within the meaning of paragraph (a) of item 3.

In this case, it follows that in consequence of the trustee's valid resolution pursuant to the deed to treat the capital gain as income of the trust, that amount is 'income' for the purpose of paragraph (a) of item 3 of the table in subsection 152-70(1) of the ITAA 1997. As the trustee did not make a distribution of capital during the income year, beneficiary A has a direct small business participation percentage in the trust of 90% whereas B has a direct small business participation percentage in the trust of 10%.

Is beneficiary A or beneficiary B a CGT concession stakeholder in the object company?

An individual with a small business participation percentage in a company of at least 20% is a 'significant individual' in that entity and thereby qualifies as a CGT concession stakeholder of that entity (sections 152-55 and 152-60 of the ITAA 1997). The 20% can be made up of direct and indirect percentages (section 152-65 of the ITAA 1997).

Although the beneficiaries do not have a direct small business participation percentage in the company they have an indirect small business participation percentage calculated under section 152-75 of the ITAA 1997 of 45% and 5% respectively (as a consequence of the trust's 50% shareholding in the company immediately prior to the sale giving the trustee a direct small business participation percentage in the company of 50%).

Beneficiary A is therefore a CGT concession stakeholder in the company (by virtue of holding an indirect small business participation percentage in the company of at least 20%). However, Beneficiary B is not a CGT concession stakeholder as its indirect small business participation percentage is only 5%.

Despite beneficiary B not satisfying the significant individual test, the additional basic condition under paragraph 152-10(2)(b) will be met in respect of the capital gain made by the trustee from the disposal of the shares because beneficiary A is a CGT concession stakeholder in the object company and has a small business participation percentage in the trust of 90%.

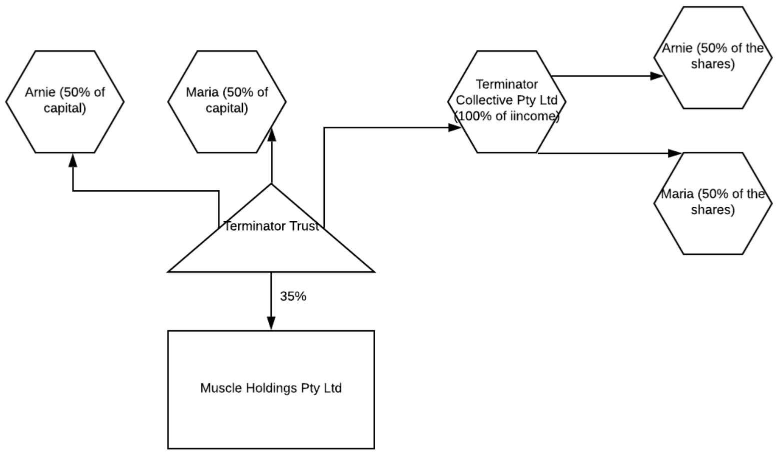
Note 1: The result would be different if the trustee had not resolved to treat the capital gain as income of the trust and had instead distributed the capital gain to beneficiary A as a capital distribution. The additional basic condition under paragraph 152-10(2)(b) would not be met because beneficiary A and B would each have a direct small business percentage in the trust worked out under item 3 of the table in subsection 152-70(1) of 0% (being the smaller percentage of the distributions of capital and income to which each beneficiary is beneficially entitled).

Note 2: The reasoning in this ATOID would also broadly apply to the interpretation of income in subsection 328-125(4) of the ITAA 1997.

- Note, however Commissioner’s response to the Bamford decision (Decision Impact Statement, Draft Taxation Ruling TR 2012/D1 [meaning of income of the trust estate] and Law Administration Practice Statement PS LA 2010/1 [Commissioner’s view in relation to deliberate attempts to exploit Division 6])

Example: Trust distributions and CGT concession stakeholders (indirect interests)

- Facts
  - Before the advisor prepared the trustee resolutions for the 2023 year for Terminator Family Trust he asked Arnie and Maria whether the trustee had entered or considering entering into any agreements to sell any assets.
  - Arnie and Maria told the advisor that they had signed a share sale agreement on 1 January 202 to sell all of its shares (35%) in Muscles Holdings Pty Ltd and that Muscle Holdings Pty Ltd had paid Terminator Family Trust a $2 million dividend prior to the sale of shares.
  - The advisor knowing that CGT concession stakeholders of Muscles Holdings Pty Ltd had to receive at least 90% of the distributions but also that there was a sizable dividend then proceeded to:
    - establish a new company, Terminator Collective Pty Ltd which was owned 50% by Arnie and 50% by Maria; and
    - prepare the trustee 2023 resolution for Terminator Family Trust as follows:
      - Arnie – 50% of the capital;
      - Maria – 50% of the capital;
      - Terminator Collective Pty Ltd – 100% of the income.



- Question: Who are the CGT concession stakeholders of Muscles Holdings Pty Ltd?
  - Arnie's small business participation percentage
    - Direct: 0% [Arnie's interest in Terminator Family Trust being the lower of the distributions of income or capital] x 35% [Terminator Family Trust's small business participation percentage in Muscle Holdings] = 0%
    - Indirect: 50% [Arnie's interest in Terminator Collective Pty Ltd] x 0% [Terminator Collective's small business participation percentage in Terminator Family Trust being the lower of the distributions of income or capital] x 35% [Terminator Family Trust's small business participation percentage in Muscle Holdings] = 0%

- Maria’s small business participation percentage
  - Direct: 0% [Maria’s interest in Terminator Family Trust being the lower of the distributions of income or capital] x 35% [Terminator Family Trust’s small business participation percentage in Muscle Holdings] = 0%
  - Indirect: 50% [Maria’s interest in Terminator Collective Pty Ltd] x 0% [Terminator Collective’s small business participation percentage in Terminator Family Trust being the lower of the distributions of income or capital] x 35% [Terminator Family Trust’s interest in Muscle Holdings] = 0%

3.5.8 CGT concession stakeholder tips

- Dealing with discretionary dividend shares:
  - Review structures to determine whether there are shares with discretionary dividends rights which are not being used and deal with them.
  - Part IVA risk if they are dealt with just before the CGT event.
  - Consider inserting a restriction on the rights attaching to discretionary dividend shares so that they do not have an automatic right to be paid a dividend.
  - Issue discretionary dividend shares as redeemable preference shares.
- Selling down shares
  - If a shareholder is selling down interests gradually over time – bear in mind that if their shareholding falls below 20% they will not be able to satisfy the CGT concession stakeholder test.
  - Also be careful if shares are issued to other shareholders as this will dilute shareholding.
  - Example:
    - Bob owns 20 of the 100 shares issued in ABC Pty Ltd (20%)
    - ABC issues 10 shares to Tom.
    - Bob now owns 20 of the 110 shares (18.18%)
- Trust Distributions:
  - Need to be done on time.
  - Need to ask whether any CGT events have occurred during the year.
  - Basis of the resolution should be prepared at the time of the CGT event.
- If the CGT event does not occur in relation to shares or units, then the CGT concession stakeholder test does not need to be satisfied in the year of the CGT event.
  - Can still apply the active asset reduction.
  - However, will not be able to apply the 15 year exemption or the retirement exemption.
  - If a trust has the capital gain, then apply:
    - general 50% discount;

- active asset reduction; and
- roll-over.

Look at applying retirement exemption if a replacement asset is not acquired within the two year replacement period.

4. Small business CGT concessions re transfer of shares or units (additional tests)

4.1 Introduction

- The February 2018 rules apply to CGT events occurring in relation to shares in companies or interests in trusts which occur on or after 8 February 2018. Under these rules there are modifications to the application of the active asset test for shares and units and additional tests.
  - Modified rules for applying the active asset test for shares (that is, the 80% look-through test).
  - If the taxpayer did not satisfy the $6 million net asset test, that is, they are relying on the CGT small business entity test – the taxpayer must be carrying on a business just before the CGT event.
  - The company or trust in which the shares (or units) are held (Object Entity) would be a CGT small business entity for the income year or satisfy the $6 million net asset test if the assets of each entity which the Object Entity controlled (assuming the control percentage is 20%) were included.
- CGT concession stakeholder test also needs to be satisfied.

  That is:

  - there must be a significant individual just before the CGT event and the shareholder or unitholder claiming the concession must be a CGT concession stakeholder in the company or trust; or
  - CGT concession stakeholders of the Object Entity have a 90% small business participation percentage in the entity which owns the shares or interest in the trust.

4.2 CGT small business entity test of shareholder

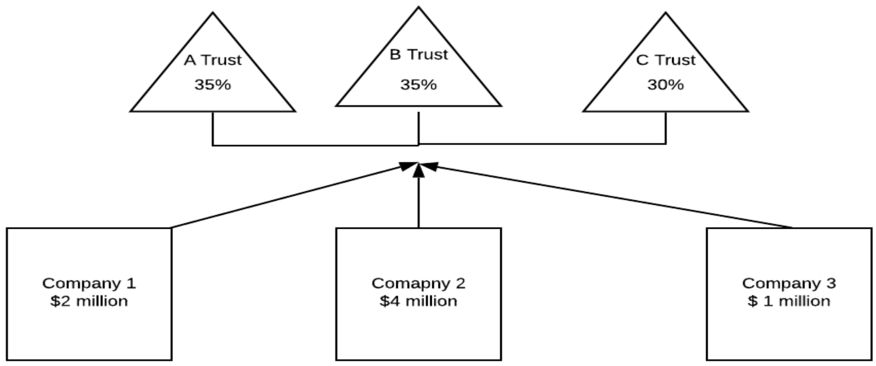
If the taxpayer (that is, shareholder or unitholder) did not satisfy the $6 million net asset test, that is, they are relying on the CGT small business entity test – the taxpayer must be carrying on a business just before the CGT event.

4.3 The Object Entity must be a CGT small business entity or satisfy $6 million net asset test

- Either the company or trust in which the shares (or units) are held (Object Entity) would be a CGT small business entity for the income year or the Object Entity would satisfy the net asset test if the only CGT assets or annual turnovers considered were:
  - those of the Object Entity;
  - each affiliate of the Object Entity; and
  - each entity controlled by the Object Entity in a way described in section 328-125;
  - the reference to the ‘control’ percentage in section 328-125 is 20% not 40%.
- That is, the Object Entity will be taken to control another entity (under these modified rules) in the following circumstances:
  - If the other entity is a company – the Object Entity, its affiliates or together with its affiliates own shares which have the right to **at least 20%** of the income, dividend or capital rights.
  - If the other entity is a trust which does not have fixed interests to income and capital:
    - the Object Entity, its affiliates or together with its affiliates received **at least 20%** of the distributions of income or capital in the previous four years; or
    - the trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of the Object Entity, its affiliates or together with its affiliates.
  - If the other entity is a trust which has fixed interests to income or capital - the Object Entity, its affiliates or together with its affiliates own interests which have the right to **at least 20%** of the income or capital distributions.
  - If the other entity is a partnership - the Object Entity, its affiliates or together with its affiliates owns interests which have the right to **at least 20%** of the net income of the partnership.

- Examples – assume each entity has a turnover in excess of $2 million.

    - Example: Shareholders A, B and C own 35%, 35% and 30% respectively in the issued capital of three companies which have a net value equal to $2 million, $4 million and $1 million respectively. Each company operates a separate business and do not own shares or units in other entities.

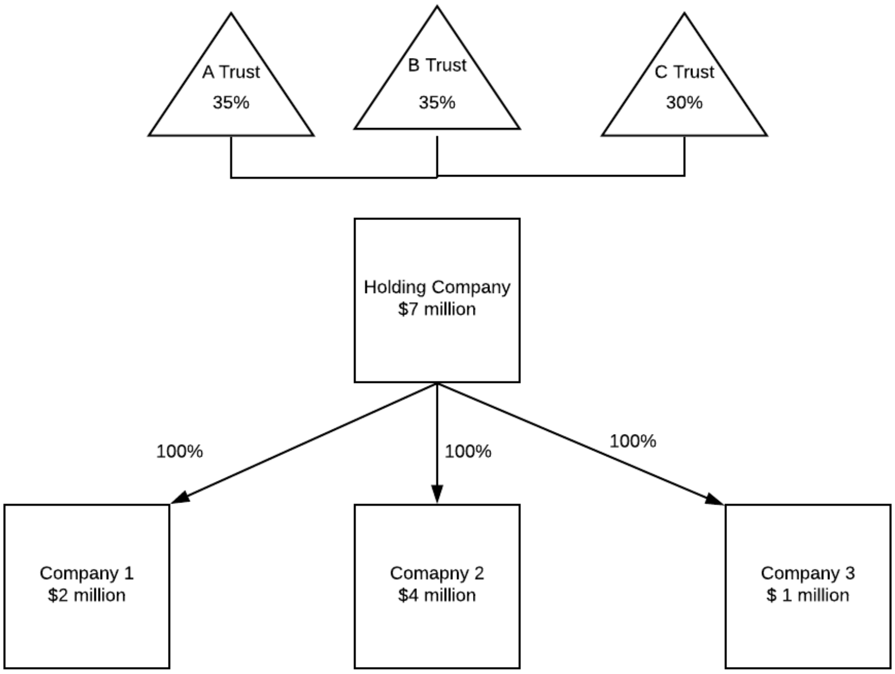


- Shareholder A disposes of its shares in each of the companies. Shareholder A only has a 35% interest in the respective companies, and therefore for the purpose of section 152-10(1) only needs to include the net value of its interest (not 100% of the net value of each company). That is, $2,450,000 ([35% of $2 million] + [35% of $4 million] + [35% of $1 million])

- For the purpose of section 152-10(2), there are three object entities, Companies 1, 2 and 3. For the purpose of determining whether each company satisfied the $6 million net asset test, you only need to look at including the net assets of other companies or trusts in which those companies (and its affiliates) have a 20% interest or those entities which are affiliates of the relevant Object Entity.

- In this case, assuming that Company 1, 2 and 3 are not 'affiliates' of each other and none of the companies own shares or units, then none of the companies need to include the net assets of any other entities. This means that each company satisfies the $6 million net asset test.

- Example: Shareholders A, B and C own 35%, 35% and 30% respectively in the issued capital of Holding Company which has a net value of $7 million.

