
TREASURY LAWS AMENDMENT (2018 MEASURES NO. #) BILL 2018

EXPOSURE DRAFT EXPLANATORY MATERIALS

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
CGT	capital gains tax
ITAA 1997	<i>Income Tax Assessment Act 1997</i>

Chapter 1

Improving the small business CGT concessions

Outline of chapter

1.1 Schedule # to the Bill amends the ITAA 1997 to include additional conditions that must be satisfied to apply the small business CGT concession to capital gains. The new conditions ensure that the small business CGT concessions in Division 152 of the ITAA 1997 are only available for assets that are either used or held ready for use in the course of a small business or are an interest in a small business.

1.2 All legislative references in this Chapter are to the ITAA 1997 unless the contrary is indicated.

Context of amendments

Operation of existing law

1.3 Division 152 provides four concessions that can permit small businesses or, in some cases, their owners to reduce, defer or disregard certain capital gains.

1.4 These four CGT concessions are:

- the 15-year exemption (Subdivision 152-B);
- the 50 per cent asset reduction (Subdivision 152-C);
- the retirement exemption (Subdivision 152-D); and
- the replacement asset rollover (Subdivision 152-E).

1.5 Section 152-10 sets out the basic conditions that all taxpayers must satisfy in relation to a CGT event before they can be entitled to these concessions in relation to any resulting capital gain. To satisfy these conditions:

- the taxpayer must:
 - be a CGT small business entity for the income year (broadly, an entity that carries on a business and has an aggregated turnover of less than \$2 million) (see subparagraph 152-10(1)(c)(i));

- if the asset is an interest in an asset of a partnership that is a CGT small business entity for the income year — be a partner in that partnership (see subparagraph 152-10(1)(c)(iii));
 - if the taxpayer does not carry on a business in the income year (other than in a partnership) and the asset is not an interest in an asset of such a partnership — be affiliated, connected with or a partner in an entity that is both a CGT small business entity and carry on the business in which the asset is an active asset (see subparagraph 152-10(1)(c)(iv)); or
 - not have CGT assets (including the CGT assets of related entities) with a net value exceeding \$6 million (the maximum net asset value test) – see section 152-15 (see subparagraph 152-10(1)(c)(ii)), and
- the asset must satisfy the active asset test (see sections 152-35 and 152-40).

1.6 Additional basic conditions apply if the asset is a share in a company or an interest in a trust. In this situation, subsection 152-10(2) provides that the concessions will only be available for a taxpayer if:

- the taxpayer, or their spouse, is a CGT concession stakeholder in the object company or trust (ie. broadly holds an interest entitling it to at least 20 per cent of the voting rights, capital distributions and income distributions of the object entity); or
- at least 90 per cent of the interests in the taxpayer must be held by entities that are CGT concession stakeholders in the object company or trust.

CGT small business entities

1.7 CGT small business entity is a more recently introduced concept that is defined in subsection 152-10(1AA). Broadly, it limits access to the CGT small business concessions to small business entities with aggregated turnover in an income year that does not exceed the previous small business turnover threshold of \$2 million, rather than the new threshold of \$10 million.

1.8 Small business entity is defined in section 328-110. Broadly, an entity will be a small business entity for an income year if the entity carries on business in the year and either:

- carried on business in the previous income year with aggregated turnover not exceeding \$10 million; or

- is likely to have aggregated turnover for the current income year not exceeding \$10 million.

Budget announcement

1.9 In the 2017-18 Budget the Government announced it would amend the small business CGT concessions to ensure that the concessions can only be accessed in relation to assets used in a small business or interests in a small business, with effect from 1 July 2017.

Summary of new law

1.10 The amendments include additional basic conditions that must be satisfied for a taxpayer to apply the CGT small business concessions to a capital gain arising in relation to a share in a company or an interest in a trust (the object entity).

1.11 Broadly, the conditions require that:

- if the taxpayer does not satisfy the maximum net asset value test, the relevant CGT small business entity must have carried on a business just prior to the CGT event;
- the object entity must have carried on a business just prior to the CGT event;
- the object entity must either be a CGT small business entity or satisfy the maximum net asset value test (applying a modified rule about when entities are ‘connected with’ other entities), and
- the share or interest must satisfy a modified active asset test that looks through shares and interests in trusts to the activities and assets of the underlying entities.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
To be eligible to apply the CGT small business concessions, a taxpayer must satisfy the basic conditions set out in subsection 152-10(1) in relation to the capital gain. Additional basic conditions apply for capital gains relating to shares in a company or interests in a trust. These	To be eligible to apply the CGT small business concessions, a taxpayer must satisfy the basic conditions set out in subsection 152-10(1) in relation to the capital gain. Additional basic conditions apply for capital gains relating to shares in a company or interests in a trust – the

