The Tax Institute

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Small business CGT concessions – When you think you're eligible and why you are not

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1. Introduction

Unfortunately, I am of a certain vintage where I was well into my career when Division 152 was introduced in 1999. As far as tax reform goes those days were heady and changes to our income tax system came thick and fast (let alone GST was also being introduced).

I recall attending TIA conferences where we waded through the meaning of new terms like controlling individual, small business CGT affiliate and a $5m net asset value test. It was obvious even then how generous the concessions were but also how complicated they would be. I probably would not have believed you if you had told me in 1999 or 2000 that the concessions would be significantly more complex in 2025 than how they started – but here we are.

Whilst the title of this session does emit some negative energy, I would like to think it is providing each attendee/reader an opportunity to use the issues covered to avoid problems when advising clients.

I would like to say that this paper assumes a good knowledge of the concessions and the basic conditions (and extra conditions) required to access them. The paper itself focuses on discrete risk areas involved in accessing and utilising the concessions.

All references in this paper to a statutory provision is a reference to the *Income Tax Assessment Act 1997* (Cth), unless stated otherwise.

2. Connected Entities and Affiliates

Whilst initially introduced as part of the new Division 152 in 1999, the concept of connected entities and affiliates is used widely in our Tax Acts.

We now apply these concepts to determine aggregated turnover which impacts access to a range of concessions in Division 328 and also whether a company is a base rate entity for tax rate purposes.

However, I would submit that the most consequential application of these concepts arises in determining whether the small business concessions can be used by a client. This is the focus of this part of the paper.

2.1 Why are these terms important?

In the context of Division 152 the concepts of "connected entity" and "affiliate" are relevant in the following main areas:

- Application of the $6m net asset value condition – Section 152-10 and 152-15.
- Application of the $2m aggregated turnover test to qualify as a CGT small business entity – Section 152-10.
- Basic conditions regarding assessing the concessions for passively held assets – Section 152-10(1A).
- Active asset test – Section 152-40.

Naturally, in an ATO review involving a client who has claimed the concessions would involve enquiry on one or more of the above areas to determine if the concessions were properly claimed.

2.2 Who (or what entity) is an affiliate?

As will be shown below, in determining whether entities are connected requires an identification of who is an affiliate so it is logical that in any analysis of connected entity the affiliate analysis should occur first.

The source of the definition is in Section 328-130 which states that:

> *An **individual** or **company** is **your** affiliate if they act, or could reasonably be expected to act:*
>
> > *In accordance with your directions or wishes, or*
> >
> > *In concert with you*
>
> *In relation to **affairs of the business of the individual or company**.*

A couple of observations:

- It is clear that only a company and an individual can be an affiliate of a taxpayer. Any entity **can have** an affiliate but only an individual or company can **be** an affiliate.
- The affiliate test should only work one way – a person or company (A) is an affiliate of the "you" in the definition (B) then that does not mean that B will automatically be an affiliate of A. It is a one-way test.
- Spouses are not automatically affiliates, just because they are spouses. However, refer below at 2.2.4 for a discussion on the deemed affiliate rule.
- It should be clear that an individual or company can only be an affiliate if they carry on a business (whether alone or in partnership) as the definition requires the affiliate to have business affairs in which the "you in your" in the definition is involved.

However, in a 2022 PBR[1], the Commissioner found that siblings were affiliates of one another in relation to their role only as shareholders/directors of a trustee company, despite the fact that none of the siblings appear to carry on business (together or in partnership with the other siblings). In the PBR, the outcome was a positive one for the taxpayer as the issue appeared to assist the connection between each sibling that owned a property used by a joint discretionary trust (with a corporate trustee) that did not appear to be otherwise connected with each sibling, for the purposes of the active asset test. The Commissioner ruled that each sibling were affiliates of one another (with not much analysis) so that each of them was taken to control the trust under the control over trustee test (discussed below at 2.3.4).

Whilst it can be dangerous to cherry pick and extrapolate a PBR without knowing the full facts, it appears the Commissioner found an affiliate relationship despite none of the siblings carrying on any business but rather found the relationship because the siblings made decisions together as directors of the trustee company. I would submit that despite the positive outcome for that taxpayer it is not correct in light of the definition in Section 328-130.

In support of this position, I would point out that in the withdrawal notice of TD 2006/79 (dealt with former definition of CGT affiliate) the Commissioner stated at para 3 - "*In other words, an affiliate must carry on a business.*"

- The reference to a company in the definition is limited to a person or company in its own right and not in the capacity as trustee (Section 960-100(4)). On that basis, a Trust can never be an affiliate.
- The definition also makes it clear that a person or company is not your affiliate merely because of the nature of the business relationship you and the individual/company share. A common example is that partners in a partnership are not affiliates merely because one partner may act in accordance with the directions/wishes or in concert with the other partner in relation to the

[1] PBR 1051961337890 (full credit given to Josh Pascale from Cowell Clarke in his September 2024 paper 'The cutting edge of the small business CGT concessions', that identified this PBR).

affairs of the partnership. Likewise, a company would not (absent more facts) be an affiliate of one of its directors).

2.2.1 What does "in accordance with your directions/wishes" & "act in concert" mean?

The Explanatory Memorandum to the *Tax Laws Amendment (Small Business) Bill 2007* outlined several factors that will assist in determining whether a party is an affiliate of the taxpayer.

- Family and close personal relationships.
- Financial relationships or dependencies.
- The extent to which the entities consult with one another on business matters.
- The informality of the arrangements between the parties.

In Taxation Ruling TR 2002/6 (withdrawn), the Commissioner addressed the meaning of "in concert with" in the context of the former definition of STS affiliate, to include the following:

- Nature and extent of commercial dealings between the entities.
- Supplies of good and services between the entities that contribute to a large proportion their income.
- The use of common resources or services. The Ruling lists shares staff, premises, management and income producing assets.
- Involvement in managerial day to day management of the business.
- Financial interdependencies – reliance on loans/guarantees or even shared banking facilities.

As a matter of practice, the process for determining whether a person or company is an affiliate would be best described as:

- Determine the test entity (the subject entity) or the "you" in the definition of affiliate.
- Map out the people or companies in their group and identify which entities carry on a business. You can ignore other entities that conduct businesses.
- Review the role that that the test entity plays in the business carried on by each identified individual or company.

- Determine if the person or company in business acts in accordance with the test entity's directions or wishes.
- Determine if the person or company acts in concert with the test entity in relation to the business the individual or company carries on.

In most SME client (non-primary production) groups, the above process would not be onerous and after some level of discussions with the client the possibility of an affiliate relationship existing would be relatively evident. Consider the following example:

Example 1

Simon is a retired architect. His son, Will took over the practice from Simon 5 years ago. Will operates the practice through a company wholly owned by Will. Simon owns the building and leases it to Will for below market value rent. There is no formal lease in place. Upon enquiring with the Simon, you learn:

- Will's company has not paid rent for a few years due to business being a bit slow.
- There is no formal lease in place.
- Simon is heavily involved in helping Will manage his practice and Will habitually follows Simon's instructions/advice.
- Simon has lent Will's company some interest-free funds to assist fund the business.

It is likely that in light of the facts that Will's company will be an affiliate of Simon – we have the non-arms-length lease, rent arrears and interest free loan indicating "acting in concert" and evidence that the company acts in accordance with Simon's directions. That may be a positive for Simon in the context of the active asset test should he wish to sell the property in the future (refer Section 3 below).

The identification of an affiliate relationship can often be more challenging in cases where the business and related activities are being conducted by the wider family group. This is not uncommon in families who operate farming businesses where the broader family may also own and operate their own farming businesses (often in partnerships of parents/children/siblings). In many cases, these businesses operate with shared resources and are commonly not on arms-length terms.

2.2.2 What is the impact of having an affiliate?

In determining whether a taxpayer is able to access the small business CGT concessions then knowing if another person or company is their affiliate assists in the following:

- Whether an entity is connected with the taxpayer (refer 2.3 below).
- Possible inclusion of the net assets of the affiliate (and entities connected with the affiliate) for the purposes of the $6m net asset value test.

- Inclusion of the 'annual turnover' of the affiliate in the taxpayer's aggregated turnover calculation to determine if the taxpayer is a CGT small business entity.

2.2.3 What about spouses?

As noted above, spouses are not automatically affiliates of one another absent the normal rules applying (one spouse in in business and acts in accordance with directions/wishes or in concert with the other spouse).