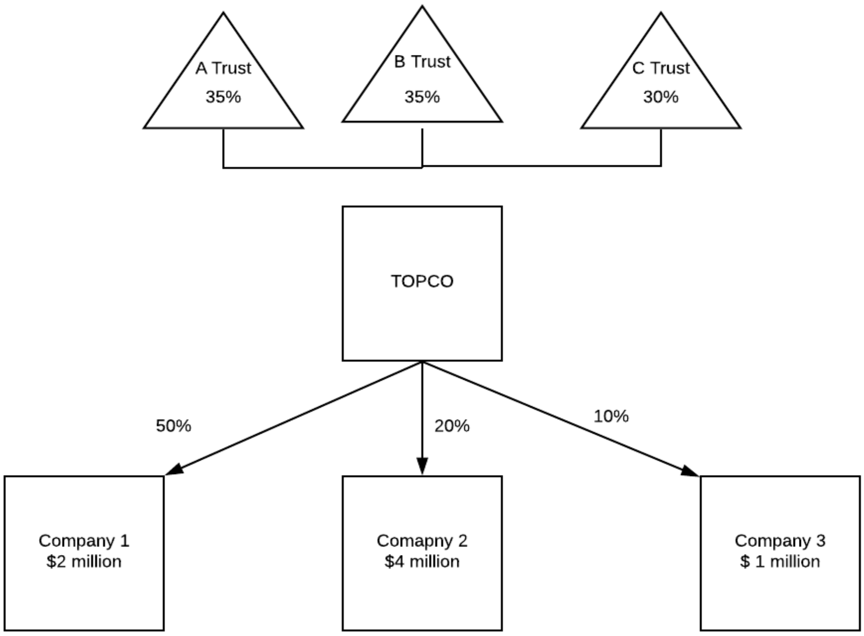


- Shareholder A disposes of its shares in Holding Company. Shareholder A only has a 35% interest in holding company, and therefore for the purpose of section 152-10(1) only needs to include the net value of its interest (not 100% of the net value of holding company). That is, $2,450,000 (35% of $7 million)

- However, for the purpose of section 152-10(2), Holding company also needs to satisfy the $6 million net asset test. It does own at least 20% of the shares in other companies, therefore, 100% of the net assets of Company 1, 2 and 3 need to be included.

- In this case, Shareholder A will not be able to access the small business CGT concessions as Holding company does not satisfy the $6 million net asset test.

- Example: Shareholders A, B and C own 35%, 35% and 30% respectively in the issued capital of TOPCO which has a value of That is, $1,900,000 ([50% of $2 million] + [20% of $4 million] + [10% of $1 million]). Shareholder A's value in TOPCO is $665,000 (being 35% of $1.9 million).



- Shareholder A disposes of its shares in TOPCO. Shareholder A only has a 35% interest in holding company, and therefore for the purpose of section 152-10(1) only needs to include the net value of its interest in TOPCO.

- However, for the purpose of section 152-10(2), TOPCO also needs to satisfy the $6 million net asset test. It does own at least 20% of the shares in other companies, therefore, 100% of the net assets of Company 1 and 2 need to be included as well as its 10% interest in Company 3.

- In this case, TOPCO will fail the modified $6 million net asset test as its net assets will be taken to be $6.1 million ([100% of $2 million] + [100% of $4 million] + [10% of $1 million]).

4.4 Active asset test (modified for shares and units)

- The CGT asset (shares or units) would still satisfy the active asset if certain assumptions were made when applying section 152-40(3).

> Section 152-40(3) provides that a CGT asset is also an active asset at a given time if, at that time, you own it and:
>
> (a) It is either a share in a company that is an Australian resident at that time or an interest in a trust that is a resident trust for CGT purposes for the income year in which that time occurs; and
>
> (b) The total of:
>
> (i) The market value of the active assets of the company or trust; and
>
> (ii) 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
>
> (iii) 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.

- Assumptions to be made when applying section 152-40(3):
- An asset of a company or trust is covered by neither:
  - section 152-40(3)(b)(ii) (about financial instruments); nor
  - section 152-40(3)(b)(iii) (about cash);

  if the company or trust acquired that asset for a purpose that included assisting an entity to otherwise satisfy the active asset test.
- Section 152-40(3)(b) does not cover an asset that:
  - is a share in a company, or an interest in a trust (the later entity); and
  - is held at the test time by the Object Entity directly or indirectly (through one or more interposed entities).

  That is, shares or units held in another entity cannot themselves be active assets.
- Section 152-40(3)(b)(i) also covers each asset that is:
  - held at the test time by a later entity covered by section 152-10(2B); and
  - for that later entity, an asset of a kind referred to in section 152-40(3)(b)(i), (ii) or (iii), as modified by paragraphs (iii)(a) and (b)

  That is, if an asset is an active asset of a ‘later entity’ which is covered by section 152-10(2B), it will be taken to be an active asset of the Object Entity.

- For the purposes of section 152-40(3)(b), the market value at the test time of an asset held by a later entity were the product of:
    - the asset's market value at the test time; and
    - the Object Entity's small business participation percentage in the later entity at the test time.
- An entity is a 'later entity' covered by section 152-10(2B) if:
    - at the test time the taxpayer (shareholder) has a small business participation percentage in the later entity of at least 20% or the taxpayer is a CGT concession stakeholder of the later entity; and
    - either the later entity would be a CGT small business entity for the income year that includes the test time or would satisfy the maximum net asset value test (see section 152-15) for a notional CGT event taken to have happened at the test time if the only CGT assets or annual turnovers considered were:
        - those of the later entity;
        - each affiliate of the later entity; and
        - each entity controlled by the later entity in a way described in section 328-125;
        - the reference to the 'control' percentage in section 328-125 is 20% not 40%.
- That is, the later entity will control another entity (under these modified rules) in the following circumstances:
    - If the other entity is a company – the later entity, its affiliates or together with its affiliates own shares which have the right to at least 20% of the income, dividend or capital rights.
    - If the other entity is a trust which has fixed interests to income or capital - the later entity, its affiliates or together with its affiliates own interests which have the right to at least 20% of the income or capital distributions.
- This means that even if an asset is an active asset of a later entity, it will only be taken to be an active asset of the Object Entity if:
    - the shareholder has a small business participation percentage of at least 20% in the later entity or is a CGT concession stakeholder of the later entity; and
    - the later entity satisfies the $6 million net asset test or is a CGT small business entity (under the modified control tests).

- Issues in applying modified 80% test
  - Shares must be active (based on the modified 80% test) for at least half the time the shareholder owned the shares (or 7.5 years if owned at least 15 years).
      - In applying the modified 80% test, the assets of the 'later entity' are taken to be assets of the Object Entity based on the percentage of shares or units owned in the later entity.
      - For example:
    - Red Trust owns 100% of the shares in WhiteCo Pty Ltd for five years. WhiteCo has always owns 5% of the shares in BlueCo Pty Ltd.

      For the purpose of applying the modified 80% test, WhiteCo is taken to own 5% of the market value of the assets of BlueCo.

      PRACTICAL ISSUE: How does WhiteCo obtain this information?
    - Black Trust owns 100% of the shares in YellowCo Pty Ltd. YellowCo has always owned 10,000 shares in BHP.

      For the purpose of applying the modified 80% test, YellowCo will need to determine what percentage of shares it owns in BHP and what the market value of BHP's assets are.

      PRACTICAL ISSUE: How does YellowCo obtain this information?
      - The Object entity needs to continually monitor the $6 million net market value of the assets of the later entities and their turnover.
    - This is because if the later entities have a net market value of more than $6 million or are not CGT small business entity at a point in time, the assets which are taken to be Object Entity's assets will not be active assets during that period.
    - In determining whether the later entities satisfy the $6 million net market value of assets or are CGT small business entities, the later entities need to include 100% of the assets (or turnover) of entities which they have at least 20%.
  - Calculating the 80% Test
      - Need to look at market values (not book value). This may require valuations to be performed.
      - All of the assets (regardless of whether they are active or not active assets) other than interests in Later Entities are included in the denominator.
      - If an asset is not an active asset of the company or trust, then unless it is a financial instrument or cash that is inherently connected with the business carried on by the entity, it will not be included in the numerator. For example
    - If it is not used in the business of the entity, an affiliate or connected entity.
    - If the main use is derive rent, interest or royalties.

    - Financial instruments (such as loans and bank accounts) and cash are included provided that they are inherently connected with the business carried on by the company or trust.

  - Small business entity concessions guide published by the Australian Taxation Office:

    Inherent connection requires more than just some form of connection between the cash or financial instrument and the business. Examples of things inherently connected to a business include:

    - when it is a permanent or characteristic attribute of the business, for example, goodwill, or trade debtors

    - excess funds the business has as a result of a temporary spike in trading activity or the sale of a business asset

    - a financial instrument that is inherently connected with a business that the owner of the financial instrument carries on, rather than any business a related entity carries on.

    Example 2: Loan to a related company

    Archimedes Pty Ltd is a manufacturing business. It lends $300,000 to a related company, Galileo Pty Ltd, to acquire various assets for use in the businesses of both companies.

    Although the loan is made between members of a corporate group as part of the overall financing of the group, it is not a permanent or characteristic attribute of the business (which is manufacturing, not the acquisition of assets).

    The loan is included in the total market value of all the assets, but not included as an active asset.

- Are loans ‘active assets’?

  Loans from Object Entity to subsidiaries

    - The loans from Object Entity to subsidiaries are likely to be ‘financial instruments’. In order for these to qualify as active assets it is necessary that they are ‘inherently connected with a business’ carried on by Object Entity[31].

    - There are arguments that Object Entity is carrying on a business (being a holding company) and that loans made by it to subsidiaries will be assets inherently connected with that business and therefore active assets.

    - In American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue[32], Lord Diplock stated that:

    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 assets prima facie amounts to the carrying on of 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[33]

[31] Section 152-40(3)(b)(ii) of the 1997 Tax Act
[32] [1978] 3 All ER 1185
[33] Page 1188

  - A company can carry on the business of a holding company, even if the holding company is not involved in the active management[34].
  - The Commissioner in *Taxation Ruling* TR 2019/1 accepts that (for the purpose of section 328-110 of the 1997 Tax Act and section 23 of the Income Tax Rates Act 1986) companies are typically formed for the purpose of carrying on a business and are unlike individuals or trusts whom may have multiple purposes for undertaking activity other than to make a profit or carry on a business (at paragraph 23)
  - In Private Binding Ruling Authorisation Number 80022, the ATO accepted that a loan was inherently connected with a business that a holding company carried on as it was lent by the parent to fund stock and debtors of the subsidiary company.
  - While these arguments support the contention that the loans from a holding company to a subsidiary will qualify as active assets there is still some degree of uncertainty about what approach the Commissioner would take in particular circumstances or should it apply to all loans to 'later entities'.

  ISSUE: What about loans to other entities?

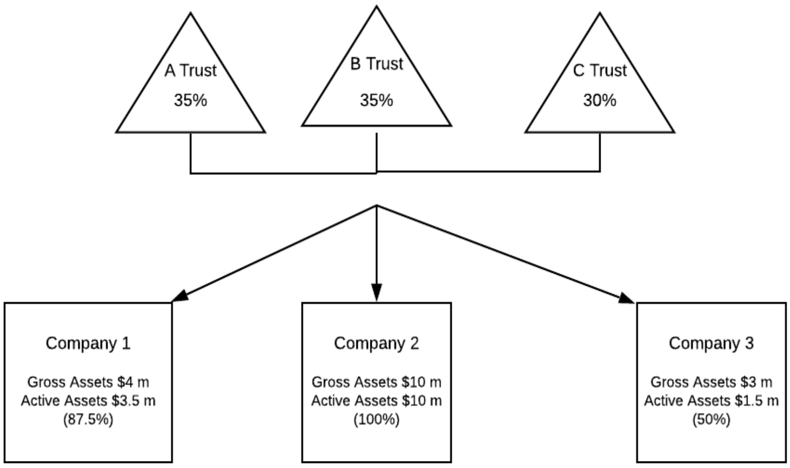
- Are bank accounts inherently connected with the business?

  Based on private binding rulings issued by the ATO it would appear that bank accounts (including cash management accounts and term deposits) which consist of funds earned by the business and are retained by the business for working capital and capital expenditure will be considered to be 'inherently connected with the business'. However, the client will need to ensure that the level of funds is not consistently in excess to the needs of the business.

[34] *Spassked Pty Limited v Commissioner of Taxation [*2003] FCAFC 282*, Federal Commissioner of Taxation v Total Holdings (Australia) Pty Ltd* [1979] FCA 30

Examples – assume each entity has a turnover in excess of $2 million.

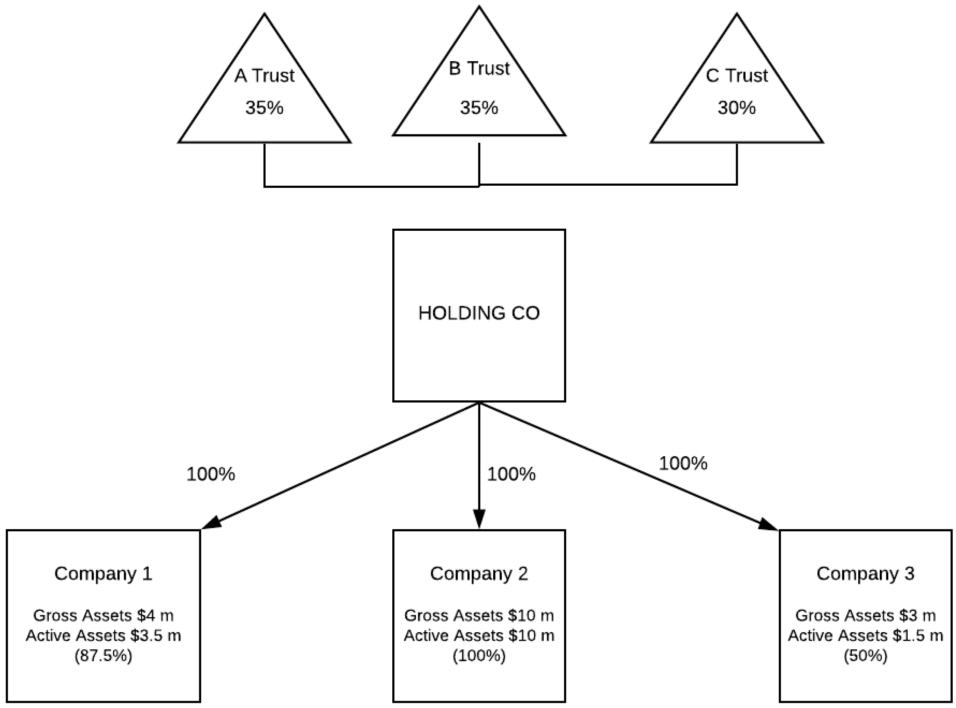
- Example: Shareholders A, B and C own 35%, 35% and 30% respectively in the issued capital of Company 1, 2 and 3. For half the time the shares have been owned the market value of the gross assets and active assets have always been as follows.