<i>New law</i>	<i>Current law</i>
<p>are:</p> <ul style="list-style-type: none"> • either: <ul style="list-style-type: none"> – the taxpayer must be a CGT concession stakeholder in the object entity; or – CGT concession stakeholders must hold at least 90 per cent of the taxpayer; • unless the taxpayer satisfies the maximum net asset value test, the relevant CGT small business entity must have carried on a business just prior to the CGT event; • the object entity must: <ul style="list-style-type: none"> – carry on a business just prior to the CGT event; and – either be a CGT small business entity for the income year or satisfy the maximum net asset value test; and • the shares or interests in the object entity must satisfy a modified active asset test that looks through shares in companies and interests in trusts to the activities and assets of the underlying entities. 	<p>taxpayer must be a CGT concession stakeholder in the object entity or at least an interest of 90 per cent of the taxpayer must be held by CGT concession stakeholders.</p>

Detailed explanation of new law

1.12 Schedule # amends Division 152 of the ITAA 1997 to include additional basic conditions that must be satisfied for a capital gain of a taxpayer to be reduced or disregarded under that Division. The new conditions are intended to prevent the concessions from being inappropriately applied to interests in large businesses.

1.13 Consistent with this purpose, the additional basic conditions only apply to capital gains relating to CGT assets that are a share in a company or interest in a trust (the object entity). [*Schedule #, item 2, subsection 152-10(2)*]

1.14 There are broadly three additional basic conditions relating to the asset (the modified active asset test), the taxpayer, and the object entity.

1.15 These conditions apply on an entity basis. A taxpayer at the top of a chain of companies or trusts may not qualify for the concessions in respect of shares or interests it holds (for example, because the chain includes an entity with an interest in a large business). However, another taxpayer in the same chain of companies or trusts may qualify for the concessions in respect of shares or interests it holds in a small business.

Modified active asset test

1.16 In order to satisfy the first new condition, at least 80 per cent of the sum of the:

- total market value of the assets of the object entity (disregarding any shares in companies or interests in trusts); and
- total market value of the assets of any entity in which the object entity has a small business participation percentage of greater than zero (a later entity), multiplied by that percentage

must relate to assets that are:

- active assets;
- financial instruments that are inherently connected with a business carried on by the entity and either:
 - held as trading stock; or
 - issued by the entity in the course of a financial services business (within the meaning of the *Corporations Act 2001*) or credit activity (within the meaning of the *National Consumer Credit Protection Act 2009*) covered by a Australian financial services licence or a licence under the *National Consumer Credit Protection Act 2009*, or
- cash that is inherently connected with a business carried on by the later entity and held as trading stock.

[Schedule #, item 2, paragraph 152-10(2)(a) and paragraphs 152-10(2A)(a) and (b)]

1.17 Further, for assets held by a later entity (see paragraph 1.15), these assets must also be held by a later entity:

- that is either:
 - a CGT small business entity; or
 - satisfies that maximum net asset value test in relation to the capital gain; and

- in which the taxpayer or their spouse has a small business participation percentage of at least 20 per cent (ie. is a CGT concession stakeholder).

1.18 In determining if an entity is a CGT small business entity or satisfies the maximum net asset value test, this test also does not include the turnover or value or assets of entities that can control the object entity. This ensures that the outcomes for taxpayers do not depend upon the income or assets of third parties for which the taxpayer has no control.

1.19 For the purposes of this test, an entity is treated as controlling another entity if it has an interest of 20 per cent or more in that other entity, rather than 40 per cent or more. This means that more entities are considered to be ‘connected with’ one another for the purpose of this test and need to count the assets or turnover of the other entity towards their aggregate turnover or total net CGT assets.

1.20 In effect, for the purposes of this test, the active asset test in section 152-35 is modified to adopt a ‘look-through’ approach. Rather than treating shares or interests as active assets based on the activities of the underlying company, the modified test instead looks through such membership interests to include the proportionate amount of the value of the assets of other entities (referred to as later entities) to which the interests ultimately relate.

1.21 Further, the modified test only treats assets as active if they meet additional requirements. Assets that are not cash or financial instruments must be used in carrying on the business of a later entity (see above) that does not have both significant turnover and assets. Assets that are cash or financial instruments must be both closely connected with such a business and held as trading stock or, in the case of financial instruments, issued by the later entity in the course of a financial services business or credit activity that is licenced.