This default position can allow some excellent planning opportunities where assets that may normally be included in the net asset value test being owned by a spouse who is deliberately kept separate from the activities of the other spouse.

Example 2

A recent example of this I encountered was a client group where the wife operated a number of successful businesses in a discretionary trust. The accountant had been careful to ensure that the husband could not be taken to be connected to the Trusts (no influence over trustee and not connected via distributions). In this case, the husband operated a farm on land he owned. The husband needed to rely on the aggregated turnover test and if his wife was an affiliate he would have been required to include the annual turnover of her business which would have caused the $2m threshold to be well and truly exceeded.

Under the Section 328-130 definition discussed above, the husband was the "you" and his wife did not carry on a business, so it was not possible for her to be his affiliate. As he was not otherwise connected to the entities that operated the businesses in the trust controlled by his wife they could be treated separately.

Through diligent planning and though the adviser was able to separate the activities and allow one of the spouses to access the concessions.

I would note that it is my experience that many advisers still automatically treat spouses as affiliates (or even connected entities) when that is often not the case which may cause the inclusion of assets/turnover in the respective tests that should not be included.

2.2.4 Deemed Affiliate Rule – Spouses and Children under 18

In 2009, Division 152 was amended to include a deeming rule which has the effect that a spouse and/or child under 18 is deemed to be your affiliate in certain circumstances (refer Section 152-47). This was supposedly meant to be a concession of the definition of affiliate. In fact, Section 152-47(4) specifically states:

'*To avoid doubt, subsection (2) applies:*

> *a) For the purposes of reducing or disregarding, under this Division, any capital gain from any asset…'*

The rationale for the deeming of an affiliate relationship between spouses when none existed under the actual definition of the term is best explained by the following example.

Where the rule deems a spouse to be affiliates it is the Commissioner's view that each spouse will be an affiliate of the other spouse (i.e. the rule works both ways between spouses)[2]. **The rule operates automatically, whether the taxpayer needs it or wants it.**

Example 3

Jay and Carly are spouses. Jay owns a legal practice in a company he wholly owns. With the objective of asset protection in mind the strata titled office in which the practice is located was purchased recently by Carly. The property is leased on arms-length terms. Carly is not involved in the legal practice, other than the input normally offered by a spouse. Jay does not generally take Carly's advice.

If we are looking at the small business concessions from Carly's perspective in relation to the property, we need to determine if the company is her affiliate. On the facts, it appears that the company is not her affiliate as she has no influence over its decision making and does not act in concert with the company. Jay is also not her affiliate as he does not conduct business in his own name.

Therefore, based on the definition of affiliate in Section 328-130 alone, we do not have any type of affiliate relationship and that would result in the premises not being an active asset.

With the above unfortunate outcome in mind, Section 152-47 was introduced which deems a spouse to be an affiliate of the other where:

- One entity owns an asset (whether intangible or tangible); and
- Either:
    - The asset is used, or held ready for use in the course of carrying on a business in a 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 owner is not an affiliate or of connected with the asset owner under the normal rules.

In applying Section 152-47 to Example 3 above. I have shown that Carly is not connected with the company and the company is not Carly's affiliate. The company is the business entity that uses the asset in its business and they would be connected if Jay and Carly were actually affiliates. The rule is therefore activated, and Jay is deemed to be Carly's spouse (and vice versa). That would lead to the

[22] ATO Advanced Guide to Small Business CGT concessions 2012-2013.

conclusion that the company is now connected with Carly (as it is owned by her affiliate, Jay) and the active asset test is satisfied.

Now that outcome may appear quite generous, but the kicker is in subsections (2) and (3) of the provision. These state that once the rule is activated then the spouse is an affiliate for all purposes of Division 152 and the provisions in Division 328 that deal with connected entities.

This means that the rule could result in the taxpayer having to include additional assets or turnover in their various calculations which would be ordinarily excluded. This negative outcome was specifically acknowledged in the Explanatory Memorandum to the Bill that introduced the deeming rule in 2009[3].

Therefore, it is essential in looking at a client group to determine if the deeming rule is triggered and if so, what additional consequences does that cause.

Example 4

Referring back to Example 2 above, if on the facts, the wife's trust hired some equipment to the husband for use in his business then the deeming rule would appear to be triggered. The rule would operate to generously allow the Trust and husband to be connected (through deeming the wife to be an affiliate). However, the consequence of wife being an affiliate would be to connect husband and the discretionary trust causing him to fail the aggregated turnover test. All because of the use of an asset in his business and the deemed affiliate status!

2.3 Connecting Entities

Once you have considered the affiliate test above you are now ready to consider who is connected with who. These rules are set out in Division 328 (specifically Section 328-125).

A few initial observations:

- Individuals can never be connected to one another – this because control needs to be in a legal form as shown below. A person can be connected to an entity (and vice versa) but two individuals can never be connected.
- <u>Unlike the affiliate rule</u>, the connected entity rule works both ways. If entity A is connected to entity B, then it naturally follows that entity B is connected to entity A. Connection is a two-way street.
- More often than not there will be multiple entities that are taken to control the same entity, or it is possible that an entity has no other entity or person that controls it.
- Connection can often flow through multiple entities in a chain or group. The indirect control rules work to connect entities down the chain to the ultimate controller as noted below.

[3] Refer para 2.38 of the EM to Tax Laws Amendment (2009 Measures No.2) Bill 2009.

- For the purposes of the net asset value test connection is a moment in time test. For the purposes of prior year annual turnover and active asset test then connection is an historical look at the connection in that relevant year. Therefore, the analysis of connection needs to occur through multiple lenses.
- Connection can be manufactured or prevented through diligent planning. Of course, inadvertent connections can be established that cause issues for the client that may result in some embarrassment or worse. Such is the lot of a tax adviser.

2.3.1 Basic Test

An entity is connected with another entity if:

- Either entity controls the other entity in the way described below; or
- Both entities are connected by the same third entity in the way described below.

Control can be direct (A controls B) or indirect (A controls B who in turn controls C – A will be taken to control both B and C).

I thought it helpful if I summarise the control methods for different types of entities in the following table rather than reproducing the legislation.

Entity	Control
Company	An entity (and its affiliates) has a right to 40% or more of dividends, distributions of capital or voting rights.
Unit Trust	An entity (and its affiliates) has a right to 40% or more of distributions of income <u>or</u> distributions of capital.
Partnership	An entity (and its affiliates) has a right to 40% or more of distributions of net income of the partnership.
Discretionary Trust	There are 2 control tests (refer below). They are applied <u>independently</u> of one another. **Test 1** – An entity controls a trust if the trustee acts, or could reasonably be expected to act, in accordance with the directions or wishes of the first entity (either alone or with its affiliates). This is often referred to as the "influence over trustee test". **Test 2** – An entity controls a trust if in any of the 4 years immediately <u>prior</u> years the entity (either alone

	or together with its affiliates) received a distribution of 40% of either income or capital from the trust. This is often referred to as the "distribution test".

The Commissioner has discretion to make a determination that one entity does not control another entity is when an entity has a control % in the above table of between 40% and less than 50% where the Commissioner considers that one or other entities actually control the entity.

In TD 2023/5 the Commissioner set out its views on how the above discretion will be applied. As a general rule, the discretion will only be applied where there is a single controlling mind that controls the entity rather than the entity with a control percentage of between 40% and 50%. An example would be where a shareholder holds 45% of the shares of a company but there is a single shareholder that holds the remaining 55% and who has actual control. In that case, and absent other facts the Commissioner should exercise the discretion to treat the 45% shareholder as not connected to the company.

2.3.2 Why is a connected entity relevant?

Determining whether one entity is connected to another is necessary for three different basic conditions for the small business concessions. They are:

- Which entities assets are included in a taxpayer's $6m net asset value test (moment in time).
- Which entities annual turnover is included in the taxpayer's aggregated turnover test (as determined for the previous or current year turnover).
- In determining in an asset is used by a connected entity for the purpose of the active asset test (over the ownership period of the asset).

Therefore, establishing connection can be helpful where the active asset test is concerned or troublesome for the net asset/aggregated turnover tests.

For the purpose of the net asset value test, connection will be a moment in time analysis (being the time of the CGT event) whereas for the active asset test where the test is applied over the ownership period of the asset that a historical analysis of connections is needed.

2.3.3 Discretionary Trust Connection – Distribution Tips

As noted in the above table, there are two tests that establish connection to a discretionary trust, namely the distribution test and the influence over trustee test.