- Shareholder A disposes of its shares in each of the companies. Shareholder A only has a 35% interest in the respective companies.

- For the purpose of section 152-10(2A) and section 152-40(3), the shares in Companies 1 and 2 satisfy the active asset test, as for half the time which A has owned the shares in these companies, at least 80% of the market value of the assets have been active.

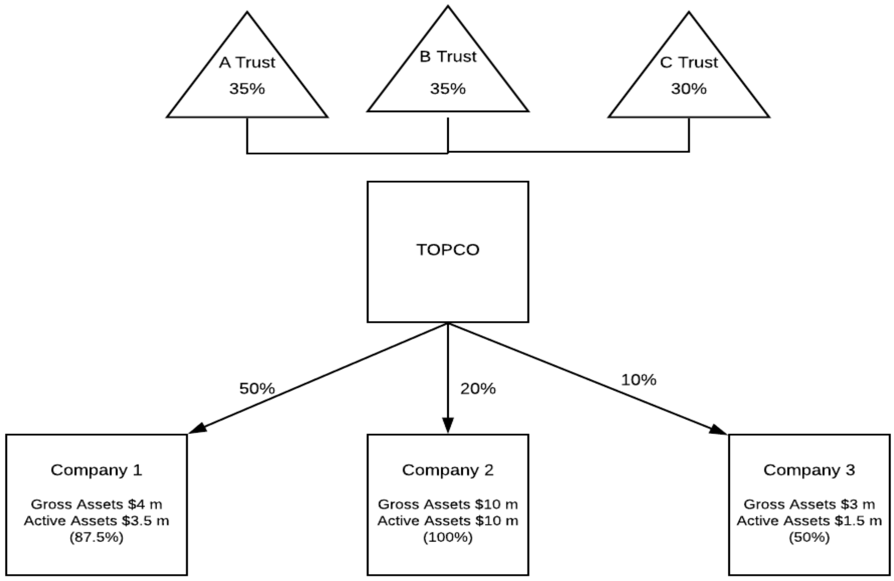
Example: Shareholders A, B and C own 35%, 35% and 30% respectively in the issued capital of Holding Coy. For half the time the shares have been owned the market value of the gross assets and active assets have always been as follows.



- Shareholder A disposes of its shares in Holding Co. Shareholder A only has a 35% interest in Holding Co. Holding Co only assets are the shares in the three companies. Each of three companies satisfies the $6 million net asset test.
- For the purpose of section 152-10(2A) and section 152-40(3):
  - The shares Holding Coy owns in Company 1, 2 and 3 are ignored.
  - The market value assets of each of these companies multiplied by Holding Coy's small business participation percentage in each of these companies are taken to be assets of Holding Coy.
  - The 'active assets' of these companies can only be taken to be active assets of Holding Coy if Shareholder A has a small business participation percentage of at least 20% in these companies and the companies satisfy the $6 million net asset test or is a CGT small business entity.

Company	**Assets taken to be Holding Coy’s assets**	**Active assets of company taken to be active asset of Holding Coy**
Company 1	$4 million (100% of $4 million)	$3.5 million (A has small business participation percentage of at least 20% in Company 1)
Company 2	$10 million (100% of $10 million)	$10 million (A has small business participation percentage of at least 20% in Company 2)
Company 3	$3 million (100% of $3 million)	$1.5 million (A has small business participation percentage of at least 20% in Company 3)
TOTAL	$17 million	$15 million
$15/$17 million = 88% (active asset test satisfied)		

- Example: Shareholders A, B and C own 35%, 35% and 30% respectively in the issued capital of TOPCO. For half the time the shares have been owned the market value of the gross assets and active assets have always been as follows.



- Shareholder A disposes of its shares in each of the companies. Shareholder A only has a 35% interest in TOPCO. TOPCO's only assets are the shares in the three companies. Each of three companies satisfies the $6 million net asset test.

- For the purpose of section 152-10(2A) and section 152-40(3):
  - The shares TOPCO owns in Company 1, 2 and 3 are ignored.
  - The market value assets of each of these companies multiplied by TOPCO's small business participation percentage in each of these companies are taken to be assets of TOPCO.
  - The 'active assets' of these companies can only be taken to be active assets of TOPCO if Shareholder A has a small business participation percentage of at least 20% in these companies and the companies satisfy the $6 million net asset test or is a CGT small business entity.

Company	**Assets taken to be TOPCO's assets**	**Active assets of company taken to be active asset of TOPCO**
Company 1	$2 million (50% of $4 million)	Nil (A does not have small business participation percentage of at least 20% in Company 1)
Company 2	$2 million (20% of $10 million)	Nil (A does not have small business participation percentage of at least 20% in Company 2)
Company 3	$300,000 (10% of $3 million)	Nil (A does not have small business participation percentage of at least 20% in Company 3)
TOTAL	$4.3 million	Nil
$0/$4.3 million = 0% (active asset test not satisfied)		

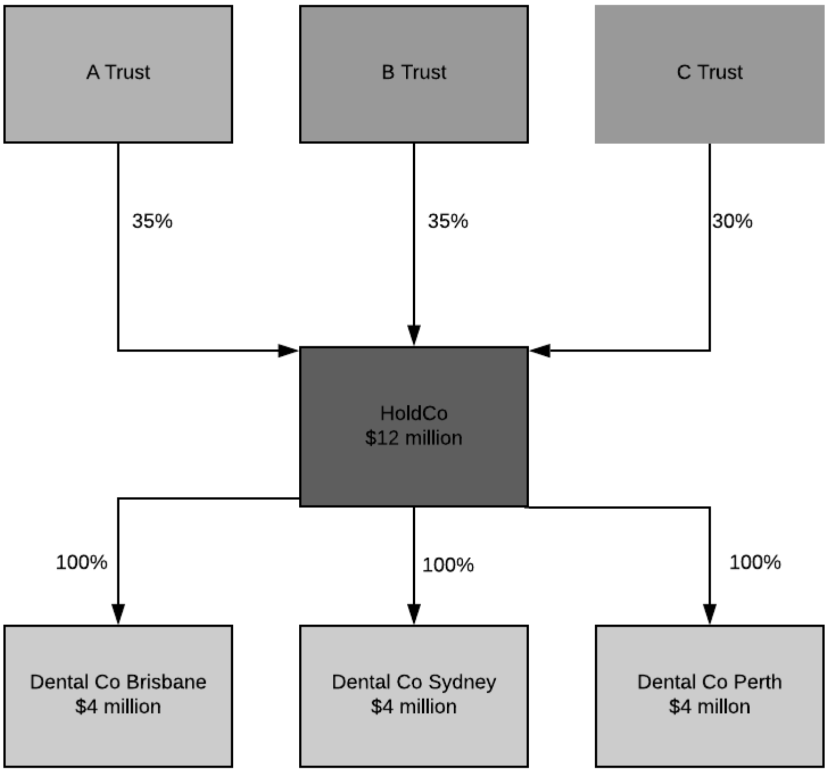
4.5 Significant individual and CGT concessional stakeholder requirements (no change in these rules)

- If the CGT asset is a share in a company or interest in a trust:
  - there must be a significant individual just before the CGT event and the shareholder (or unitholder) claiming the concession must be a CGT concession stakeholder in the company (or trust); or
  - CGT concession stakeholders in the Object Entity must together have at least a 90% small business participation percentage in the entity which has the shares (or units).

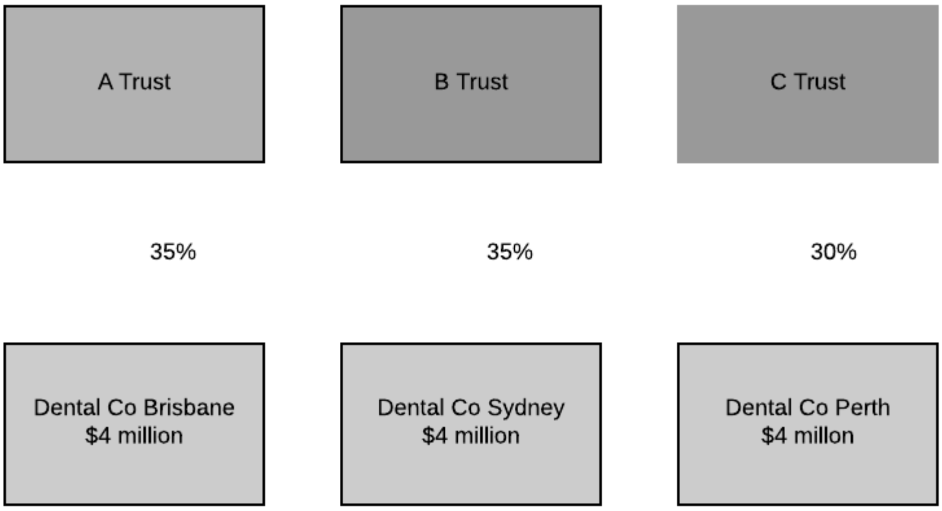
4.6 Structuring issues with respect to February 2018 rules (shares/units)

4.6.1 Higher risk of failing $6 million net asset test with multi-tier structures

- Where it makes commercial sense, it may be better to have single tier structures rather than one holding company with a number of subsidiaries.
  - For example: Structure A



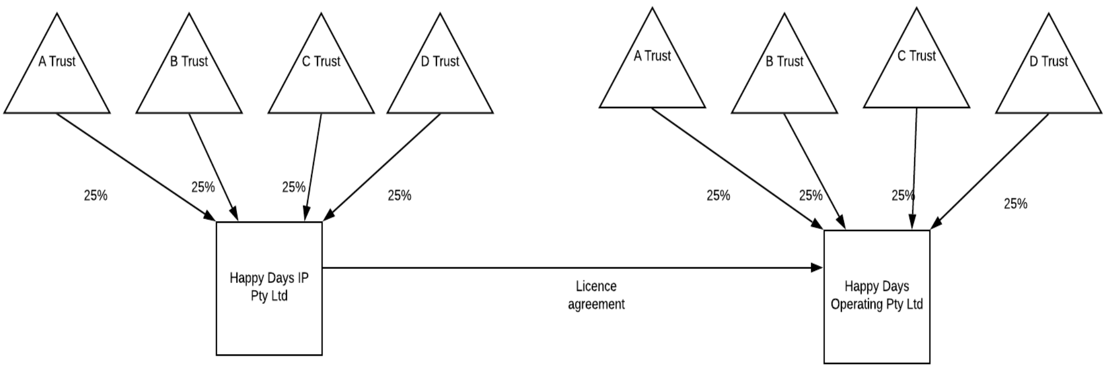
- For example: Structure B (each trust holds 35%, 35% and 30% respectively in each company.



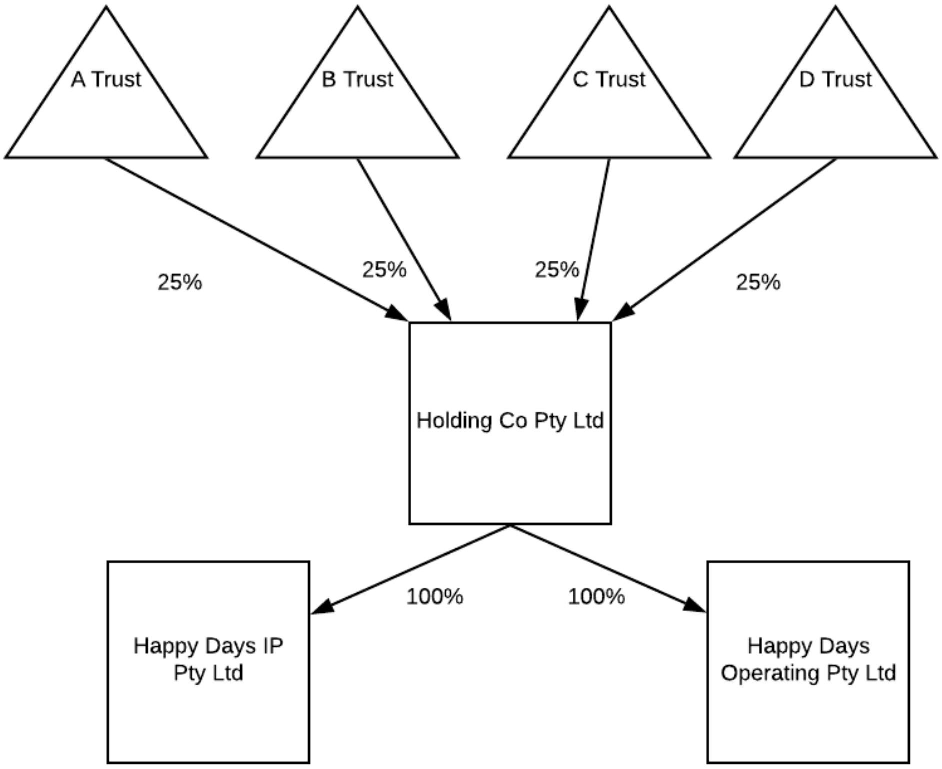
  - In both cases, the effective ownership in shares in each of the subsidiaries are the same. If the shareholders sell their shares in HoldCo (Structure A) – HoldCo fails the $6 million net asset test.
  - If the shareholders sell their shares in each of the Dental companies (Structure B), each of the dental companies pass the $6 million net asset test.
- Business assets being used by another entity to carry on business
  - If an entity owns the asset which is being used by another entity to carry on its business, the entities will need to be ‘connected’ or ‘affiliates’.