1.22 The assets must also be held by an entity in which the taxpayer is a CGT concession stakeholder – ie. has a direct, indirect or spousal interest of 20 per cent or more.

1.23 This condition prevents the concession from being available for interests in entities if most of the value of the assets of the entity is unrelated to its business activities. In such cases, while the entity is small and carries on a business, most of the value of the interest held by the taxpayer is not attributable to the small business and it is not appropriate for the small business concessions to apply to the disposal of the interest.

1.24 The condition also recognises that an investment is effectively passive in nature if an entity has an interest of less than twenty per cent in another entity.

Example 1.1: Holding company

Jesse carries on a small lapidary business as a sole trader. He is a CGT small business entity for the 2019-20 income year.

Jesse owns 50 per cent of the shares in A Co. A Co carries on a business providing cleaning services and is a CGT small business entity in 2019-20. The net value of its CGT assets (excluding its investments in other entities), is \$3 million and all of its assets are and always have been active assets.

A Co also owns 25 per cent of Small Pty Ltd and 20 per cent of Big Ltd. Small Pty Ltd is also a CGT small business entity in 2019-20 and the net value of its CGT assets (all of which are active assets) is \$2 million in 2019-20. Big Ltd is not a CGT small business entity in 2019-20 and does not satisfy the maximum net asset value test at any point in that income year. The net value of its CGT assets is \$100 million in 2019-20.

There has been no significant change in the activities or holdings of A Co, Small Pty Ltd or Big Ltd over the period Jesse has owned his shares.

On 9 November 2019, Jesse sells his interest in A Co. Jesse is not eligible to access the CGT concessions under Division 152 for any resulting capital gain.

While Jesse may satisfy the basic conditions for relief for the capital gain, he does not satisfy the new conditions.

Firstly, A Co is not a CGT small business entity and does not satisfy the maximum net asset value test for the purposes of these conditions due to the modified test that applies.

Under the modified test, A Co is connected with both Small Pty Ltd and Big Ltd and therefore must include their turnover and assets when applying the tests. The combined turnover exceeds the turnover threshold for A Co to be a CGT small business entity. Likewise, the value of the combined assets is too great for A Co to satisfy the maximum net asset value test.

Secondly, for the purposes of the modified active asset test, the net value of the CGT assets of A Co is \$23.5 million. This includes the \$3 million in assets held by A Co, 25 per cent of the \$2 million in assets held by Small Pty Ltd (\$0.5 million) and 20 per cent of the \$100 million in assets held by Big Ltd (\$20 million). It does not include the value of the shares A Co holds in Small Pty Ltd and Big Ltd.

Only the \$3 million in assets held by A Co are treated as active assets. While the assets held by Big Ltd and Small Pty Ltd are used in carrying on their businesses, under the modified tests that apply for this condition Big Ltd and Small Pty Ltd are not CGT small business entities and do not satisfy the maximum net asset value test. Under the

modified test, A Co controls both Big Ltd and Small Pty Ltd. As a result, all of the businesses are connected with each other and their combined turnover and assets exceed the asset and turnover thresholds.

Even if this was not the case, Jesse is not a CGT concession stakeholder in Big Ltd or Small Pty Ltd as his small business participation percentage is only 10 per cent for Big Ltd (ie. his 50 per cent interest in A Co multiplied by his 20 per cent interest in Big Ltd) and 12.5 per cent for Small Pty Ltd (i.e. his 50 per cent interest in A Co multiplied by his 25 per cent interest in Small Pty Ltd).

As a result, Jesse's interest in A Co also fails the modified active asset test requirement of the new conditions as less than 80 per cent of the total assets of A Co are considered active for the modified test.

As Jesse does not satisfy the new conditions relating to the object entity and the modified active asset test, he cannot access the CGT concessions under Division 152 for the disposal of his interest in A Co.

Example 1.2: Small investments

Arnold carries on a small marketing business as a sole trader. He is a CGT small business entity for the 2019-20 income year.

Arnold also owns 20 per cent of Channel Investments Trust, a trust that invests in a wide range of widely held trusts and companies.

Channel Investments Trust has assets with a total net market value of \$2 million, of which \$1.95 million consists of shares in companies and units in trusts. Channel Investments Trust has never had a small business participation percentage exceeding 10 per cent in any other entity.

On 20 April 2020, Arnold sells his interest in Channel Investments Trust. Arnold is not eligible to access the CGT concessions under Division 152 for any resulting capital gain.