As far as the distributions test is concerned it is important to note that connection is only established where a person/entity (or their affiliates) receive a distribution of capital or income of 40% in any of the prior 4 years prior to the year the test is being considered. Importantly, connection is not established for the actual year of the distribution but only the 4 following years. Also, that means that to establish connection over a period of time to ensure an asset is active only requires a sufficient income distribution every 4 years.

Depending in the historical pattern of distributions by a discretionary trust it is very possible that multiple individuals may control a trust under this test. All that is required is for that person to receive 40% of income or capital distributions in <u>any</u> of the previous 4 income years, <u>before</u> the CGT event or relevant year where connection is being determined. For many of our SME clients this does not pose much of a practical difference as it is likely that control will rest with Dad and Mum client or children in some cases.

If you were keen to separate spouses sufficiently so that you can exclude their respective net assets, connected entities or turnover from the other spouses calculation the management of distributions would be key. This is illustrated in the below examples:

Example 5

Brad and Vanessa are married. Each has their own business in their own discretionary trusts. Each Trust has a turnover of just below $2m. Neither have any input into the other's business.

You have ensured that Brad controls his trustee company and Vanessa controls her trustee company as you want to ensure that their respective turnovers are not aggregated for the purposes of the $2m aggregated turnover test.

To ensure that goal is maintained you will need to ensure that each Trust never distributes 40% of income/capital to the spouse that does not control that trust (or better yet not distribute to the other spouse at all).

Say you then you want to consider using a corporate beneficiary you will need to maintain the mantra of one corporate beneficiary for Brad and one for Vanessa. Neither should have an interest in the other company.

Separation can occur if planned carefully.

Example 6

Following on from Example 5, because of your wonderful planning Vanessa from above sells her business and avails herself to the small business concessions. It is now 5-years later and Vanessa has used the funds from the sale to acquire an investment property in Byron Bay worth $4m (debt free).

Brad's business now has a turnover exceeding $2m so any he will only be able to access the small business concessions through the $6m test. He estimates his business to be worth $3m (net).

Now – if Brad's trust has to include Vanessa's assets in its $6m calculation Brad will fail the test. Unfortunately, in 2023 you distributed 50% of the income to Vanessa due to her low taxable income. Brad's trust needs to wait out the 4-year period (2024 to 2027 years of income) to become **disconnected** from Vanessa. That sale cannot occur until at least 1 July 2027 to ensure Vanessa's assets are not included.

Distributions can be consequential and at times the annual tax objectives can cause unintended outcomes!

An example of strategic planning for connection is below.

Example 7

Brian and Lois are siblings. In 2018, they inherited a commercial office building from their father. Since that time Brian has operated his legal practice from the office. Brian's practice is conducted through a discretionary trust. Lois has no involvement in Brian's practice or the decisions of the trustee.

Lois has asked if Brian's use of the property since 2018 will allow her access to the small business concessions.

Lois has no connection to Brian's trust through the influence over trustee test. Brian is naturally reluctant to make any income distributions to Lois (despite her being an eligible beneficiary of the trust).

How to establish a connection that will enable Lois to pass the active asset test?

If Brian's Trust made a capital distribution to Lois every 4 years (even if $1) then provided that is the only capital distribution made by the Trust in that year Lois will be taken to control the trust in the 4 years after the distribution (but not the year of the distribution itself). All Lois will need is to be connected for 8 years and the property will be active from then on.

2.3.4 Discretionary Trust – 'Influence over trustee' test tips

Unlike the distributions test, which is a black/white test, the influence or control over trustee test is less so. This test requires an examination of who "runs the show" when it comes to the affairs of the trust.

You may recall prior to the decision in *Gutteridge* in 2013 the ATO had a published view that the appointor of the trust would be the person who had control/influence over a trustee due to the fact that the person who held that power could use it to influence the trustee in its decision making of the trust. In that decision the AAT looked to the person who was actually in control notwithstanding the fact the person did not hold any formal role in the Trustee company.

The AAT described the test as:

'20. The controller test s 328-125(3) has parallels with the definition of director in the Corporations Act 2001 (C'th). That text was effectively considered in Buzzle Operations Pty Ltd (In Liq) v Apple Computer Australia Pty Ltd. The following principles can be derived from the discussion of the scope of the words accustomed to act in accordance with wishes limb in that definition:

10. *treating another person's instructions or wishes as a sufficient reason so to act, rather than making personal decisions where those wishes or instructions are merely a factor considered, meets the test of being accustomed so to act;*

12. *it is not necessary that the behaviour be universal, at least some decisions, one or more important decisions, would be enough, some or all decision making is the focus;*

13. *decisions made in pursuit of one's own business goals even, if consistent with the wishes of another party, do not necessarily render the decision maker accustomed to acting in accordance with the other party's wishes. The other party may have superior bargaining power;*

14. *while not significantly different, acting in accordance with a person's wishes covers a wider field than acting in accordance with a person's instructions; and*

15. *it is necessary to undertake a critical assessment of the way in which the trustee is managed.*

These principles can be applied in the present context as a reasonable expectation to act in the prescribed way can be formed if a person is accustomed to act in that way.

It is really a matter of who makes the decisions (or influences those decisions). In many cases, this person or people will be the client who also controls the trust under the distribution test. However, I would note the following tips regarding this test:

- An individual trustee would ordinarily be in a position to make their own decisions so any individual trustee will be taken to control the trust under this test. This will occur regardless of the number of other trustees, as the definition refers to "a trustee" and not "the" trustee.
- Where an individual is the sole shareholder and director of a trustee company it would be ordinary to expect that the person would be taken to control the trustee, under this test.
- Where 2 persons are both directors and 50/50 shareholders in the trustee company it may be that neither of them control the trust under this test but that will be fact dependant and a deeper analysis of the decision-making may be required.
- Unlike the affiliate definition above, this test looks to 'wishes' and not 'instructions which is a lower hurdle to satisfy.
- Formal roles are important, but not the sole factor in this test.

If you are keen to access the concessions, then careful consideration should be given to who takes on the formal roles in the trustee company or acts as trustee if an individual. If you want to keep spouses separated, then as noted above, then you should ensure that the 'quarantined' spouse is kept well away from formal and informal decision making of the trust.

3. Active Asset – Risk Areas

3.1 What is the test?

The premise of Division 152 is that a concessional outcome should be available when a taxpayer makes a gain on an asset used in a business (that the taxpayer or a connected entity/affiliate) carries on.

Therefore, the active asset test must be satisfied by every taxpayer looking to access Division 152.

The active asset test involves two steps[4]:

1) Analyse over the ownership period of the asset when it was used in a business by the taxpayer/entities connected to the taxpayer or an affiliate of the taxpayer in a business that they carry on; and

2) Is the period in 1) above is greater than either:

    a. 7.5 years; or

    b. 50% of the ownership period.

One outcome of the test is the oft cited maxim "Once an asset has been used as an active asset for 7.5 years it will always be active.

3.2 Ownership period

It is important to note the ownership period that is to be applied to the active asset test begins when the taxpayer 'acquires' the asset and ends when the CGT event occurs.

Acquire in this context is a defined term and falls back on the definition of acquire in Division 109. In short, the date the asset is acquired when it is acquired under a contract is the date of that contract and not settlement of that contract.

Therefore, extreme care should be taken when a client disposes of an asset and the active use is close to 50% - you need to ensure that the calculation uses the acquisition contract date and not settlement. This is often overlooked.

Where this could cause your client issues would be where an asset is acquired with a longer than average settlement. Getting your dates right is crucial.

[4] Sections 152-40 and 152-35 together.

3.3 Active use

Section 152-40 sets out when an asset will be active.

As noted above, the asset must be used or held ready for use in the business carried on by the taxpayer, its connected entities or its affiliates. Where the asset is an intangible asset, the taxpayer must be inherently connected with the business in which it is used.

There are a number of specific exclusions where a particular asset cannot be an active asset. These are:

1) Shares in a company and interests in a Trust that don’t satisfy the modified active asset test in Section 152-40(3) to (3B).
2) Financial instruments (loans, debentures, bonds, promissory notes etc.)
3) An asset whose **main** use is to derive interest, rent or royalties.

When looking at the ‘main use’ of an asset the asset owner can:

1) Disregard any personal use or enjoyment of the asset by the asset owner; and
2) Treat any use by your affiliate or an entity connected with you, as your use

When a taxpayer owns an asset that is used by a connected entity/affiliate care then the following example illustrates how the test applies.