Below are examples of common structuring issues

  - Example 1: Happy Days IP Pty Ltd and Happy Days Operating Pty Ltd may not be ‘connected’ entities. Trusts cannot be ‘affiliates’ of each other. No one shareholder has at least 40% of voting, capital and dividend rights. Question: Can Happy Days IP Pty Ltd and Happy Days Operating Pty Ltd be affiliates?



- Example 2: Happy Days IP Pty Ltd and Happy Days Operating Pty Ltd owned by a Holding Company. They will be connected entities as they are both controlled by Holding Co Pty Ltd. However, if shares in Holding Co are sold, it needs to satisfy the $6 million net asset test.



- Partnerships
  - February 2018 rules do not apply to partnerships.
  - For example, four partners operate a business. Net assets worth $12 million. The partnership assets are sold. Each partner has a capital gain. No partner controls the partnership. This means only need to include their interest in the partnership assets.
  - However, does it make commercial sense to have a partnership. Need to consider the transaction costs in brining partners in and out of the partnership.

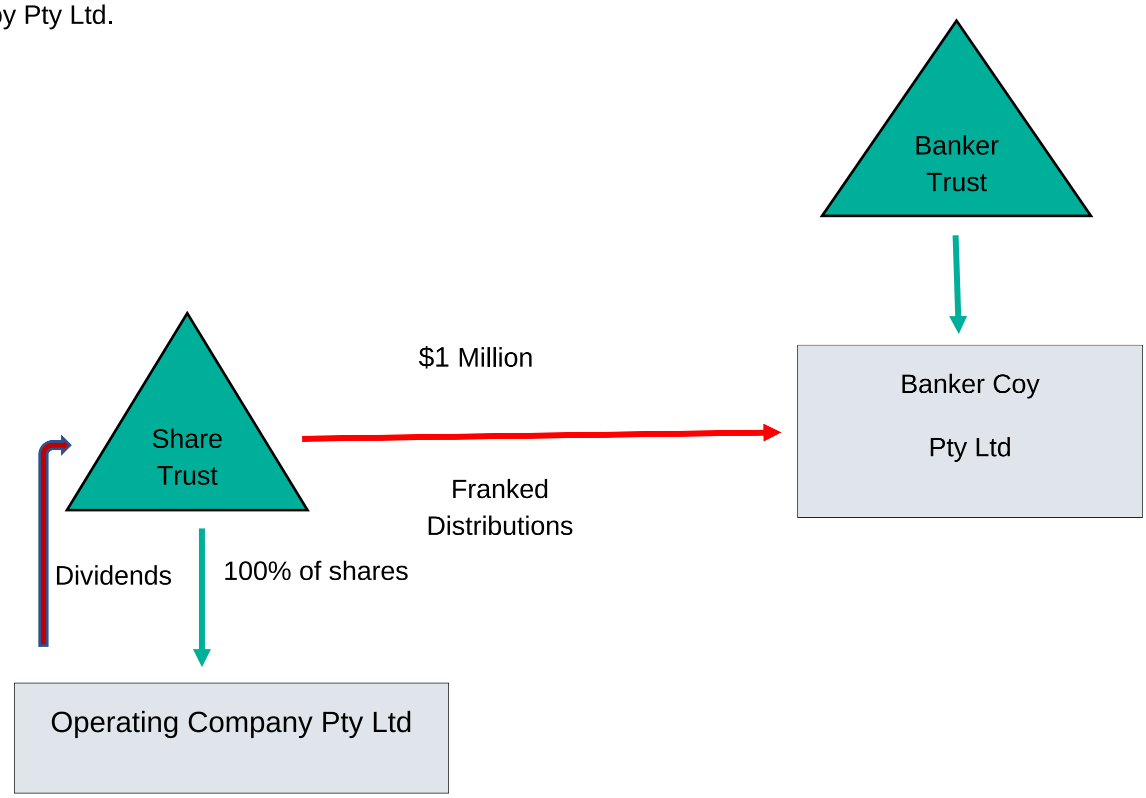
4.6.2 Structuring with the end in mind

- Different class shares
    - The shareholding of client's companies should be reviewed to determine whether there are different class shares (including discretionary dividend shares) as this may result in the company not having a CGT concession stakeholder.
    - If these share classes are not being used, is it possible to deal with the shares (for example convert the rights or buy back the shares) which triggering any CGT issues.
- As a result of the changes to the small business CGT concessions (in that a taxpayer can trace through trusts to determine whether there are CGT concession stakeholders), trading companies are generally owned by trusts.

  The trustee will need to make a FTE to pass on the franking credits. This leads to the complexity of dealing with FTE issues.
- Issues with inserting holding companies for warehousing retained profits?
    - From an asset protection perspective we would generally not want to have a trading company build up retained profits as they will be exposed to risk.
    - To remove profits from the trading company which is owned by a trust, the trading company can pay a dividend to the shareholder trust which can then distribute the dividend to a 'banker company'. The 'banker company' can then lend the funds back to the trading company under a secured loan agreement if it needs working capital.

      If the trading company is not a base rate entity (that is, pays tax at 30%) then the dividend distributed to banker company will be tax neutral. However, if the trading company is a base rate entity (that is, pays tax at 25%), then the banker company will have top up tax of 5% to pay on the gross distribution (including franking credits).
    - If a holding company is inserted between the trading company and shareholder trust, then, if the holding company sells the shares in the trading company:
        - the holding company will not be entitled to the 50% general discount on the sale of the shares;
        - the holding company (as the seller of the shares) will enter into the share sale contract and therefore have exposure to warranties and potential breach of contract issues.
    - Preferred structure: Trust owns the shares in the operating company. Need to ensure that the trust does not own any other assets, otherwise it will be exposed to warranty risks and potential breach of contract issues.

- Example: Operating company is a base rate entity (BRE) and pays dividends franked at 25%. Share Trust receives dividends franked at 25%. The dividends are not non portfolio dividends because Share Trust is not a company. Share Trust makes franked distributions to Banker Coy Pty Ltd.



Question: What is the rate of tax for Banker Coy Pty Ltd?

- Aggregated turnover less than $50 million - yes.
- BREPI % = 100% (more than 80%)

[Note, the distribution consisting of the franked dividend received from Share Trust retains in character in the hands of Banker Co. However, dividend is not a non-portfolio dividend in the hands of the Share Trust as Share Trust is not a company].

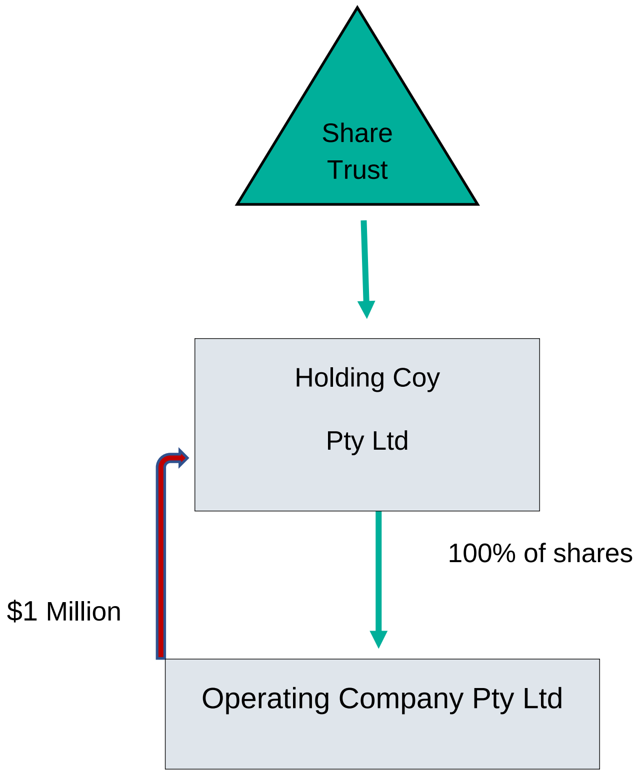
Therefore, not a BRE and rate of tax for the year is 30% (top-up tax).

- Tax payable

Dividend	$1,000,000
Franking credit	$ 333,333
Total income	$1,333,333
Tax payable (30%)	$ 400,000
Franking credit	$ 333,333
Top up tax	$ 66,667

On the sale of the shares in trading company, Share Trust will only own shares in Operating Company and will be entitled to 50% general discount.

- Example: Operating company is a BRE and pays dividends franked at 25%. The majority of its profits have had tax paid at 30%.



Question: What is the rate of tax for Holding Coy Pty Ltd?

- Aggregated turnover less than $50 million - yes.
- Dividends are not BREPI because Holding Coy is a company and owns at least 10% of the voting rights.
- BREPI % = 0% (more than 80%)

Therefore, BRE and rate of tax for the year is 25% (top-up tax).

- Tax payable

Dividend	$1,000,000
Franking credit	$ 333,333
Total income	$1,333,333
Tax payable (25%)	$ 333,333
Franking credit	$ 333,333
Top up tax	$ Nil

On the sale of the shares in trading company, Holding Coy's assets will be exposed to risk and will not be entitled to 50% general discount.

- Separating non business assets from business assets
    - Both from an asset protection perspective and to facilitate an easier path to selling the shares in a company, any 'non-business' should not be acquired in the trading company.
    - Otherwise, prior to a sale, these assets will need to be transferred out of the company which will generally result in tax and duty implications.

5. Small business restructure roll-over

5.1 Introduction

- The small business restructure roll-overs (SBRRs) which are contained in Subdivision 328-G of the 1997 Tax Act applies to:
  - transfers of assets subject to the capital gains provisions (CGT assets) where the CGT event occurs on or after 1 July 2016;
  - transfers of depreciating assets, where the balancing adjustment event occurs on or after 1 July 2016; and
  - transfers of trading stock or revenue assets where the transfer occurs on or after 1 July 2016.
- The purpose of the SBRRs as stated in the Explanatory Memorandum to the Tax Laws amendment (Small Business Restructure Roll-over) Bill 2016 (SBRR EM) which introduced the changes is as follows.
  - To provide greater flexibility for small business owners to change the legal structure of their businesses.
  - To make it easier for small business owners to restructure by allowing them to defer gains or losses that would otherwise be realised when business assets are transferred from one entity to another as part of a genuine restructure.
- There are a number of requirements which need to be satisfied to access the SBRRs including the requirement that the transaction is part of a "genuine restructure of an ongoing business".
- If all of the requirements are satisfied, then to access the SBRRs both the transferor and transferee must choose to apply Subdivision 328-G to the assets which are transferred. The choice to apply Subdivision 328-G is made on an asset by asset basis. This means that clients may choose the SBRRs in relation to only some of the assets transferred and other concessions or roll-overs to other assets.
- The SBRRs are an alternative to the concessions and/or roll-overs which are currently available. Examples of these are as follows.
  - For CGT assets
    - Division 152 of the 1997 Tax Act (small business CGT concessions);
    - Subdivision 122-A of the 1997 Tax Act (transfers of CGT assets from individuals or trustees to a wholly-owned company); and
    - Subdivision 122-B of the 1997 Tax Act (transfers of CGT assets from a partnership to a wholly owned company); and
    - Subdivision 124-N of the 1997 Tax Act (transfers of CGT assets from a unit trust to a company); and
  - Division 40 or Subdivision 328-D of the 1997 Tax Act for depreciating assets.
- The SBRRs have extended the assets and transfers to which roll-over relief was previously available. These include transfers of:
  - trading stock (without the requirement of retaining a 25% interest);
  - revenue assets;

- assets regardless of the type of entity (for example, it is possibly to apply the SBRRs to transfers from a company to another company, to individuals, to partnerships and to trusts).
- However, before undertaking a restructure to access the SBRRs:
  - care will be required to ensure that all of the requirements are satisfied;
  - a comparison between the consequences of applying the SBRRs and other roll-overs will need to be considered to determine which is the best option for the client; and
  - other 'non income tax' considerations, such as duty and GST will need to be considered.

5.2 Requirements to be satisfied to access the SBRRs

- The requirements to access the SBRRs are contained in section 328-430 of the 1997 Tax Act.
  Note: The SBRRs are not available if the transferor or the transferee is either an exempt entity or a complying superannuation fund[35].

Summary of requirements

	Requirement
Requirement 1	Genuine restructure of an ongoing business ▪ Genuine restructure ▪ Safe harbour rule
Requirement 2	Both transferor and transferee must satisfy small business entity (SBE) requirement ▪ Be a SBE ▪ Be 'connected to' or have an 'affiliate' which is a SBE ▪ Be a partner in a partnership which is a SBE
Requirement 3	Active asset at time of the transfer If the SBE is a 'connected entity', 'affiliate' or partnership – then the asset must be being used by the SBE

Requirement 4	▪ No change in ultimate economic ownership
	  ▪ Trace through to individual owners
	  ▪ Special rule for discretionary trusts

Requirement 5	Both transferor and transferee must be Australian residents for tax purposes
Requirement 6	Both transferor and transferee must choose to apply the SBRRs

[35] Section 328-430(2) of the 1997 Tax Act

Requirement 1: Genuine restructure of an ongoing business

- The transaction must be or be part of, a genuine restructure of an ongoing business36.
- The two key issues with this first requirement are as follows:
  - There must be a restructure of a business. This indicates that the SBRRs only apply to the transfer of business assets and not the transfer of shares or units.
  - The transaction is or is part of a 'genuine restructure of an ongoing business'.
- The 'genuine restructure of an ongoing business' requirement can be satisfied in one of two ways:
  - The satisfaction of the 'safe harbour rule' in section 328-435 of the 1997 Tax Act.
    However, even where the 'safe harbour rule' is met, the application of Part IVA of 1936 Tax Act would still need to be considered.
  - The transaction is or is part of a 'genuine restructure'.
    Whether this is satisfied will be a question of fact having regard to all of the circumstances.

What is the 'safe harbour rule'?