While Arnold may satisfy the basic conditions for relief for the capital gain, he does not satisfy the new conditions.

The investment in Channel Investments Trust does not satisfy the modified active asset test as 97.5 per cent of its assets are shares and interests in trusts that are considered passive assets as its small business participation percentage in the relevant entities is less than 20 per cent.

Condition relating to the taxpayer

1.25 In order to satisfy the second new condition, the relevant CGT small business entity must have been carrying on business immediately prior to the CGT event happening. This ensures that entities do not benefit from this concession where the relevant business activities are remote from the relevant disposal. [*Schedule #, item 2, paragraph 152-10(2)(b)*]

1.26 However, this requirement does not apply to taxpayers that satisfy the maximum net asset test in relation to the CGT event. In this case, eligibility to access the concession relates to the size of the taxpayer, not the duration of the related small business activities. *[Schedule #, item 2, paragraph 152-10(2)(b)]*

Condition relating to the object entity

1.27 To satisfy the third new condition, the object entity (see paragraph 1.13) must have carried on a business immediately prior to the CGT event happening and also must either be a CGT small business entity or satisfy the maximum net asset value test in relation to the capital gain. This prevents the concession being available for interests in entities that are not carrying on a business prior to the CGT event happening or are carrying on a business that is not a small business as it has both substantial aggregate turnover and net assets. *[Schedule #, item 2, paragraphs 152-10(2)(c) and (d)]*

1.28 When working out if the object entity is a CGT small business entity or satisfies the maximum net asset value test, the turnover or assets of entities that may control the object entity are disregarded. This ensures that the outcomes for taxpayers do not depend upon the income or assets of third parties. *[Schedule #, item 2, subparagraphs 152-10(2)(d)(iii) and (iv)]*

1.29 Further, for the purpose of this test, an entity is treated as controlling another entity if it has an interest of 20 per cent or more, rather than 40 per cent or more. This means that more entities are considered to be ‘connected with’ one another for the purpose of this test and need to count the assets or turnover of the other entity towards their aggregate turnover or total net CGT assets. *[Schedule #, item 2, subparagraph 152-10(2)(d)(iv)]*

Example 1.3: Investment in large business

Karen carries on a small consulting business as a sole trader. She is a CGT small business entity for the 2019-20 income year.

Karen also owns 30 per cent of the shares in Big Pty Ltd, a large private company with annual turnover in excess of \$20 million in both 2018-19 and 2019-20. The net value of Big Pty Ltd’s CGT assets exceeds \$100 million throughout this period.

On 1 October 2019, Karen sells her shares in Big Pty Ltd. She would not be eligible to access the Division 152 CGT concessions for any resulting capital gain.

Even if Karen satisfies the other basic conditions for relief, she cannot satisfy the new condition. Big Pty Ltd is not a CGT small business entity in the 2019-20 income year. It also does not satisfy the maximum net asset value test in relation to the capital gain, as its net

assets exceed \$6 million immediately prior to the CGT event happening (being in excess of \$100 million for the entire income year).

Example 1.4: Passive investment entities

George and Alex carry on a small gardening business in partnership. The partnership is a CGT small business entity for the 2019-20 income year.

The partnership holds all of the units in G Trust, a trust that holds a number of investments in other entities but which does not carry on a business.

On 17 February 2020, the partnership sells the units it holds in G Trust. George and Alex are not eligible to access the Division 152 CGT concessions for any resulting capital gain.

Even if George and Alex satisfy the basic conditions for relief, neither can satisfy the new condition as G Trust does not carry on a business.

Consequential amendments

1.30 Schedule # also makes a number of consequential amendments to the ITAA 1997, including updating guide material to reflect the substantive amendments. [*Schedule #, item 1, section 152-5*]

1.31 These amendments also change the existing structure of subsection 152-10(2) to accommodate the new conditions. These structural changes do not make any substantive changes to the operation of the pre-existing condition. [*Schedule #, item 2, subsection 152-10(2)*]

Application and transitional provisions

1.32 The amendments made by Schedule # commence on the first day of the first quarter to start after the day of Royal Assent. [*clause 2*]

1.33 The amendments apply to CGT events that occur on or after 1 July 2017. [*Schedule #, item 3*]

1.34 This retrospective application is consistent with the Budget announcement by the Government on 9 May 2017. It is necessary to minimise the scope for entities to inappropriately access the CGT concession in the period after the measure was announced and when the legislation is enacted.