Example 8

Dominic is an architect who practices in his own company that he wholly owns. He also owns his business premises in a discretionary trust that he controls (and is connected to). The Company pays $100,000 in rent to the Trust which is the arms-length rental amount. The company is the sole tenant.

Technically, from the Trust’s perspective the property’s use is to derive rent and that would result in the premises not being an active asset. However, Section 152-40(4A) allows the trust to treat the use of the premises by the company as its own use. Given that the company uses the premises to operate its business the rental use is overridden by the company’s business use.

3.4 Used in business

The most important decision to date on the use of an asset and whether it was active is the Full Federal Court decision in *Eichmann*[5].

In short, a Trust controlled by Mr Eichmann operated a bricklaying and paving business. Mr Eichmann and his wife acquired a block of vacant land adjacent to their main residence. The land was approximately 660m2 in area.

Mr Eichmann installed 2 sheds on the land, each with an area of 12m2 which were used as storage for tools, equipment and materials. The sheds were accessed every workday (often multiple times on the same day) by the Trust. The ATO considered that the land was not an active asset on the basis as its use was merely incidental to the Trust's business. The Federal Court found for the Commissioner and considered the use of the sheds as preparatory to the bricklaying and paving business (which took place at the various building sites).

This was a common sense and welcome decision.

3.5 Extent of use

Another interesting decision that considered how much of the asset (land in this case) needs to be used for an active purpose for the whole asset to be considered active, was *Rus*.

In Rus, the taxpayer owned a property with an area of approximately 16 hectares. The property contained the taxpayers' home and another private dwelling (for private use). The area of the private structures was 1.6 hectares. Near the boundary of the property there was a shed (with dimensions of 24m x 8m) and 2 shipping containers. The shed and shipping containers were used as an office and storage for a business carried on by a company controlled by the taxpayer. Overall, only 10% of the property was used in the company's business.

The balance of the land was vacant and had no relevant use for the business.

The AAT held that the use of the 10% of the property by not sufficient to result in the land being an active asset. The AAT noted that:

> *'At its highest, the company used part of the structures which had been constructed on the land (namely the shed, containers, the room used as a home office and the room containing the dining table used as a conference table). In these circumstances, we do not conclude that the parcel of land comprising the CGT asset was used in carrying on the company's business.'*

The writer has been involved in two PBR applications for farming properties where crops were grown on a large property but over a relatively small area (when compared to the entire property). In both cases, it was necessary to show that the crops were being grown on as much of the property that was suitable for such use, with the balance of the land remaining vacant. The fact that the balance of the land was vacant was acceptable to the ATO and the land was considered active.

[5] *Eichmann v FCT* [2020] FCAFC 155.

The key for a client scenario similar to the above is to ensure that a material area of the property is used in the business and secondly, that use must be more than incidental.

3.6 Part rental use

The use of the term 'main use' in Section 152-40(4)(e) can be troublesome where a property is used both in the business of the taxpayer and also to derive rent from unrelated parties.

In TD 2006/78, the Commissioner stated that the 'main use' analysis for an asset that is used partly for business and partly for rental use requires 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.

The TD contains the "famous" Mick example in Example 5. I say famous as it is commonly quoted in part rental use cases.

I have reproduced the example below:

> ***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 motorcycle repair business. He leases the other sheds (55% of the land by area) to unrelated third parties. The income derived from the motorcycle repair business is 80% of the total income (business plus rentals) derived from the use of the land and buildings*.
>
> 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*.

Conveniently, the area used in the business was quite high (45% of the floor area) and despite less than half the property used in the business the business income derived saved the day. What is less clear is where the area leased to derive rent from unrelated parties was (say) 80% and only 10% of the property was used in the business. You may recall 90% of the property was vacant land not used in business caused the property to not qualify as an active asset in *Rus* – but if the business income was significant compared to the rental income, which of the calculations is more influential? I note that in PBR 1051595599979 the Commissioner referred to an area used in the business as '2X%' (full number omitted by ATO) as 'quite low' and commented that the comparative income test would be a more important factor.

Whilst the Mick example is helpful there is some doubt on how the logic applied in it may be used where the property is owned by a different entity than the entity that conducts the business.

If we vary Mick's example slightly to have Mick own the property but his Family Trust conduct business from it with an arms-length lease. The Trust is connected to Mick.

As noted above, when determining the 'main use' of an asset Section 152-40(4A) allows the use by a connected entity/affiliate of the asset as your use. Let's apply this to Mick.

Comparative Area

We are allowed to treat the 45% floor area used by the Trust in its business as Mick's use consistent with the analysis in TD 2006/78.

Comparative income

There are two different approaches here. Both have been applied in PBR's issued by the ATO.

In approach 1, Mick can use the business income derived by the Trust as his notional income in calculating the total income generated by the property. That would essentially mirror the analysis in TD 2006/78. In that case, Mick would bring in the business turnover derived by the Trust and compare it to his external rental income – job done.

This approach has been applied in multiple PBR's[6]. Relevantly, in PBR 105200669773 the Commissioner noted:

> *'As the property **was used by an affiliate of yours to carry on a business**, but was also used partly to derive rental income, it must be considered whether the property's main use was to derive rent.*
>
> *For the whole time the property was owned, 45% of the space was occupied by Company A to carry on the business. This business had a turnover of more than $XXXX per year. The other 55% of the space was rented to an unrelated third party, which brought in less than $XXX of rent per year. It can be seen that **a substantial amount** (although not the majority) of the property was used to carry on the business, and this proportion of the property derives the vast majority of the total income. This leads to the conclusion that the main use of the property was not to derive rent and accordingly, the property is not excluded from being an active asset under paragraph 152-40(4)(e) of the ITAA 1997.*
>
> *Therefore, the property is an active asset under section 152-40 of the ITAA 1997. Consequently, the property also satisfies the active asset test in subsection 152-35(1) because it was an active asset for more than half the period of ownership.'*

The result of Approach 1 is the same outcome as if Mick operated the business himself as was the case in the TD.

However, in a 2019 PBR[7] the ATO applied what I will refer to as Approach 2. In the PBR, the Commissioner referred back to the 2009 amendments that included the introduction of Section 152-

[6] Refer to PBR 1012844404240 and 1052006692773 for examples.

[7] Refer PBR 1051595599979.

40(4A) to the active asset test Explanatory Memorandum (which post-date TD 2006/78) as support the contention that when applying the comparative income approach to our scenario, Mick cannot include the gross business income from his Trust but instead must include only the rent paid to him by the Trust and compare that to the rent from the unrelated parties to determine main use. I have reproduced an excerpt from the PBR below with emphasis added to key phrases:

> *'To the extent we are applying the Mick example to this case, we are looking at the Trust's income earned in relation to its activities, being the leasing of the Property to both Company XYZ and the external tenants.* ***While the use of the Property by Company XYZ is viewed as the Trust's use of the Property, the percentage of the Trust's rental income earned from Company XYZ is not the majority of income earned by the Trust from the Property.***
>
> *The main point is that the* ***Mick example only considers the income earned by the owner of the property from the property. The gross business income is included because Mick carried on the business. The Kiki example from the EM considers the matter where it is an affiliate that conducts the business from the property. Both examples are consistent in only using the income earned by the owner of the property.***
>
> *The income earned by Company XYZ in relation to its business activities has been provided to support that the majority of the income received in relation to the Property was not received from the rental of the Property.* ***However, Company XYZ's business income is not the income that is taken into consideration when determining the comparative income levels. It is the Trust's income earned in relation to the Property from all sources that is taken into consideration as supported in TD 2006/78 and the EM.'***

In the EM, an example was included that confirms that the above approach is consistent with the manner in which the ATO would apply the attribution of a connected entity's use of the asset. The example looks to the rental income from both the connected entity and the unrelated parties and treats the rental income from the connected entities as 'business use'.

'*Example 2.12*

> *Further to Example 2.8: The amendments ensure that the determination of the main use of Kiki's property takes into account the 90 per cent rental use to Lost Dog Pty Ltd, which neither is Kiki's affiliate nor is connected with her.*
>
> *The amendments treat Beaglehole Pty Ltd's use of that part of the property rented to it as Kiki's use because Beaglehole Pty Ltd is connected with Kiki. Because Beaglehole Pty Ltd uses that part of the property as its business premises, Kiki is treated as using that part as business premises.* ***This means that the rent Beaglehole Pty Ltd pays to Kiki is not treated as rent for the purposes of determining Kiki's main use of the property.***
>
> ***Kiki's main use of the property is to derive rent, because 90 per cent of the revenue she derives from the property is rent received from Lost Dog Pty Ltd.***
>
> *Therefore, Kiki's property is not an active asset in these circumstances for the purpose of section 152-40 in its proposed new form.'*

The key difference is the interpretation of the attribution approach in Section 152-40(4A) between the PBR's is how far does the attribution extend?