- The 'safe harbour rule' as contained in section 328-435 of the 1997 Tax Act is follows:
  A transaction is or is a part of a genuine restructure of an ongoing business if, in the **three year period** after the transaction takes effect:
  - there is no change in ultimate economic ownership of any of the significant assets of the business (other than trading stock) that were transferred under the transaction; and
  - those significant assets continue to be active assets; and
  - there is no significant **or material use of those significant assets for private purposes**.
- The major issue for clients is that they will not know whether the 'safe harbour rule' is satisfied until three years after the transaction occurs.
- Even if the 'safe harbour rule' is satisfied, clients will still need to consider the application of Part IVA.
- *Law Companion Guidelines* LCG 2016/3 provides an example (Example 10) where the safe harbour rule may be satisfied, however the application of Part IVA would need to be considered. The example given is as follows:

  A sole trader wants to sell his business to the father of his sister's husband. The sole trader transfers the business assets to a trust which makes a family trust election specifying the sole trader's sister as the test individual. After the transfer the father manages the business and the trustee distributes the trust income and capital to him and his family.

  Part IVA of the 1936 Tax Act would need to be considered.

What is a 'genuine restructure of an ongoing business'?

- Even if the safe harbour rule cannot be satisfied, the first requirement will be met if the transaction is a 'genuine restructure'.
- Guidance as to what is a 'genuine restructure of an ongoing business' can be obtained from the SBRR EM and Law Companion Guidelines LCG 2016/3.

[36] Section 328-430(1)(a) of the 1997 Tax Act

- SBRR EM
    - The SBRR EM states:[37]

      The genuine restructure principle distinguishes genuine restructures from artificial or inappropriately tax-driven schemes. This acknowledges that while tax considerations are significant factors in small business structuring, a minority of taxpayers and advisers may try to manipulate the operation of a 'black letter' provision of the tax law to achieve an inappropriate or uneconomic tax outcome.

    - The SBRR EM[38] provides the following factors that would indicate a genuine restructure of an ongoing business.
        - It is a bona fide commercial arrangement undertaken to enhance business efficiency.
        - The business continues to operate following the transfer, through a different entity structure but under the same ultimate economic ownership.
        - The transferred assets continue to be used in the business.
        - The restructure results in a structure likely to have been adopted had the business owners obtained appropriate professional advice when setting up the business.
        - The restructure is not artificial or unduly tax driven.
        - It is not a divestment or preliminary step to facilitate the economic realisation of assets.
- *Law Companion Guideline* LCG 2016/3
    - The purpose of LCG 2016/3 is to provide guidance as to the meaning of 'genuine restructure of an ongoing business' for the purpose of accessing the SBRRs.
    - Features of a 'genuine restructure of an ongoing business'

      LCG 2016/3 lists a number of features which would indicate that a transaction is, or is part of, a 'genuine restructure of an ongoing business'. These are as follows:[39]

        - It is a bona fide commercial arrangement undertaken in a real and honest sense to:
            - facilitate growth, innovation and diversification;
            - adapt to changed conditions, or
            - reduce administrative burdens, compliance costs and/or cash flow impediments.
        - It is authentically restructuring the way in which the business is conducted as opposed to a 'divestment' or preliminary step to facilitate the economic realisation of assets.
        - The economic ownership of the business and its restructured assets is maintained.
        - The small business owners continue to operate the business through a different legal structure. For example, there is:
            - continued use of the transferred assets as active assets of the business;
            - continuity of employment of key personnel; and
            - continuity of production, supplies, sales or services.

[37] at paragraph 1.20
[38] at paragraph 1.22
[39] at paragraph 7

- It results in a structure likely to have been adopted had the small business owners obtained appropriate professional advice when setting up the business.

- Taxation considerations may factor in restructuring[40]
  - The Commissioner acknowledges that tax considerations are factors that can be taken into account under a genuine small business restructure. For example, a sole trader subject to the highest marginal rate moving to a company structure to access the lower corporate tax rate.
  - However, this is not without limits. There are concerns where the restructure is contrived or unduly tax driven in the sense that it achieves a tax outcome that does not reflect the economic reality or creates an outcome that would, but for the SBRR, ordinarily attract other integrity measures in the law. For example, a restructure directed at eliminating an impending or existing tax liability, would indicate that a restructure is not a 'genuine restructure of an ongoing business'.
- Factors which tend to indicate that a restructure is not a 'genuine restructure of an ongoing business'

  The following factors indicate that the restructure is not a ‘genuine restructure of an ongoing business’:[41]
  - Where the restructure is a preliminary step to facilitate the economic realisation of assets, or takes place in the course of a winding down to transfer wealth between generations.
  - Where the restructure effects an extraction of wealth from the assets of the business (including accumulated profits) for personal investment or consumption or otherwise designed for use outside of the business.
  - Where artificial losses are created or there is a bringing forward of their recognition.
  - The restructure effects a permanent non-recognition of gain or the creation of artificial timing advantages.
  - There are other tax outcomes that do not reflect economic reality.
- Examples
  - LCG 2016/3 provides a number of examples which may indicate the transaction is or is not a ‘genuine restructure of an ongoing business’.
    - Examples 1 to 4 are examples whose features indicate that the restructure is a ‘genuine restructure of an ongoing business’.
      - Example 1: Restructuring from an individual to a discretionary trust for asset protection reasons and due to the growth of the business.
      - Example 2: Restructuring from a discretionary trust to a company to allow for shares to be issued to key employees.
      - Example 3: Restructuring from a partnership to a company to allow for new capital to be injected into the business.
      - Example 4: Restructuring from a company to an individual to simplify the business affairs.

[40] at paragraphs 8 and 9
[4141] at paragraph 10

Note: If there is a change in ownership of the entities or if any of the assets cease to be active assets within three years, the client will need to show that at the time the transaction occurred, it was not part of a plan to divest the assets.

- Examples 5 to 7 are examples whose features indicate that the restructure is not a 'genuine restructure of an ongoing business'.

  - Example 5: A company transfers business assets to the shareholders as prospective purchasers do not want to acquire the shares in the company. After 12 months of the transaction, the shareholder disposes of the businesses assets to the purchasers. The shareholders obtain the 50% general discount.

  - Example 6: A company operates two separate businesses. The shareholder (father) is looking to retire and pass control of the businesses to his sons (one business each). The company transfers one business to another company which is owned by the father. Within three years the father transfers his shares in the first company to one of his sons and the shares in the second company to his other son.

  - Example 7: A business is operated through a trust which has unpaid income distributions owing to a company. The trust transfers the assets to the company in satisfaction of the unpaid income distributions. The company then transfers the business assets to another trust who then sells the assets to a third party.

- The transaction may be a genuine restructure if the trust transfers the assets to the company in satisfaction of the unpaid income distributions and the business continued to be operated in the company (Example 8).

- Example 9 is an example of the application of 'significant assets' and the 'safe harbour rule'.

  Example 9: A sole trader transfers the business assets and premises to a company. The premises (in terms of value compared to the other business assets) is a significant asset of the business. Twelve months after the transaction occurs, the sole trader finalises her matrimonial property settlement and transfers the premises to her former partner and begins operating the business online.

  As the premises are a significant asset, the sole trader cannot rely on the 'safe harbour rule' even though the company continues to carry on the business. The transaction may still be a 'genuine restructure' though.

Can the SBRR be used for succession planning?

- As outlined above, the Commissioner's view [at paragraph 10 of LCG 2016/3] is that a transaction will not be 'genuine restructure of an ongoing business' if it takes place in the course of a winding down to transfer wealth between generations.
- Example 6: Succession planning

  Facts

  53. Nick owns all the shares in Holding Co a company that operates two restaurants, Fish and Chips. Nick has two sons and is looking to retire.

54. Nick causes the company to transfer the active assets relating to Fish restaurant to Gone Fish Inc., a newly incorporated company that he also owns. The SBRR is claimed.

55. Sometime later, but within three years, Nick retires and disposes of the shares in the Holding Co (which now holds the active assets of Chips only) to his first son and the shares in the new company to his other son, so that each of them can run their own restaurants separately. Nick cedes control to his sons as a result of his plan to retire.

- Therefore, if the purpose of the restructure is to facilitate succession planning, then the transfer is unlikely to be part of a genuine restructure of an ongoing business.
- The issue therefore is whether the client can apply the 'safe harbour' rule. Although there may not be a change in the economic ownership for three years, the Commissioner may apply Part IVA.

Example 10: Anti-avoidance rules may have application

Facts

88. Leor operates his small business as a sole trader. Samuel approaches Leor, wishing to acquire his business. One of Samuel's sons is married to Leor's sister.

89. Leor and Samuel enter into an agreement to sell the business.

90. Leor transfers the active assets relating to his business to a newly established discretionary trust where Leor is one of the beneficiaries.

91. To satisfy the 'genuine restructure of an ongoing business' condition, the trustee relies on the 'safe harbour rule' where no significant assets, apart from trading stock, are disposed of, or used for private purposes, for a three year period.

92. To satisfy the 'ultimate economic ownership test', the trustee relies on the 'alternative ultimate economic test' where the family trust election is made specifying Leor's sister is the primary individual.

93. The SBRR is claimed.

94. After the transfer, Samuel starts managing and expanding the business where its service, managements and personnel change materially. The trustee distributes its trust income and capital to Samuel and his family.

Relevant considerations

95. Although all the requirements for the SBRR to apply might be met, the arrangement is contrived and is undertaken as a step in the economic realisation of Leor's business, as well as wealth transfer to Samuel's family members.

Conclusion

96. The anti-avoidance rules would need to be carefully considered for their application to the arrangement.

- This then raises the question as to whether the Commissioner will apply Part IVA where the intention is that the ownership and control will remain with the client until they are ready to pass control either during their lifetime or under their Will (but as part of a long term succession plan strategy).
- PRB 1051659884980 (issued 1 May 2020) indicates that the 'genuine restructure' requirement may not be satisfied but the 'safe harbour' concession may be satisfied.

Relevant facts and circumstances

- You are an Australian resident company for income tax purposes.
- You hold a number of parcels of farming land.
- The land has been used in farming businesses.
- Your shares are currently owned by siblings following the death of their parents.
- You are proposing to transfer the land to the family trusts of the siblings such that each trust will own 100% of the respective property.
- Each party of the transfer is a CGT small business entity or connected with a CGT small business entity.

Application to the circumstances: In your case it is not considered that proposed restructure will be a genuine restructure for the purposes of the small business restructure rollover. The proposed restructure is designed to split the assets between the shareholders in the company and will create distinct businesses. Your situation is comparable to example 6 in LCR 2016/3. While the transfers in your case have occurred after the death of the shareholders, the main purpose of the proposed restructure is to enable a tax-effective inter-generational transfer of wealth. Consequently, the transaction won't be a genuine restructure for the purposes of section 328-430 of the ITAA 1997.

However, provided that in the three years after the transaction occurs:

· there is no change in ultimate economic ownership of any of the significant assets of the business that were transferred under the transaction; and

· those significant assets continue to be active assets; and

· there is no significant or material use of those significant assets for private purposes.

the safe harbour rule will apply and the transaction will be deemed to be part of a genuine restructure under section 328-435 of the ITAA 1997.

Conclusion: Based on the facts the provided, the transfer of the land will be part of a genuine restructure under the safe harbour provision, each party to the transfer is either a small business entity or connected with a small business entity, the transaction does not have the effect of changing the ultimate economic ownership, the residency requirements will be met, and the transferor and each transferee will elect to use the rollover. Consequently, the transfer of the land will satisfy the requirements of the Small Business Restructure Rollover in accordance with Subdivision 328-G of the ITAA 1997.

- It may be prudent to obtain a private binding ruling.

Requirement 2: Small business entity

- Both the transferor and transferee must be one or more of the following:[42]
  - Be a small business entity for the income year during which the transfer occurred.
  - An entity which has an affiliate that is a small business entity for the year in which the transfer occurred.
  - An entity which is connected with an entity that is a small business entity for the year in which the transfer occurred.

[42] Section 328-430(1)(b) of the 1997 Tax Act

  - Be a partner in a partnership that is a small business entity for the year in which the transfer occurred.

- What is a small business entity?

  An entity is a small business entity[43] for an income year if it:

  - carries on business in the income year; and
  - at least one of the following applies.
    - It has an aggregated turnover of less than $10 million[44] for the income year (worked out at the end of the year).
    - It carried on business in the previous year and had an aggregated turnover of less than $10 million for the previous income year.
    - Its aggregated turnover for the current year is likely to be less than $10 million (provided that if it carried on business for the previous two years its aggregated turnover for those two years was not $10 million or more).

Requirement 3: Active asset requirement

- At the time the transfer takes effect, the CGT asset (other than a depreciating asset) must be:
  - an active asset of the transferor and the transferee; and
  - if under Requirement 2 above:
    - the 'small business entity' was an affiliate or connected entity of the transferor and/or the transferee, then the affiliate or connected entity (as the case may be) must be using the asset in carrying on its business; and
    - a party to the transaction was a partner in a partnership that was a small business entity, then the asset must be an interest in an asset of the partnership and be used by the partnership in carrying on its business.
  - Note: The asset only needs to be an 'active asset' at the time the transfer occurs, it does not have to be an active asset for at least half the time the asset is owned.
- What is an active asset?

  A CGT asset is an active asset if at that time:

  - the taxpayer owns the asset (whether the asset is tangible or intangible) and it is used, or held ready for use, in the course of carrying on a business that is carried on (whether alone or in partnership) by either the taxpayer, the taxpayer's affiliate or another entity that is connected with the taxpayer;
  - if the asset is an intangible asset – the taxpayer owns it and it is inherently connected with a business that is carried on (whether alone or in partnership) by the taxpayer, the taxpayer's affiliate or another entity that is connected with the taxpayer.[45]
- Note: some assets cannot be active assets, being:
  - 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); or
  - assets where the main use is to derive rent, interest or royalties.[46]

[S]as defined in section 328-110 of the 1997 Tax Act
[44] From 1 July 2016
[45] Section 152-40(1) of the 1997 Tax Act
[46] Section 152-40(4) of the 1997 Tax Act

- Shares or interests in a trust

  Although shares in a company that is an Australian resident at that time or interests in a trust that is a resident trust for CGT purposes for the income year may be active assets provided that at least 80% of the market value of all of the assets of the company or trust are active assets,[47] transfers of shares and trust interests are unlikely to be eligible to access the SBRRs because:

  - the roll-over applies to the restructure of a business not the shareholding; and
  - the 'small business entity' requirement (Requirement 2 above) is unlikely to be satisfied.

- Examples

  - Examples of transactions where Requirement 3 is satisfied:

    - Sam Jones carries on business and is a small business entity (SBE). Sam transfers the business assets to ABC Trust who will use the assets in carrying on its business and will be a SBE for the year.
    - Requirement 3 is satisfied as:
      - Sam and ABC Trust are both SBEs.
      - At the time of the transfer the business assets are active assets.
    - Sally Brown is a SBE who uses business assets including the premises in carrying on her business. Sally transfers the business assets excluding the premises to Brown Pty Ltd. Sally transfers the premises to Brown Trust who is connected to Brown Pty Ltd. Brown Pty Ltd who will be a SBE for the year will use the premises in carrying on its business.

      Requirement 3 is satisfied in relation to the business assets transferred to Brown Pty Ltd as:

      - Sally and Brown Pty Ltd are both SBEs.
      - At the time of the transfer, the business assets are active assets.

      Requirement 3 is satisfied in relation to the business premises as:

      - Sally is a SBE.
      - Brown Trust is connected with Brown Pty Ltd who is a SBE.
      - At the time of the transfer the business premises:
        - are an active asset of Sally; and
        - are an active asset of Brown Trust and are used by Brown Pty Ltd (a connected entity) in carrying on its business.

  - Example of a transaction where Requirement 3 is not satisfied:

    Brian Smith (who is not a SBE) owns 100% of the shares in Smith Pty Ltd. Brian transfers the shares in Smith Pty Ltd to Smith Trust. Smith Pty Ltd is a SBE. The shares are active assets as they satisfy the 80% test.

    - Requirement 3 is not satisfied as although the shares are active assets and Brian is connected with Smith Pty Ltd who is a SBE, the shares are not used by Smith Pty Ltd in carrying on its business.
    - Even if Brian and Smith Trust were both SBEs, it is questionable whether Requirement 1 (about the restructure of an ongoing business) is satisfied. This is because the business is still being carried on by Smith Pty Ltd.

[47] Section 152-40(3) of the 1997 Tax Act

Requirement 4: No change in ultimate economic ownership of the assets

- The transaction must not have the effect of materially changing:
  - which individual has, or which individuals have, the ultimate economic ownership of the assets; and
  - if there is more than one such individual – each such individual's share of that ultimate economic ownership.[48]
- Who are the ultimate economic owners?

  The ultimate economic owners of an asset are those individuals who directly or indirectly own the asset. This allows a 'look through' test where assets are owned by entities or the interests in the assets or entity which owns the assets are held by non-individuals.

  If there is more than one individual owner, then that individual's proportionate interest cannot materially change.

  Examples:
  - If mum and dad as equal partners own an asset which is transferred to a company, then mum and dad must each own 50% of the shares in the company.
  - If mum, dad and their son as equal partners own an asset which is transferred to a company, mum, dad and son must each own one-third of the shares. That is, the proportion of shares which they hold (and the rights attaching to those shares) must be the same as their proportionate interest in the partnership asset.
- Special rule for discretionary trusts[49]
  - If an asset or interest in an entity is owned by a discretionary trust then it will not be possible to trace through to individual owners as the beneficiaries will only have a contingent interest in the trust. Therefore there is special rule where the transferor and/or transferee is a non-fixed trust.
  - In relation to accessing the SBRRs, a transaction does not have the effect of changing the ultimate economic ownership of an asset, or an individual's share of that ultimate economic ownership, if all of the following are satisfied:
  - Criteria One:
    - Either or both of the following applies
      - Just before the transaction took effect, the asset was included in the property of a non-fixed trust that had made a family trust election (FTE).
      - Just after the transaction took effect, the asset was included in the property of a non-fixed trust that had made a FTE.
    - Note: This means that either the transferor or transferee (or both) must be a trust which has made a FTE.
  - Criteria Two

    Every individual who, just before the transfer took effect, had the ultimate economic ownership of the asset was a member of the family group (within the meaning of Schedule 2F of the 1936 Tax Act) of the individual specified in the FTE.
  - Criteria Three

[48] Section 328-430(1)(c) of the 1997 Tax Act
[49] Section 328-440 of the 1997 Tax Act

Every individual who, just after the transfer takes effect, has the ultimate economic ownership of the asset is a member of that family group.

- What is a non-fixed trust?
  - A trust is a non-fixed trust if it is not a fixed trust.[50]
  - A trust will be a fixed trust only "if persons have fixed entitlements to all of the income and capital of the trust".[51]
  - Beneficiaries will have fixed entitlements to the income and capital of a trust if, under a trust instrument they have "a vested and indefeasible interest" in a share of the income and/or capital52 .
  - Discretionary trusts will be non-fixed trusts and therefore to satisfy requirement 3 of the SBRR will need to make a FTE.
  - It is unlikely that a non-fixed unit trust with unrelated unitholders will be able to satisfy the requirement of making a FTE as it:
    - may not satisfy the 'family control' test in order to make a FTE; and
    - is generally impractical for any trust with unrelated beneficiaries to make a FTE as this will limit who can receive distributions from the trust without the trustee incurring family trust distribution tax.
- Who is part of the family group?
  - To meet both criteria two and three, the individual beneficiaries of the trusts who are a party to the transaction can only consist of individuals who are part of the family group of the individual specified in the FTEs (that is, the test individual).
  - 'Family Group'[53]

    A member of the test individual's family is a member of the test individual's family group.
  - The 'family'[54] of a test individual consists of the test individual and all of the following:
    - any parent, grandparent, brother or sister of the test individual or the test individual's spouse;[55]
    - any nephew, niece or child56 of the test individual or the test individual's spouse;
    - any lineal descendant of a nephew, niece or child of the test individual or the test individual's spouse;
    - the spouse of the test individual or of anyone who is a member of the test individual's family because of the above paragraphs.
- Note:
  - A person does not cease to be a family member merely because of the death of any other family member.

[50] Section 272-70 of Schedule 2F of the 1936 Tax Act
[51] Section 272-65 of Schedule 2F of the 1936 Tax Act
[52] s272-5(1) of Schedule 2F of the 1936 Tax Act
[53] Section 272-90 of Schedule 2F of the 1936 Tax Act
[54] Section 272-95(1) of Schedule 2F of the 1936 Tax Act
[55] Spouse is defined in section 995-1(1) of the 1997 Tax Act and includes same sex couples
[56] Child is defined in section 995-1(1) of the 1997 Tax Act to also include the individual's adopted child, stepchild or ex-nuptual child and a child of the individual's spouse.

- An adopted child, step-child or ex-nuptual child of a person is taken to be a lineal descendant of that person for the purposes of determining the lineal descendants of that person or any other person.
- The following former family members are members of the test individual's family group.
    - A person who was a spouse of either the test individual or of a member of the test individual's family before a breakdown in the marriage or relationship.
    - A person:
        - who was the spouse of either the test individual or of a member of the test individual's family before the death of the test individual or of a member of the test individual's family; and who is now the spouse of a person who is not a member of the primary individual's family; and
        - a person who was a child of the spouse of either the test individual or of a member of the test individual's family before a breakdown in the marriage or relationship of the primary individual or the member of the primary individual's family.

- Issues in relation to the 'special rule' for discretionary trusts
    - Criteria two and three above require that, just before and just after the transfer takes effect, every individual who had the ultimate economic ownership of the asset is a member of the family group of the test individual.
    - The purpose of having the 'special rule' for discretionary trusts is that it is not possible to identify individuals who have the 'ultimate economic ownership' of the asset.
    - Although it is clearly not the intention, on a strict reading of the legislation, this means that if the transferor or transferee (or both) are trusts, then criteria two and three cannot be satisfied.
    - Only individual beneficiaries who are members of the family group can have the ultimate economic ownership of the asset.
        - Aunts, uncles and cousins of a test individual are not part of the 'family' group (as defined in Schedule 2F of the 1936 Tax Act.
        - As the class of beneficiaries under the terms of most discretionary trusts are quite wide it will be important to review the terms of the deeds to determine who are the 'beneficiaries' and whether they are part of the family group.
    - Where the aunts, uncles and cousins of the 'test individual' are beneficiaries under the terms of the deed, does that mean that the deeds will need to be amended to exclude them as beneficiaries as they are not part of the 'family group'?
    - Tip: The terms of the trusts who are parties to the transactions could be amended so that whilst a FTE is in force, any person who is not a member of the family group of the test individual is excluded as a beneficiary. As there are adverse tax consequences of distributing outside the family group (in the form of family trust distribution tax [FTDT]), this would eliminate the risk of the trustee inadvertently triggering FTDT by distributing outside the family group and overcome the uncertainty as to whether only individuals who are members of the family group can be beneficiaries.

- Examples of transactions involving trusts where the special rule may be satisfied:
    - Transfer from Sam Jones (individual) to ABC Trust provided that:
        - ABC Trust makes a FTE;

    - Sam Jones must be in the ‘family group’ of the test individual specified in the FTE; and
    - only individuals who are in the ‘family group’ of the test individual are the individual beneficiaries of ABC Trust.
  - Transfer from DEF Pty Ltd (which is owned 100% by Sam Jones) to ABC Trust provided that:
    - ABC Trust makes a FTE;
    - Sam Jones must be in the ‘family group’ of the test individual specified in the FTE; and
    - only individuals who are in the ‘family group’ of the test individual are the individual beneficiaries of ABC Trust.
  - Transfer from XYZ Pty Ltd (which is owned 100% by Jones Trust) to ABC Trust provided that:
    - Jones Trust makes a FTE;
    - ABC Trust makes a FTE with the same test individual as Jones Trust because all of the ultimate owners before and after the transaction must be in the same family group; and
    - in relation to individual beneficiaries – only individual who are in the ‘family group’ of the test individuals are the individual beneficiaries of ABC Trust.
  - Transfer from Smith Pty Ltd (of which Bob and Julie Smith own the ordinary shares and their son Tom owns a discretionary dividend share) to Smith Trust provided that:
    - Smith Trust makes a FTE;
    - Bob, Julie and Tom must be in the ‘family group’ of the test individual specified in the FTE;; and
    - in relation to individual beneficiaries – only individual who are in the ‘family group’ of the test individuals are the individual beneficiaries of Smith Trust.
  - Transfer from Jones Trust to ABC Trust provided that:
    - Jones Trust makes a FTE;
    - ABC Trust makes a FTE with the same test individual as Jones Trust because all of the ultimate owners before and after the transaction must be in the same family group; and
    - in relation to individual beneficiaries – only individuals who are in the ‘family group’ of the test individual are the individual beneficiaries of ABC Trust.
- Examples of transactions involving trusts where the special rule will not or may not be satisfied:
  - Transfer from Sam Jones and his uncle Bob Jones (individual) to ABC Trust if ABC Trust makes a FTE with Sam Jones as the test individual.
    - This is because Bob Jones (Sam’s uncle) will not be part of Sam’s family group.
    - If however, ABC Trust made a FTE with Bob Jones as the test individual, then the special rule will be satisfied as Sam (Bob’s nephew) is in his family group.
    - If ABC Trust makes a FTE with Bob as the test individual, then care will need to be taken as any distributions will need to be in relation to Bob’s family group, otherwise the trustee of the ABC Trust will be subject to family trust distribution tax.

- Transfer from ABC Pty Ltd (which is owned by ABC Trust) to DEF Pty Ltd (which is owned by DEF Trust).
  - In this case Requirement 3 cannot be satisfied as the ultimate economic ownership cannot be traced through to individuals.
  - The special rule relating to discretionary trusts will not apply as in this case, although both trusts may have made a FTE with the same test individual, the transfer is between two companies. For the 'special rule' to apply, either the transferor or transferee (or both) must be a trust which has made a FTE.

Requirement 5: Residency

- Transferor and transferee must be Australian residents. If the transferor or transferee is a partnership, then at least one of the partners must be an Australian resident.

Requirement 6: Choice

- Both transferor and transferee must choose to apply the roll-over in relation to the assets transferred under the transaction other than depreciating assets.
- If a depreciating asset is transferred then, provided all the SBRR requirements are satisfied, roll-over applies automatically to the depreciating assets.57

  Note: The choice to apply the SBRRs does not need to be made in relation to all assets transferred.
- How do the transferor and transferee make the choice?

  Division 328-G is silent as to how or when the transferor and transferee must make the choice to apply the roll-over. Therefore it would be prudent that prior to the lodgement of their tax returns both the transferor and transferee have written evidence as to which assets they have chosen to apply the SBRRs to.

5.3 Consequences of making the choice in relation to particular assets

- Direct consequences of transfer ignored
  - Except as provided for under Subdivision 328-G, a transfer of an asset has no direct consequences under the income tax law provided that the SBRR is applied to the asset.
  - Issues:
    - Must be a 'direct' consequence.
    - Only applies to 'income tax law'. Therefore still need to consider GST, FBT and duty.
  - This means that any income tax consequences (including Division 7A issues are ignored) provided that they are as a direct result of the transfer of the asset.
  - Examples of direct consequences:
    - ABC Pty Ltd transfers the business premises which have a market value of $1 million to ABC Trust for nil consideration. All of the SBRR requirements are satisfied.
    - ABC Pty Ltd would ordinarily have a capital gain on the transfer of the business premises.
  - However the capital gain is disregarded as the capital gain is a direct result of the transfer of the premises.

    ABC Trust would ordinarily have a deemed unfranked dividend of $1 million to include in its assessable income (as the transfer of the premises will be a Division 7A payment).

[57] Item 8 of section 40-340(1) of the 1997 Tax Act

  - However the unfranked dividend is ignored as the dividend was a direct result of the transfer of the premises.
- Transferee acquires the assets for its ‘roll-over cost’ or adjustable value in relation to depreciating assets.

  What is an asset’s roll-over cost?