It is more likely that Approach 2 is correct in light of the fact that the Mick example in TD 2006/78 pre-dates the introduction of Section 152-40(4A) and its attribution approach. It appears that within the ATO there is a difference in approach.

I have a matter in which the difference between applying the respective approaches means the difference in whether the property will qualify as an active asset. Advice had previously been given that the Mick example would result in active asset status. I have informed the client of a differing view and also the fact that the example in the EM does support that approach. Perhaps a PBR is necessary?

3.7 The "forever" active asset problem

As noted above, once an asset has been put to an active purpose for 7.5 years then that asset will retain that status for as long as that asset is owned (or the law changes).

I recently encountered this scenario, and I imagine it is not an uncommon one. This is best illustrated by the following example.

Example 9

John has a discretionary trust he controls. For the past 12 years he has operated a business in the Trust. Approximately 9 years ago, his Trust also acquired the business premises out of which the Trust operates its business. There is no rental income from unrelated parties.

In 2024, the Trust sold its business and qualified for the small business CGT concessions because the Trust was an SBE with aggregated turnover less than $2m. John would not have satisfied the $6m net asset value test. When he was selling the business John raises the possibility of retaining the property as an investment leasing it back to the purchaser, but he has had other offers for the building – he is not sure which way to go.

You tell him that as the premises was used by the Trust for 9 years the active test is satisfied so the concessions will always be available to him in the future. On that advice, he decides to retain the building.

Fast forward 3 years to 2027 – John wishes to sell the building and utilise the small business CGT concessions. You look into it and realise that as John or his Trust no longer conduct a business, he cannot access the concessions, using the SBE pathway. He must satisfy the $6m net asset value test which he is unable to do. The concessions are not available.

Had the premises been sold in the same year as the business was sold the SBE pathway was available for both assets.

This scenario is a reminder that active asset status is just part of the analysis of applying the small business CGT concessions.

4. Selling Shares

The application of the concessions to a business asset is at times complicated enough. The level of complexity really picks up when your client is looking to sell shares.

The additional basic conditions (refer Section 152-10(2) that apply to the sale of shares that can cause problems for practitioners are:

- For individual shareholders – the CGT concession stakeholder condition.
- For non-individual shareholders – the CGT concession stakeholder test (looking through the shareholding entity) and the 90% test.
- The shares must satisfy the modified active asset test – often referred to as the 80% test.
- The company in which the shares are being sold (the object company) must also satisfy a modified $6m net asset test or modified aggregated turnover test.

It is beyond the scope of this paper to analyse each of the above in any detail. For a wonderful analysis I recommend Linda Tapiolas' paper from March 2024, 'The cutting edge of small business CGT concessions – planning and traps'. I will focus on the common pitfalls of the above tests in practice.

4.1 Division 7A loans and the 80% test

Section 152-40(3) provides that a share can be an active asset (at a given time) if the total market value of:

1) active assets of the company; and
2) financial instruments inherently connected with the business of the company; and
3) cash held by the company that is inherently connected with such a business.

Is more than 80% of the value of **all** of the assets in the company.

This measure is an integrity measure to ensure that companies (and Unit trusts) are not stuffed with non-business assets and the shares are treated as active assets.

It is very likely that a loan to a shareholder (subject to Division 7A) or any related company would not qualify as an active asset of the company. It would be quite difficult to show that the loan (as a financial instrument) would be inherently connected to the business of the company. If that is the case the loan balance may cause issues is satisfying the 80% test.

When a client is looking to sell shares, it will be necessary to look at the 80% test historically over the period of ownership. You will be required to show that for 50% of that time (or 7.5 years) that the company was able to pass the 80% test. Of course, because the analysis requires an assessment of market value of the assets then some thought will need to be given to the goodwill valuations for those historical years.

As a practical tip – I look at the balance sheets for the ownership period and determine whether the 80% test is satisfied on a tangible asset basis only. If the 80% test is satisfied, then the historical valuation of intangible assets is of no further benefit and not necessary. However, if the loans exceed 20% of the tangible asset value for more than 50% of the time the shares have been owned then it is time (and worthwhile) to bring the intangible assets such as goodwill into the calculation.

One word of warning! We all have clients who despite our cautions, take loans from their companies throughout the year and then have those loans 'magically' repaid prior to 30 June only to then re-borrow those amounts in July. That would mean that an historical analysis of 30 June financial statements would not necessarily show the loan, but it does not mean they were not in play for 350+ days of each year. Some further digging as the test is not just a 30 June test, but an ongoing time test. If this particular issue was to emerge in an ATO review of the small business concessions that would likely lead to an adverse outcome for everyone.

4.2 Non-standard share rights

Whenever I am approached to assist with a small business concession matter that involves a share sale, the first thing I ask for is an ASIC search of the shares on issue. On too many occasions it is quickly evident that there is a problem with the significant individual test because the company does not have a CGT concession stakeholder.

As noted above, there are additional basic conditions when a share is being sold. The main threshold condition is the shareholder must be a CGT concession stakeholder at the time of the CGT event.

A CGT concession stakeholder is the significant individual of the company and that person's spouse (but only where the spouse has an interest in the company that results in them having a small business participation percentage of greater than nil%.

A significant stakeholder is an individual (only a person can qualify) that has a **small business participation percentage ("SBPP") of at least 20%,** at a particular time.

An SBPP is dealt with in Sections 152-65 to 152-75.

In short, the SBPP is the total of the direct and indirect SBPP's that individual has in the company. An entity's direct SBPP in a company is worked out as the percentage calculated in the table in Section 152-70 as:

An entity's *direct* small business participation percentage		
	In this entity:	**Is:**
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; or, if they are different, the smaller or smallest.

In practical terms, you need to be able to show that the relevant shareholder holds shares that gives them rights to at least 20% of voting power, any capital distribution **may** make and any dividend the company **may** pay.

It is important to note that in applying the table above only non-redeemable shares are counted. To put it another way shares that are redeemable are ignored for this particular purpose[8]. That creates a particular planning opportunity (discussed below).

The issue of dividend only (or access) shares has been well traversed. Where a company has non-redeemable 'dividend only' shares held by shareholder A to the exclusion of shareholder B then B will not qualify as a CGT concession stakeholder as they hold 0% of rights of any dividend that the company may pay.

[8] Confirmed in TD 2006/77.

In 2015, the Full Federal Court in the *Devuba* decision confirmed that for the purposes of the SBPP calculation only the rights that exist at the time of the CGT event are relevant. Famously, in Devuba, the offending dividend access shares could not receive a dividend until the Directors of the company resolved that the share had the right to be paid a dividend. In other words, the dividend rights had to be 'switched on' before those rights could be recognised in the SBPP calculation. Provided that 'switch' was in the 'off' position at the time of the event then the dividend access shares did not distort the dividend rights component of the SBPP calculation.

Therefore, if you have a client where dividend only shares were necessary you should consider either:

- Have those shares redeemable so the rights attaching to them may be ignored; or
- Use a 'Devuba' style dividend only share with a carefully designed Constitution.

On many occasions, after the abovementioned ASIC search has been done it is clear that the company has plain vanilla dividend only shares on issue. For example, it is not uncommon for a company to have the following shareholders:

Shareholder	Share Class
Dad	1 Ordinary share 1 'A' class share (dividend only share)
Mum	1 Ordinary share 1 'B' class share (dividend only share)

In the above, the company could pay a dividend to the A class to the exclusion of the other shareholders or the B class to that same exclusion. Therefore, on that basis Dad and Mum will both have an SBPP of nil% (being the smallest of the voting, dividend or capital rights either of them hold).

What to do!

Where the above problem is discovered with sufficient time then it would be prudent to buy-back or cancel the dividend only shares. Alternatively, it might be easier to issue a 'B' share to dad and an 'A' share to mum to ensure that both of them hold 50% of every class of share on issue.

Either of the above strategies may be looked at by the ATO in the prism of Part IVA, if those actions are occurring imminently prior to a CGT event in respect of the shares. It would be best that these potential problems are identified earlier than later (or not at all).