The roll-over cost will depend on the type of assets being transferred. These are summarised below

Type of asset	Roll-over cost (other than depreciating assets)	Depreciating assets
CGT assets (other than trading stock, revenue assets or depreciating assets)	The transferor’s cost base just before the transfer takes effect.	
Trading stock	The amount equal to: • the cost of the item for the transferor; or • the value of the item under Division 70 for the transferor if the transferor held the item as trading stock at the start of the income year.	
Revenue asset	The amount which would not give rise to the transferor making a profit or loss on the transfer.	
Depreciating assets		Transferor’s adjustable value (written down value). Transferee also adopts transferor’s method of depreciation and rate

  - Note: In most cases where there is a disposal of all of the stock as part of a sale of the business, the market value of the stock will be equal to its cost.   One of the exceptions will be the transfer of livestock where in most cases the market value of the stock is considerably higher than the cost reflected in the livestock trading account (particularly as a result of natural increase of cattle being reflected at the cost prescribed by the regulations, being $20).
  - This means that primary production clients who want to transfer livestock have to retain at least a 25% interest in the livestock in order to choose to transfer the livestock at cost under Division 70 of the 1997 Tax Act. At a later point, the remaining 25% interest in the livestock could then be transferred. This is generally known as the ‘double shuffle’.
- Under the SBRRs it may be possible to transfer livestock without any income tax consequences.
- Cost base of shares or units if part of consideration

- Where shares or units are part of the consideration, then the roll-over cost of assets plus the adjustable value of depreciating assets form part of the cost base of the shares or units.
- The cost base is reduced if the shares or units are only part of the consideration.

  Example: Tom transfers business assets to ABC Pty Ltd in exchange for shares in ABC Pty Ltd plus $200,000. The roll-over cost of the assets plus adjustable value of the depreciating assets is $800,000.

  The cost base of the shares which Tom receives in ABC Pty Ltd will be $600,000 (being the $800,000 less the consideration of $200,000 received).

- Pre-CGT assets retain status
  - Pre-CGT assets which are transferred retain their pre-CGT status.
  - Note: If pre-CGT assets are transferred to a company, although the assets retain their pre-CGT status, the legislation is silent as to the treatment of any shares issued in the company as consideration. This means that the shares do not appear to be taken to have been acquired pre-CGT even if the transferred assets are taken to have been acquired pre-CGT.
  - If pre-CGT assets are being transferred to a company, clients should consider applying roll-over relief under Subdivision 122-A or Subdivision 122-B as the shares will be taken to be pre-CGT assets if the assets being transferred are pre-CGT assets (or to the extent that the assets transferred are pre-CGT assets).
- 50% general discount under Division 115
  - For the purpose of the 50% general discount, the asset is acquired on the date it is acquired for CGT purposes (generally contract date) for determining whether it has been held at least 12 months.
  - Unlike other roll-overs, there are no deeming rules.

Interaction with the small business CGT concessions

- Small business roll-over under Subdivision 152-E of the 1997 Tax Act
  - If the transferred asset was a small business replacement roll-over asset under Division 152 of the 1997 Tax Act in the hands of the transferor, then the transferee is taken to have made the choice for the purpose of CGT events J2, J5 and J6.
  - This means that if the transferor had acquired a replacement asset which it transfers under the SBRR's then:
    - if the replacement asset ceases to be an active asset of the transferee, CGT event J2 will occur for the transferee;
    - if the replacement asset is not an active asset of the transferee at the end of the replacement period, CGT event J5 will occur for the transferee;
    - if the cost base of the replacement asset is less than the amount chosen by the transferor to disregard under the small business roll-over, CGT event J6 will occur for the transferee.
  - Example
    - ABC Pty Ltd acquired goodwill as a small business replacement asset in the 2010 year. In the 2017 year it transferred the goodwill to ABC Trust. The SBRRs requirements were satisfied.
    - ABC Pty Ltd disregards the CGT event J2 which would have occurred as the goodwill ceased to be an active asset of ABC Pty Ltd.

    - ABC Trust is taken to have made the choice to apply the small business roll-over and therefore when the asset ceases to be an active asset of ABC Trust, CGT event J2 will occur for ABC Trust.

- Small business 15 year exemption under Subdivision 152-B of the 1997 Tax Act
    - For the purpose of the small business 15 year exemption, in determining whether the asset has been owned for at least 15 years just before the CGT event, the transferee is taken to have acquired the asset when the transferor acquired it.
    - Generally, unless an asset is acquired which satisfies the requirements for a roll-over under Subdivision 124-B (about an asset being compulsorily acquired, lost or destroyed) or Subdivision 126-A (about marriage or relationship breakdowns), then for the 15 year exemption, a taxpayer's period of ownership commences when they become the owner.
- Capital losses on shares and units may be disregarded
    - If membership interests are affected by the transfer of assets under the SBRRs, then any capital loss which arises from a CGT event in relation to that membership interest is disregarded except to the extent that the entity can demonstrate that the loss is attributable to something other than the transaction.
    - Example

      Tom owns 100% of the shares in ABC Pty Ltd. The shares have a cost base of $100,000. ABC Pty Ltd transfers its only asset to ABC Trust for nil consideration under the SBRRs. After the transfer ABC Pty Ltd's equity is reduced to nil and is wound up. This means that Tom will not receive any return on his shares and will have a capital loss of $100,000 as a result of CGT event C2 occurring when ABC Pty Ltd is deregistered.

      Tom will disregard the capital loss on his shares as the capital loss would be attributable to the fact that the asset was transferred for nil consideration under the SBRRs.

6. SBCGT concessions versus SBRR v general roll-overs

- Assuming that the requirements are satisfied, a decision will need to be made as to whether to apply the SBRRs or in particular the small business CGT concessions under Division 152 of the 1997 Tax Act. Although both of the concessions are for the benefit of small business, there are differences in the requirements to access the concessions and also the implications of choosing the concessions.
- In particular, the SBRRs may be attractive if:
  - the asset is a pre-CGT asset (particularly where the transferor is a company);
  - the asset is livestock.
- One major benefit of the small business CGT concessions for post-CGT assets is that the transferee will obtain an uplift in the cost base of the asset.

  Also, although any income tax implications may be ignored under the SBRRs, other implications of the transactions will need to be considered, in particular GST and duty.
- Major differences between the requirements to access general roll-overs, SBRRs and small business CGT concessions

Roll-overs in general	**Small business CGT concessions**
Number of requirements to be satisfied.	Number of requirements to be satisfied
Common requirement – no change in underlying ownership	Major requirements – net asset test, active asset test
No uplift in cost base	Uplift in cost base
In majority of cases will retain pre 1985 status	Pre 1985 status not retained

Consequences	**SBRRs**	**Small business CGT concessions**
Transferor	Disregard tax consequences on CGT assets, revenue assets, depreciating assets and trading stock including Division 7A implications where the transferor is a company.	Only applies to CGT assets. Can choose to apply small business CGT concessions. For retirement exemption – need to pay into superannuation if 55 years of age.
Transferee	Acquires assets for their rollover cost (no uplift in cost base) Retains pre-CGT status	Acquires asset for its cost base (Uplift in cost base)

Consequences	SBRRs	Small business CGT concessions
	For 15 year exemption - asset deemed to be acquired when transferor acquired it	Asset becomes post-CGT asset For 15 year exemption – assets acquired when transferee becomes the owner (resets the 15 year time)

Requirements	SBRRs	Small business CGT concessions
Genuine restructure of an ongoing business	Needs to be satisfied (Business assets)	Not a requirement (Business assets or shares or units)
Small business entity	Needs to be satisfied	Alternative test to the $6 million net asset test
Active asset	Needs to be satisfied at the time the transaction occurs	Needs to be satisfied for at least: • Half of time commencing when the asset is acquired and ending just before the CGT event; or • 7.5 years if the asset is owned at least 15 years
Economic ownership	Needs to be satisfied	Not a requirement
Residency	Needs to be satisfied	Not a requirement
Choice	Both transferor and transferee must choose	Only transferor taxpayer to make the choice

- Major differences between the consequences of choosing SBRRs and small business CGT concessions

Consequences	Roll-overs in general	SBRRs	Small business CGT concessions
Transferor	Disregard capital gain Retain cost base for replacement asset Retain CGT status for replacement asset	Disregard tax consequences on CGT assets, revenue assets, depreciating assets and trading stock including Division 7A implications where the transferor is a company.	Only applies to CGT assets. Can choose to apply small business CGT concessions. For retirement exemption – need to pay into superannuation if 55 years of age.
Transferee	Acquires CGT assets for cost base (no uplift in cost base) Retain CGT status	Acquires assets for their rollover cost (no uplift in cost base) Retains pre-CGT status For 15 year exemption - asset deemed to be acquired when transferor acquired it	Acquires asset for its cost base (Uplift in cost base) Asset becomes post-CGT asset For 15 year exemption – assets acquired when transferee becomes the owner (resets the 15 year time)

7. Duty – Small business restructure

- The small business restructure duty exemption (**SBRDE**) was introduced originally as a ruling under an administrative arrangement in Public Ruling DA000.16.1 on 9 October 2020.
- The ruling was later withdrawn when Part 1A of Chapter 10 was inserted into the Duties Act effective from 30 June 2022.
- The SBRDE provides for a duty exemption worth up to $555,525 on restructures of certain small business entities to a wholly owned company.

7.1 Basic requirements

- The SBDRE is available where:
  - There is a dutiable transaction that is a transfer, or an agreement for the transfer property
  - The property is small business property
  - A small business entity that is an individual, partnership or discretionary trust agrees to transfer the small business property to a transferee corporation
  - The individual, partnership, default beneficiaries of a discretionary trust or discretionary trust is a shareholder in the transferee corporation
  - the unencumbered value of the property the subject of the transfer or agreement is not more than $10m.
- The SBRDE applies to both the transfer duty applicable the relevant dutiable transaction and also, if the small business property includes vehicles, vehicle registration duty is not imposed on an application to transfer the vehicle.

7.2 Requirement 1 – Is there a dutiable transaction

- The relevant dutiable transactions for the SBRDE are those set out in section 9(1)(a) and (b) of the Duties Act. These are the transfer or agreement to transfer dutiable property.
- Relevant dutiable property includes:
  - land in Queensland;
  - a transferable site area;
  - an existing right;
  - a Queensland business asset;
  - a chattel in Queensland.
- A Queensland business asset is defined to be an asset of a Queensland business with each of the following constituting a business asset:
  - goodwill;
  - a statutory business licence used for carrying on a business;
  - a right to use a statutory business licence used for carrying on a business;
  - the business name used for carrying on a business;

- a right under a franchise arrangement used for carrying on a business;
- a debt of a business if the debtor resides in Queensland;
- a supply right of a business;
- intellectual property used for carrying on a business;
- personal property in Queensland of a business.

7.3 Requirement 2 – Small business entity

- Section 413A of the Duties Act provides:

> *(1)* ***A small business entity*** *is an individual, partnership or discretionary trust carrying on a relevant Queensland business with an annual turnover of not more than $5m.*
>
> *(2) In this section—*
>
> ***relevant Queensland business*** *means a business—*
>
> *(a) conducted on or from a place in Queensland; or*
>
> *(b) the conduct of which consists wholly or partly of supplying land, money, credit or goods or any interest in them, or providing any service, to Queensland customers*

Small business entity - Carrying on a business

- Whilst it is usually readily determinable whether or not a business is being carried on, there will inevitably be matters that touch on the fringes of carrying on business. Some cases of note are *YPFD and FCT* (2014) 94 ATR 484. In that case the AAT held that the activities of the taxpayer with respect to operating and managing their residential letting arrangements were sufficient to be carrying on a business. It should be noted there were quite a number of residential lettings within that case and it was pretty well a full time job for the taxpayer.

- It is also important to note that size does not always matter when it comes to establishing a business. In *T&S Liapis Pty Ltd v the Commissioner of State Taxation* [2015] SASC 63, the taxpayer owned five hectares of land in the foothills of Adelaide. The Company ran an olive grove on 1.5 hectares of the land and in the years 2003 to 2007 generated a primary production income of between $3,500 and $6,000 in each of the years. In that matter, it was held the company was in business of primary production given the sophisticated nature of the olive trees planted on the 1.5 hectares. There was some sophisticated grafting techniques utilised which was sufficient to bring the company into the realms of carrying on a primary production business.

- *Ferguson v FCT* (1979) 37 FCA 51 provides another example that size does not always matter. In that case the Taxpayer leased 5 cows which (with requisite intention) was sufficient to carry on a business.

- Otherwise a reasonable list of the indicia that indicated carrying on a business is set out in paragraph 7 of Duty Ruling DA105.2.3 which criteria were developed from income tax cases of

Martin v FCT (1953) 90 CLR 470 and *Ferguson v FCT*. These provisions establish that there must be a commercial purpose and character; more than just an intention to engage in business; a profit making intention; and the activities need to be of a continuous nature or occur with sufficient regulatory. The arrangements need to have a commercial flavour.

- As to the further limbs of this definition, the definition of small business entity includes supplying interests in land and so it is contemplated that a business of leasing property (if business can be established) gets the benefit of these concessions.

- It should also be noted that if you are seeking to establish that you are carrying on a business then there may be consequences from a Federal income tax perspective. It should just be noted that any submissions made to the QRO can and do come up in Federal Tax disputes.

Turnover of less than $5m

- There is no definition for what annual turnover means for the purposes of the SBRDE.
- Unlike 328-120 ITAA97, there is no discussion for the purposes of the SBRDE whether:
  - turnover is inclusive or exclusive of GST.
  - turnover is limited to ordinary income derived in the ordinary course of carrying on a business;
  - extraordinary events (such as revenue generated from the disposal of capital asset) that produce gains are included in the $5m turnover test.
- The annual turnover also does not consider whether it is annual turnover on an accruals basis or a cash basis. The safe approach has been to adopt the tax and accounting treatment of receipts as has previously been adopted by the small business entity. However, if that poses a particular issue in your relevant year you may seek to put an alternative position in submissions to the QRO.
- The Commissioner has published comments in addition to this SBRDE on the Queensland Government website that the turnover from the previous three financial years may be used and averaged when determining the annual turnover of the entity for the purposes of the small business entity provisions.
- The QRO have in previous discussions with the authors intimated that they will be taking a relatively relaxed view to the turnover requirements as so long as the calculations are reasonable having regard to the facts, they will likely accept most reasonable positions put to them. This is on the basis that this SBDRE is meant to be providing relief to taxpayers and it will be interpreted beneficially.
- Practically also, the QRO have been content to provide the SBRDE based on the relevant turnovers that have occurred in the latest completed financial year. There is currently no requirement in to SBRDE to estimate or annualise what would be the turnover of the small business entity for the year in which the restructure takes place. This can have positive and negative effects on satisfying this limb of the SBRDE requirements and, depending on the taxpayer situation it may suit to provide details to the QRO of current year turnover.