Some years ago, I had a matter where the company was incorporated in the 1970's. The shareholder who was exiting acquired their shares well after 1985 and was looking to exit through a share sale. When the share register was examined, it was noted that one of the original shareholders had a cumulative preference share that entitled the holder to preference to dividends to ensure he earned a

7% return on the paid-up amount of the shares. His investment was $10,000. The way the rights worked was that he had a preferred position in relation to any dividend the company paid up to the cumulative interest that was accruing on his $10,000 investment. After that, he had no further rights to dividends which would then all go to the ordinary shareholders in the usual way.

In calculating the SBPP for the purposes of the 15-year exemption, it was concluded that as the company could pay a dividend to the holder of the cumulative preference share (capped of course to the cumulative return) to the exclusion of the ordinary shareholders. As a result, the ordinary shareholders did not have an SBPP, as the rights they held to <u>any dividend the company may pay</u> was Nil%.

The lesson is every client who trades through a company and who may one day potentially qualify for the small business concessions should have their shareholding reviewed and shares with problematic rights be dealt with well ahead of time. Fixing the rights, a month before the sale involves a significant element of risk.

4.3 90% test

The 90% test is a confusing extra condition imposed when an entity (not an individual) sells shares or units. The confusion comes from the fact that the test combines some concepts from different levels in the ownership chain. I will try to demystify the test.

The test is located in Section 152-10(2)(d)(ii). It is stated simply as:

> *'(d) just before the CGT event, either:*
>
> *(i) you are a * CGT concession stakeholder in the object entity; or*
>
> *(ii) CGT concession stakeholders in the object entity together have a * small business participation percentage in you of at least 90%.'*

Subparagraph i) relates to an individual shareholder as only an individual can be a CGT concession stakeholder. The 90% test comes into play when the vendor of the shares or units is itself another entity.

The test is a two-fold test best explained by reference to who the players being referred to are:

- **Object entity** – the company or trust in which the shares/units are being sold
- **You** – the entity selling the shares and seeking to apply the small business concessions.

The selling entity must ensure that individuals that qualify as CGT concession stakeholders in the object entity have a SBPP in the selling entity of at least 90% at the time of the CGT event. It is important to note that for a discretionary trust a distribution at 30 June in a year will establish the SBPP for the whole year so there is no need to undertake interim distributions before the relevant CGT event.

The first step is ensure that you can identify an individual who qualifies as a CGT concession stakeholder in the object entity. Without that first step you are in the dark.

As noted above, a person is a CGT concession stakeholder in an entity where they have an SBPP of at least 20%.

Consider the following common scenario.

Example 10

The Kohli Family Trust owns 50% of Santoz Trading Pty Limited. It is selling its shares for a substantial capital gain in the 2025 year of income.

The controllers of the Trust are Virat and his wife Jiya. You are looking at preparing the 2025 year. You propose the income will be distributed in the following percentages:

Virat –	25%
Jiya –	35%
Sami (Child over 18) -	20%
Aditi (Child over 18) -	20%

On the above basis none of them will qualify as CGT concession stakeholders as none of them will have an SBPP in Santoz Trading Pty Limited of 20% (Jiya's SBPP is 35% x 50% or 17.5%).

You realise you need to increase Virat and Jiya to above 40% to establish them as CGT concession stakeholders to you <u>adjust</u> your proposed distributions to below:

Virat –	40%
Jiya –	40%
Sami (Child) -	10%
Aditi (Child) -	10%

On the basis of the above Virat and Jiya will both be CGT concession stakeholders of Santoz Trading as they both will have an SBPP in Santoz Trading of 20% (being 40% x 50%).

However, this is where the second element of the test is failed as between the only CGT concession stakeholders in Santoz Trading they have a combined SBPP in the Trust of only 80%. Back to the drawing board. You propose a <u>third</u> version:

Virat –	45%
Jiya –	45%
Sami (Child) -	5%

Aditi (Child) - 5%

Both Virat and Jiya remain as CGT concession stakeholders (SBPP in Santoz Trading of at least 20%) and combined they have an SBPP in the Trust of 90%. The test is satisfied.

The 90% test can be more precarious when the entity selling the shares/units holds a lower % than 50%. Recently, I assisted a unitholder exit a unit trust. Her Discretionary Trust owned 20% of the units and all other conditions for the small business concessions were satisfied.

We had to ensure that in the CGT event year that the individual had to receive 100% of that year's distribution or else she would not have satisfied the 90% test as there would not have been any CGT concession stakeholders in the Unit Trust receiving distributions from the selling trust.

The method of the test (whilst circular in logic) requires:

1) Distribute sufficient to make individuals CGT concession stakeholders;
2) Then increase the combined distributions to the stakeholders in 1) to no less than 90%.

5. SBPP and Discretionary Trusts

Following on from the discussion above it is worthwhile to consider the issues that should be considered in working out an SBPP for a discretionary trust.

An SBPP is relevant for a trust in determining if it has a CGT concession stakeholder for the following purposes:

- Trust claiming the 15-year exemption – as the trust needs a significant individual for at least 15-years the asset in question was owned (historical) and the trust needs a significant individual in the year of the sale who is 55 (and retiring).
- For a trust to claim the retirement concession the trust must pass the significant individual test just before the CGT event.
- For the retirement concession for a trust the individual to which the concession is claimed must be a CGT concession stakeholder.
- Satisfying the 90% stakeholder test when a trust sells shares in a company.

Similarly to companies, an individual is a significant individual where that person has an SBPP in the Trust of at least 20%. Relevantly, the table in Section 152-70 states:

3	A trust (where entities do not have entitlements to all the income and capital of the trust)	This percentage: (a) if the trustee makes distributions of income during the income year (the ***relevant year***) in which that time occurs--the percentage of the distributions to which the entity was beneficially entitled; or (b) if the trustee makes distributions of capital during the relevant year--the percentage of the distributions to which the entity was beneficially entitled; or, if 2 different percentages are applicable, the smaller.

Again, using the same process as calculating the SBPP for a company the provision looks to the **lesser** % of the income or capital distributions made during the relevant year.

Where a discretionary trust does not make a distribution of income or capital and does not have net income for that year then when applying the above table, no individual will have an SBPP. However, to alleviate that issue for loss trusts Section 152-70(4) substitutes the distributions of income and capital made in the CGT year for those loss years. Where the trust is in losses in the year of the CGT event and does not make a distribution of income or capital then Section 152-70 looks to the distributions made in the most recent year prior to the CGT event year.

Generally, most client discretionary trusts that operate a business have positive net income in the year of the CGT event. I will focus on traps for getting your sale year distributions correct.

Example 11

The Michael Scott Family Trust owns 100% of the shares in Michael Scott Paper Company Pty Limited which operates a paper and stationary business. Michael rings you to let you know that they have signed a contract to sell the shares which will settle on 30 June 2025. There will be a gain of approximately $1,000,000.

The trust is eligible for the small business concessions.

You do some tax planning for the year and see that it is estimated that the Trust will have a net income for tax purposes (and Deed income purposes) of $750,000 (dividends declared earlier in the sale year). The client has traditionally used a corporate beneficiary, Dunder Mifflin Pty Limited (owned 50/50 by Michael and his wife Pam).

Michael and Pam are only 42 and do not wish to contribute into superannuation or use the replacement asset rollover. The net capital gain will therefore be $250,000 (after CGT discount and active asset).

You decide after reviewing the deed that you wish to stream the net capital gain to Michael and Pam on a 50/50 basis. Having done streaming before you ensure to make them specifically entitled to the gross gain (total financial benefits from the gain). The Deed is has a Section 95 clause to define income.

In preparing your June 2025 resolution you:

- Make Michael and Pam specifically entitled to the net gain on a 50/50 basis as an income distribution- $125,000 each.
- Make Dunder Mifflin Pty Limited presently entitled to the net income excluding the net capital gain of $750,000
- Make an interim distribution of capital representing the non-assessable components of the gain (from trust corpus) to Michael and Pam on a 50/50 basis - $750,000

This can be illustrated below:

Beneficiary	**Income**	**Capital**
Dunder Mifflin	$750,000	$-
Michael	$125,000 (net capital gain)	$375,000 (non-assessable)
Pam	$125,000 (net capital gain)	$375,000 (non-assessable)
Total	**$1,000,000**	**$750,000**

You are pretty proud of this outcome and feel happy that all boxes are ticked. You are happy that everything flows through to Michael and Pam on a 50/50 basis so each of them will be a CGT concessional stakeholder in the Michael Scott Paper Company Pty Limited and the trust will therefore satisfy the 90% test (as CGT concession stakeholders in the company will have a combined SBBB in the Trust of at least 90%).

You get to preparing year-end and start to double check the SBPP held by Michael and Pam and you get the following:

Michael and Pam

Direct SBPP

- Received a distribution of income of $125k/$1,000k – 12.5%
- Received a capital distribution of $375k/$750k – 50%

Indirect SBPP

- Dunder Mifflin Pty Limited's Direct SBPP is calculated as the lower of income or capital distributions. As it did not receive a capital distribution it has a direct SBPP of Nil%.
- Michael/Pam have a direct SBPP in Dunder Mifflin Pty Limited of 50% each.
- Multiply 0% x 50% = **0%**.

Therefore, Michael and Pam have no indirect SBPP into the Trust through Dunder Mifflin Pty Limited because the company did not receive a capital distribution. They can only rely on the direct SBPP which is the lower of 12.5% or 50% each – therefore, it is 12.5% each.

Neither of them is a CGT concession stakeholder in the company. The concessions are not available to the share sale.

Extreme care should be taken in the year of sale and concentrating on the distributions to avoid the above. To avoid the stress and complexity of the above consider the following strategy.

Example 12

Still with Michael. Michael tells you before 30 June 2025 that he wants the trust to defer the gain using the replacement asset rollover.

You now have no net capital gain to deal with from a taxable income perspective. You only need to distribute the income prior to 30 June. You should not make any distributions of capital prior to 30 June 2025.

Even if you then distributed the entire income of the trust to Dunder Mifflin Pty Limited Michael and Pam would still have an SBPP, as there is only the income distribution to consider in the SBPP calculation. As Michael and Pam have an SBPP in Dunder Mifflin Pty Limited of 50% each that will mean that their SBPP into the Trust will also be 50% each. Both are CGT concession stakeholders', and the Trust satisfies the 90% test.

Danger lurks when you start having income and capital distributions to different beneficiaries as that will artificially distort the SBPP calculations making it impossible to make any beneficiary to qualify as a CGT concession stakeholder.

6. Getting the "payment requirements" right for the retirement concession

Sometimes the best planning and advice can come undone through poor implementation. Nothing illustrates this with the small business concessions as there are actions required after the event that can be very consequential.

The necessary payments for the retirement concession are one such area potentially fraught with danger. A missed date or miscommunication with a client can result in the denial of a concession that was otherwise freely available.

Rather than go through the provisions I thought I would develop a timetable of events for the different scenarios for a gain in the 2025 year and a 2025 tax return lodged on the due date of 15 May 2026 (for illustrative purposes) where all the capital proceeds have been received. I have assumed the client wishes to use the CGT contributions cap (as who wouldn't). The events need to occur in the order listed, unless otherwise indicated.

Individual (not yet 55 at date of 3) below)

1) Complete NAT form 71161 for contribution of exempt amount and provide to Super Fund.
2) Make contribution of exempt amount to Super Fund (can happen at same time as (1) but not beforehand). Must be before 15 May 2026.
3) Complete written choice identifying the exempt amount and stating that the individual will not exceed their lifetime retirement concession cap. Must be before 15 May 2026.

Individual (55 and over)

1) Complete written choice identifying the exempt amount and stating that the individual will not exceed their lifetime retirement concession cap. Must be before 15 May 2026.
2) Complete NAT form 71161 for contribution of exempt amount and provide to Super Fund.
3) Make contribution of exempt amount to Super Fund (can happen at same time as (1) but not beforehand). Must be before 15 May 2026.

The difference between the above is that where the individual is not yet 55 the retirement concession requires the contribution before the written choice to use the retirement concession whereas an individual 55 and over the contribution is not within Division 152 but only subject to the CGT cap provisions in Section 292-100.

Company/Trust (one CGT concession stakeholder who is not yet 55)

1) Complete written choice identifying the exempt amount and stating that the individual will not exceed their lifetime retirement concession cap, also their % of the exempt amount (in this case 100%). Must be before 15 May 2026.
2) NAT form 71161 for contribution of exempt amount and provide to Super Fund.
3) Within 7 days of or even before (1) make contribution of exempt amount to Super Fund (can happen at same time as (2) but not beforehand). Must be before 15 May 2026.

Company/Trust (one CGT concession stakeholder who is 55)

1) Complete written choice identifying the exempt amount and stating that the individual will not exceed their lifetime retirement concession cap, also their % of the exempt amount (in this case 100%). Must be before 15 May 2026.
2) Within 7 days of or even before (1) make payment of exempt amount to individual stakeholder. Must be before 15 May 2026.
3) NAT form 71161 for contribution of exempt amount and provide to Super Fund.
4) **Within 30 days of payment in 2)**, individual makes a contribution to Super Fund from personal account.

7. 15-Year Exemption curiosity – ATO change?

The 15-year exemption is a "too good to believe" exemption as you would be no doubt aware because the entire gain is not assessable provided of course the basic conditions of Division 152 and the specific conditions in Subdivision 152-B are satisfied.

In the interest of time, I will not rehash the specific conditions in detail, save for the most contentious condition – the "connection to retirement" condition.

It is a common condition for both individual as well as Trust/company gains that the CGT event giving rise to the capital gain must be in connection with the retirement of an individual who was 55 at the time of the CGT event[9].

7.1 Connection to retirement

It has been accepted within the tax profession that based on Private Rulings issued by the ATO as well as its various publications on the Small Business Concessions that the following observations could be made:

- Retirement would necessarily involve a significant reduction in working hours of the person/stakeholder.
- Retirement does not need to occur simultaneously with the CGT event but should have a nexus to retirement. In many PBR's the ATO accept that a taxpayer who is required to stay working as part of a handover to the purchaser could satisfy this condition provided retirement occurred after that obligation was over.
- There is no requirement for the individual to cease working. In PBR 1051427300988, the Commissioner was satisfied that an individual's working hours reducing from 60 hours per week to 40 hours per week phasing to full retirement over a number of years was sufficient to access the 15-year exemption.
- Retirement does not need to be permanent or everlasting. Although, if the individual returned to full working hours soon after the CGT event that of itself would likely cast doubt on the connection of retirement to the CGT event.

Given the number of PBR's on the retirement issue it is clearly an issue that advisers are wanting certainty from the ATO. Given the nebulous meaning of the term "connection to retirement" it is not surprising. This would be particularly important when the 15-year exemption was being applied by a company as an erroneous use of the exemption could lead to disastrous results when the funds are extracted (refer Section 8 below).

[9] See Section 152-105(d)(ii) for individuals and Section 152-110(1)(d)(i) for Trusts/companies.

7.1.1 ATO Change of heart?

A recent PBR from the ATO has “put the cat amongst the pigeons” when it comes to the 15-year exemption and particularly the ‘retirement condition’.

The offending PBR 1052294374162 (and other PBR’s that now reference the same logic) was issued in October 2024. In issuing the PBR the Commissioner looked back to the EM when the 15-year exemption was introduced to bring in a concept of the usage of the capital proceeds and how that interacts with retirement.

In the PBR, the Commissioner extended the analysis of whether the CGT event was “connected” to retirement of the stakeholder and included the use of the capital proceeds (as well as the reduction in working hours).

The author of the PBR harked back to the Explanatory Memorandum to the 1999 Bill that introduced the 15-year exemption. In the EM, the following statement appeared (emphasis added):

> ‘1*.68 One of the requirements of this concession for an individual small business taxpayer is that they must be either permanently incapacitated at the time of the CGT event, or at least 55 years old* ***and using the capital proceeds for their retirement****.’*

The author then concluded that based on the above wording that the usage of the capital proceeds from the event need to be used to fund the stakeholder’s retirement – refer below:

> *‘This wording would suggest that the funds arising from the disposal of the asset must predominantly be intended to fund the retirement of the individual (whether or not supplemented by other monies).’*

Further, the PBR then makes the following concerning statement:

> *‘It would similarly follow that where the funds are intended to be employed in a manner other than funding the individual’s retirement (for example the acquisition of a new business that the individual will have an active role in,* ***or the gifting of the monies, or the investment of the monies within the trust for the benefit of family members generally at the Trustee’s discretion) then the test will not be satisfied.’***

The above approach has also appeared in further PBR’s since October 2024.