Place in Queensland

- The SBDRE requires the business needs to be carried on from a place in Queensland or is otherwise dealing with Queensland customers. This provides for the SBRDE being administered to allow for multi-jurisdictional restructures.
- This does give rise to a dutiable value question as to whether Queensland assets only are included or the total value of the transaction is used. In which case an apportionment under section 26 or 27 of the Duties Act would be required.

7.4 Requirement 3 – Is the dutiable property, small business property?

- Section 413B of the Duties Act provides:

> *1) **Small business property**, of a small business entity, is dutiable property that is directly held and used by a person for the purpose of carrying on the business of the entity.*
>
> *(2) However, **small business property** does not include dutiable property—*
>
> *(a) that is used as a residence by the person; or*
>
> *(b) that is investment property the person holds and uses to generate income to fund the business of the entity.*

- Aspects to note with respect to this definition are dutiable property takes its definition from section 10 of the Duties Act. Accordingly, it includes land in Queensland, transferrable side area, an existing right, Queensland business assets and chattels in Queensland.
- The requirements that the small business property be directly used by a small business entity to carry on the small business will trigger considerations as set out in *Eichmann v FCT* [2020] FCAFC 155 case from a CGT small business concession perspective.
- It should also be noted that this direct use in a business definition of small business property can cut both ways when it comes to determining the value of the dutiable transaction. Specially, related party loans could be excluded if the transferring entity is not in the business of making those loans (thereby getting the Dutiable Value under $10m). In addition, it is possible to exclude personal-use assets if the other business assets that are being transferred would exceed $10 million value threshold described below.
- As will be discussed below, whilst the definition of small business property can include property owned by a party who is not a small business entity, the requirements in the SBRDE provisions (that is, sections 413F, 413G, 413H and 413I of the Duties Act) require the small business property to be owned by the relevant small business entity. Accordingly the SBRDE will usually only be available for trading entities of the group where there are multiple entities with separate roles including:
    - Asset owning entities
    - Trading entities
    - Employee entities

7.5 Requirement 4 – Is the property the subject of the transaction less than $10m?

- The requirements of the SBDRE are that the unencumbered value of the property the subject of the transaction is less than $10m. Section 14 of the Duties Act relevantly provides:

  *The **unencumbered value** of property is the value of the property determined without regard to—*

  (a) any encumbrance to which the property is subject, whether contingently or otherwise; or
  (b) any arrangement—

  (i) the parties to which are not dealing with each other at arm's length; and

  (ii) that results in the reduction of the value of the property; or

  (c) any arrangement for which a significant purpose of any party to the arrangement was, in the commissioner's opinion, the reduction of the value of the property.

Requirements for a valuation

- A valuation may be required where the value of the assets being transferred are close to the $10m threshold. The QRO will generally insist of a valuation being produced where the restructure involves real property and this valuation will generally need to be provided by a qualified valuer.
- In terms of goodwill of a business, it may not always be necessary to obtain a valuation for the purposes of applying for the SBRDE. That is, where on a basic enterprise value or EBITDA calculation, it is established the goodwill value of the business (including all Qld business assets) is significantly less than $10m, the QRO will not generally put the taxpayer to the burden of obtaining a formal valuation.
- Generally the Commissioner will accept the written down value of plant and equipment as indicated in the accounts as their dutiable value. If instant asset write offs or temporary full expensing have been used then a valuation of the plant and equipment may be required to establish a reasonable unencumbered value.
- Stock will generally need to be included at its wholesale cost. The basis for this is that, it should be accepted that the cost price is the market value of trading stock because the only relevant market for those goods are a wholesale purchaser, rather than a retail purchaser.

Cherry picking assets

- The requirement in this part of the SBRDE only requires that unencumbered value of the asset the subject of the dutiable transaction are less than $10m.
- This exemption can still be used where discrete aspects of a business or discrete business assets are being transferred to a wholly owned company where the unencumbered value of those assets are less than $10m. This is notwithstanding the value of the small business property of the small business entity may otherwise exceed the $10m threshold.
- Be aware however that where multiple restructures comprise dutiable transactions that together form, evidence, give effect to or arise from what is, substantially 1 arrangement, where the value of all those transactions are aggregated and exceed $10m the SBRDE may not available.

7.6 Requirement 5 - Is the transferee a transferee corporation

- Section 413C of the Duties Act provides the following definition of transferee corporation:

> *A **transferee corporation** is an unlisted corporation to which small business property is, or is agreed to be, transferred that has not, since its registration under the Corporations Act, and before the transfer or agreement—*
>
> *(a) held any assets or liabilities; or*
>
> *(b) been a party to an agreement; or*
>
> *(c) been a beneficiary or trustee of a trust; or*
>
> *(d) issued or sold any shares or rights relating to shares*

- An unlisted company for the purposes of this definition is a company whose shares are not quoted on the market operated by a recognised stock exchange. Practically this means that the transferee company will need to be a proprietary limited company or a limited company. This is to ensure the entity has share interests which meet the definition in section 161 of the Duties Act.
- This difficulty with this definition of transferee corporation is the very narrow activities the transferee corporation can have before the SBRDE is applied for.
- Of most concern if that the use of the concept of a beneficiary of a trust. Beneficiary is not defined for the purposes of section 413C and any potential discretionary object of a discretionary trust falls within usual meaning of the term beneficiary. This problem is a replication of the landholder duty problems found in section 166 of the Duties Act.
- Accordingly there are practical difficulties in ensuring the transferee corporation does not become a beneficiary of a trust immediately on its incorporation. This requires planning as part of the restructure process an obtaining a full review of all trusts within the taxpayer's group to ensure either:
  - There are no discretionary trusts within the group;
  - That any transferee corporation is removed as a potential beneficiary of any discretionary trust before the transferee corporation is incorporated.
- Other practical considerations are the transferee corporation cannot have held any asset or liabilities in the period from incorporation to the date the business sale agreement with the small business entity is signed. Practically this means that the following matters cannot happen before any restructure documents are signed, the transferee corporation:
  - acquires a bank account;
  - applies for any business licences or authorities to conduct a businesses (including real estate licences and QBCC licences);
  - applies for any services related to carrying on a business (telephone, internet, leases, domain names, business names etc)
  - does not issue shares and that the shares issued on incorporation are issued to the relevant small business entity (if a full SBRDE is being claimed).

7.7 Requirement 6 – Does the individual, partnership, default beneficiary or trustee of the transferor hold a share interest in the transferee company

- Each of the exemptions (in section 413F, 413G, 413H and 413I) require that (as relevant):
  - The individual that is a the small business entity is a shareholders in the transferee corporation and holds a share interest in the transferee corporation;
  - The partners that are a the small business entity are shareholders in the transferee corporation and they hold a share interest in the transferee corporation;
  - Where a discretionary trust that is a small business entity, all its default beneficiaries are shareholders in the transferee corporation and they hold a share interest in the transferee corporation;
  - Where the discretionary trust that is a small business entity, the trustee is the sole shareholder in the transferee corporation and that there is no change in the rights or interest of the small business beneficiaries (immediately before and after the dutiable transaction).

Individuals

- The individual provisions are relatively straight forward and require that the individual carrying on the business immediately before the transfer needs to be the shareholder in the company going forward to obtain a full exemption.

Partnerships

- Under the SBRDE the capacity in which the partners operate as partners in a partnership needs to be maintained when they take shares in the company following the transfer of small business property.
- Accordingly if the partnership is a general law partnership, the partners will need to take shares in their respective capacities. In practice this means that 2 partner are 50/50 partnership one partner will take 50% of shares in the company and other partner would take 50% of balance shares in transferee corporations.
- The other point with partnerships is that the capacity in which the partners participate in the partnership must be maintained in the company going forward. This means if there is a partnership of trusts carrying on the small business then those partners need to take shares in the company as trustee going forward.
- A partnership interest is calculated by reference to section 42 of the Duties Act which, in most basic cases, will be the greater of the percentage of capital the partner has contributed or is required to contribute; or the percentage of loss the partner is required to bear.
- If there are profit share only partners or partners with variable partnership entitlements, the partnership interests will be calculated:
  - On the profit share percentage the partner is entitled to – for profit only partners; and
  - On the proportion that the value of the partner's entitlements as a partner bear to the value of the entitlements of all partners in the partnership, expressed as a percentage – for variable partnership entitlements.

- If the partnership is a partnership of trusts with a single trustee, considerations should turn to whether the trustee of one of the partnership trusts is replaced. This is to ensure the partnership of trusts meets the general definition of a partnership – being a two or more persons carry on a business in common with a view to a profit (see section 5 of the *Partnerships Act 1891* (Qld)).
- The issue with a common trustee is that there will not be more than 2 persons carrying on business. Accordingly the trusts might not be in partnership. Replacing once of the trustees of the partner trusts mitigates the risk on this technical argument.

Discretionary Trusts – Taker in Default as Shareholder

- The taker in default need to be established in order to use this exemption.
- Usually it is a matter of tracing through if there is a taker in default of income or in the absence of the taker in default of income determining who the taker in default of capital might be under the trust deed.
- If there is no taker in default either of capital or income then the ability to use this eligible transaction would unlikely be available.
- Be aware that if the taxpayer amended their trust deed to include a taker in default to get the benefit of the SBDRE, that would likely be a trust acquisition for duty purposes. Consequently the transaction would trigger full liability of duty on the underlying unencumbered value of the trust's dutiable property.
- Section 118 of the Duties Act may provide some relief in this regard.

Discretionary Trust – Trustee as Shareholder

- This exemption is a relatively straight forward application where the discretionary trust that previously was the small business entity transfers its business assets to a company wholly owned by that same trust.
- The trust needs to be a shareholder in the transferee corporation and the SBDRE requires that the rights and interests of the small business beneficiaries of the trust immediately before the transaction are the same as immediately after the transaction.
- Practically if there are no variations to the trust deed or the class of beneficiaries and the class of beneficiaries remains the same immediately before and immediately the dutiable transaction, the requirements of this aspect of the SBRDE will be satisfied.
- Be aware with this exemption that there is no partial exemption if someone other than the trust owns shares in the transferee corporation as part of the structure. This is the only SBDRE exemption where there is no partial exemption.

Share Interest

- A share interest is defined in SBRDE by reference to section 161 of the Duties Act which imports rights to capital distributions on winding up of the company. Accordingly it is open to argue that the restructure company is not required to have solely ordinary shares on issue at the time of the restructure and could use a dividend access shares or similar that carries no capital rights on winding up.

- It should be noted that under s.161B of the Duties Act, the Commissioner does have discretion to relieve the application of s.161(1)(b) where it would be inequitable. One has to imagine how this provision might ever apply.

Partial or full exemption

- Each of sections 413F, 413G and 413H (as relevant) provide for a full or partial exemption in terms of the following:

  Transfer duty is not imposed on the dutiable transaction to the extent of the lesser of the following interests—

  (a) the individual's ownership interest in/ partner's partnership interest in the partnership that held/ beneficiary's trust interest in the discretionary trust that held the small business property immediately before the transfer or the agreement was entered into;

  (b) the individual's/partner's/beneficiary's share interest in the transferee corporation immediately after the transfer or the agreement was entered into.

- That is, where the percentage of the transferring entity's ownership interest in the small business entity (or interest as a default beneficiary as relevant) is higher than the relevant entity's share interest (both calculated as a percentage) in the transferee corporation, duty will be assessed on the differing percentage.
- This usually means that while the duty exemption will be applied for as a 100% exemption, the partial exemption also allows for a restructure to be implemented (depending on the commercial drivers of the transaction) for new owners in the transferee company.
- Accordingly the partial exemption status of the SBDRE should be kept in mind.
- Be aware that there is no partial exemption under section 413I of the Duties Act where the trustee of the trust restructure to a company in which the trustee will hold the shares.

7.8 Further comments

Unit Trusts

- The SBDRE does not apply to restructures of unit trusts.
- Moreover is unlikely that on an application for the SBDRE, the exemption would be given in respect of a hybrid trust (or unit trust with discretionary powers) and the QRO has long held these types of trusts are not discretionary trusts.
- When the authors, not in relation to the SBDRE, have sought to have certain unit acquisitions stamped on the basis that a hybrid trust was in fact a discretionary trust, such submissions have generally been rejected. Accordingly the QRO appears to take a practical view that a unit trust is a unit trust notwithstanding hybrid provisions and a discretionary trust is more akin to a trust with general powers of appointment and no units on issue. This is notwithstanding the commentary in *Buckle v Commissioner of Stamp Duties* [1998] HCA 4.

Back to back restructures/sales

- There has been considerable concern in the income tax/capital gains tax space following the announcement of the ATO developing advice and guidance on back to back CGT rollovers and certain class rulings on back to back rollovers.
- This is also a broader general anti-avoidance consideration and technical compliance issues in circumstances where a CGT roll-over is implemented solely to allow for a sale of shares in the roll-over entity.
- To date, in the authors experience, the QRO have been administering the SBDRE favourably for taxpayers. Specifically, all SBDRE submissions where the transaction is a preliminary step to a sale or broader transaction have been fully disclosed.
- The general view appears to be that because there are no clawbacks in the SBDRE (unlike say in section 412 of the Duties Act relating to corporate reconstructions). Consequently the SBDRE can be used to exempt a restructure to a transferee corporation as a preliminary step to a shares sale in the transferee corporation (where duty might have otherwise applied at one step of the transaction).
- This position is however always subject to review and accordingly caution should be had when seeking to apply the SBDRE as a preliminary step to a sale.