Taken at face value, this view represents a significant change in the ATO’s approach to the “retirement” condition. For 25 years, since the 15-exemption has existed there was no mention to my knowledge of the usage of the capital proceeds in any ATO publication or PBR. Historically, the approach was focussed on working hours and proximity to the CGT event.

Whilst a detailed discussion of the role of the EM in statutory interpretation is not for today’s session, I would note that in Section 15AB of *Acts Interpretation Act 1901* extrinsic material (such as the EM) may be used to interpret legislation:

- To confirm that the meaning of the provision is the ordinary meaning conveyed by the tax of the provision considering its context in the Act and the purpose of the Act; or
- To determine the meaning of the provision when it is ambiguous or obscure or where the ordinary meaning conveyed by the text would lead to a result that is manifestly absurd or is unreasonable.

The question that should be analysed is whether the statement in the EM regarding usage of the capital proceeds was intended to clarify the connection between the sale and the retirement. It appears that at least internally within the ATO, the EM has been applied to clarify that the usage of the capital proceeds from the CGT event for the stakeholder's retirement is an important factor in the analysis.

The view may possibly lead to some absurd outcomes. I have tried to include some of these below:

Example 13

Mick and Mary are beef cattle farmers. They are both 63 and as is common for farmers they both work incredibly hard on their properties. They have lived frugally and have accumulated sufficient net wealth for them to retire from the farm. They had planned to work for many years but recently Mary has been diagnosed with treatable breast cancer. She still needs to under chemotherapy and radiation treatment.

Mick and Mary's two daughters (Caely and Vanessa) live on adjacent properties with their own families and operate their own farms. Unfortunately, the daughter's farms were acquired for significant cost, and they have high debt levels.

Mick and Mary have decided that it is time for them to retire so they can help Mary recover and then do some travelling that they have never been able to do. They decide to gift the farms to Caely and Vanessa as there is no way the girls could afford the market value of the farm ($20m).

Mick and Mary are small business entities relying on the $2m aggregated turnover condition.

They will continue to live on their former property and that is a condition for the gift (informally agreed amongst the family). Mick has consulted a financial planner, and he commented that Mick and Mary have sufficient other assets to live for "3 lifetimes" so they do not need any funds from the sale.

Under the formerly held view by the ATO, Mick and Mary would need to show that the sale would allow them to retire through a significant reduction in working hours. However, under the new ATO view as there are no capital proceeds, the exemption would potentially not be available.

Suddenly, the ATO is considering itself the arbiter of what a person's retirement should look like as far as how retirement funds are used. I would submit the most valuable commodity in retirement for Mick and Mary is time (and not money) and the sale will give them that time as they retire. As they have already accumulated sufficient retirement funds **why** are they required to generate more funds from the sale, that are surplus to their needs.

Example 14

Prior to Mick and Mary gifting the property you inform them of the ATO's view above. You suggest that they charge capital proceeds. They ask you how much – you suggest that the full market value is used. Mick and Mary are adamant that charging the girls $20m for the sale would cause them to be insolvent. Mick suggests that they vendor finance the entire purchase price (as a loan) and amend their Wills to have that loan forgiven upon their death.

Again, we have no capital proceeds and potentially no access to the 15-year exemption as the CGT event has no connection to retirement.

Example 15

After hearing your concerns about the vendor finance arrangement, Mick suggests that they charge $4m in actual consideration that the girls will borrow. The $4m was chosen as it was the maximum amount the girls could borrow.

The $4m is surplus to Mick and Mary's requirements so they will invest the money and leave it to the girls in their Will. **In other words, the funds from the sale will not be used by them at all.**

Here, we have some capital proceeds (that will be increased to market value under the market value substitution rules) but:

- The PBR suggests the capital proceeds are predominantly used for retirement. Mick and Mary don't need the funds so will not be using them at all.
- Is the reference to capital proceeds a reference to the actual funds received ($4m) or the deemed capital proceeds ($20m)? If it is the $4m then there is an argument for them but if it is $20m then we are back to failing the retirement condition.

I would argue that the reference to "capital proceeds" in the EM can only be a reference to actual funds as deemed capital proceeds cannot be used to fund retirement. On that basis, if Mick and Mary determined that the $4m was sufficient for them to retire and they in fact do retire, then the exemption should be available. My prediction is if this scenario was tested in Court the ATO's strict approach would be rejected.

If this view continues to be held and applied by the ATO then we are left with the following uncertain scenarios.

- A sale to a family member for no consideration (such as a gift).
- A sale to a family member for below market value consideration.
- Vendor financed arrangement with family members where the repayment of the vendor loan is indefinitely deferred until death, then forgiven.
- A sale where the stakeholders gift proceeds to their family (to pay off mortgages etc). Does it matter if that gift occurs shortly after the CGT event or say 12 months later?
- A sale where the stakeholders have sufficient assets to retire, and the sales proceeds are surplus to their needs and not used at all.
- What about a client who has to use more of the capital proceeds to retire debt?

I would like to leave you with the sentiment shared by the Full Federal Court in the *Eichmann* decision. It was the Full Court's view that the provisions of Division 152 should be construed **beneficially** rather than **restrictively** in order to promote the purpose of the concessions. This new approach involving potentially tracing sale proceeds to prove a connection to retirement is clearly an example of a restrictive construction of the provisions.

8. Getting the Concessions Wrong

As the various sayings go – “mistakes happen” and “you are only human”.

There may be an occasion when the application of the concessions goes wrong and either the concessions are not available at all after they have been used or the wrong concession within Division 152 is used.

I will try to analyse some scenarios I have seen in practice.

8.1 Missed concessions

My favourite kind of mistake, as it is fixable.

There may be an occasion where you pick up a client who recently sold a business or asset and think to yourself why did the former tax agent did not apply the small business concessions when they appear that they were clearly available.

Now assuming that the relevant amendment period remains open it is possible to amend the return to claim the small business concessions. In *ATOID 2003/103,* the ATO was asked if the taxpayer in question could amend their return to claim the replacement asset rollover not claimed in a prior year, due to a mistake.

The ATO noted that as a general rule that where a taxpayer makes a choice when preparing their return that choice cannot be ‘undone’ so you are stuck with the choice. However, in a case where no choice was made because the taxpayer was not aware of the available choice, the ATO concluded that an amendment could be made for the taxpayer to utilise the replacement asset rollover provided the Commissioner allowed the taxpayer to make a late choice under Section 103-25.

One would assume that where the concessions have been missed that the active asset reduction could be claimed as the application of the reduction is not as a result of a choice (although you can choose not to apply the reduction in Section 152-220).

Amending a return to utilise the retirement concession is less likely to be successful because of the time limits for payments/contributions. However, Section 103-25 does provide the Commissioner with a discretion to extend the time that a choice can be made and that would be your only option here.

Another option would be to use the replacement asset rollover (similar to ATOID 2003/103) which would still involve the Commissioner extending the choice deadline and then using the retirement concession to the resultant J5 gain that will emerge in 2 years post CGT event.

8.2 Concessions in a company gone wrong

Apart from the stress and potential embarrassment of claiming the concessions incorrectly the consequences take on a different level of discomfort when claimed by a company due to the knock-on impacts of extraction of the funds.

This is best illustrated by the following example.

Example 16

Matthew has owned his business for 22 years through a company he wholly owns as an individual. He is now 60 years old and has just sold the business. As Matthew is clearly wishing to retire you are satisfied of the connection to retirement. You advise the 15-year exemption is available.

The company claims the 15-year exemption on a capital gain of $2m in the 2025 year.

In accordance with your advice, Matthew has the company make a payment to him of the exempt amount ($2m) in July 2025 within the 2-year time limit for such a tax-free payment.

In 2027, the ATO review the company's eligibility of the concessions. In gathering the information, you realise that prior to you taking the company over in 2017 there were some non-redeemable 'dividend only' shares on issue from when the company was formed until 2015. Therefore, the company did not have a significant individual for 15-years the business was owned. The 15-year concession was incorrectly claimed.

You make a voluntary disclosure to the ATO and successfully negotiate that the company could have claimed the active asset reduction and retirement concession which the ATO graciously allow an extension of time to make those choices.

However, what is the outcome of the payment to Matthew of the $2m now that the 15-year exemption was not in fact available? It is likely a deemed dividend under Section 109C as it would be a 'payment' as defined. Perhaps it can be converted into a Division 7a loan which Matthew has to repay? Is it simply an unfranked dividend? That will be the next painful conversation with the ATO and client.

Either way it is potentially a painful exercise.