Tel: +61 7 3237 5999
Fax: +61 7 3221 9227
www.bdo.com.au

Level 10, 12 Creek St
Brisbane QLD 4000
GPO Box 457 Brisbane QLD 4001
Australia

Via email: Email: SBCGTintegrity@treasury.gov.au

Senior Adviser
Small Business Entities and Industry Concessions Unit
The Treasury
Langton Crescent
PARKES ACT 2600

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IMPROVING THE INTEGRITY OF THE SMALL BUSINESS CGT CONCESSIONS

To whom it may concern,

BDO welcomes the opportunity to provide feedback in response to the Improving the integrity of the small business CGT (SBCGT) concessions exposure draft legislation released on 8 February 2018.

This BDO submission contains the following recommendations:

- The legislation needs to be better targeted, or the Government needs to justify the reduction in scope of the concessions.
- The proposed changes should not be retrospective in nature and instead of applying from 1 July 2017 should apply from 1 July 2018 to provide small businesses with time to prepare for them.
- The requirement for the Object Entity to meet the MNAVT or small business entity test should be replaced with the simpler requirement that the relevant CGT asset have a sufficient link to the relevant small business carried on by the taxpayer
- The proposed changes should be less complex and align with the policy intent

These and other issues are expanded upon in the attached appendix.

Should you wish to discuss any of our comments, please feel free to contact me on +61 2 9240 9736, or via email: Lance.Cunningham@bdo.com.au.

Kind regards,

Lance Cunningham
BDO National Tax Director

APPENDIX

Recommendation 1 – The proposed changes need to be better targeted

The proposed provisions will significantly reduce the circumstances in which taxpayers can claim the SBCGT concessions. While they are being badged as integrity measures, the proposed law does more than just limit abusive arrangements — it removes the concessions from 'plain vanilla' circumstances that were clearly meant to be captured by the existing provisions.

Changes to the additional basic conditions for shares in companies or interests in trusts in section 152-10 ITAA 1997 that change the controlling entity test from 40% to 20% were not apparent from the 2017/18 Federal Budget announcement regarding the "Tax Integrity Package – improving the small business capital gains tax concessions". The Budget announcement referred to "some taxpayers … arranging their affairs so that their ownership interests in larger businesses do not count towards the tests for determining eligibility for the concessions". This indicated there was some manipulation of taxpayer's affairs to obtain the concessions. However, the proposed changes will also impact taxpayers that we think should not be affected.

Below is an example where we consider the proposed changes will undo the significant changes that were brought into the small business concessions package in 2007.

Change to the Controlling entity test

John, George and Jan are unrelated and each own one third of the shares in JGJ Pty Ltd. JGJ runs an engineering business turning over $8m per year and its assets are more than 80% active assets. John, George and Jan agree to sell their shares for a total of $7m (i.e. $2.3m each). Under the existing law John, George and Jan are likely to be entitled to the small business concessions. This has been the case since 2017 when section 152-55 ITAA 1997 was amended to replace the "controlling individual test" (50% test) with the "significant individual test" (20% test). The effect of the proposed change to subsection 152-10(2) ITAA 1997 is that the 20% test is in effect being increased to 40%, thus mostly undoing the 2007 concessions. This was not apparent as the intent in the 2017/18 Budget announcement.

Passive held assets held by affiliates or connected entities

The changes to the additional basic conditions for shares in companies or interests in trusts in section 152-10 ITAA 1997 also requires that the "object entity is carrying on a business just before the CGT event". This requirement reverses the "passively held assets by affiliates and connected entities" in subsection 152-10(1A) ITAA 1997, which was an important concession that was introduced in 2009 and is outlined in the example below.

Zed Unit Trust is 100% owned by Jenny. Zed Unit Trust owns a small commercial tenancy which is leased to Why Pty Ltd, which carries on an active business with an aggregate turnover of less than $2 million. Jenny also owns 100% of the shares in Why Pty Ltd. Zed Unit Trust is not considered to carry on a business because its leasing activities are small scale. Jenny sells all of the shares in Zed Unit Trust and all of the shares in Why Pty Ltd for a total of $1m. The existing small business concessions would apply to the entire transaction. Under the proposed law, the concessions would be available for the sale of the shares, but not the sale of the units. The proposed law in effect undoes the passively held asset by connected entities concession in subsection 152-10(1A) ITAA 1997.

Cash in trading accounts

The proposed changes that will insert subsection 152-10(2A) ITAA 1997 in relation to the exclusion of financial instruments from being active assets, will also have what appears to be unintended consequences in relation to cash held in trading accounts of companies or trusts with active businesses. There are many businesses that need or can't avoid having large amounts of cash in their trading accounts at various times. Where the business in owned by a company or trust and the shareholder or unit holder sells the shares or units, the proposed change will mean they will have to monitor the amount in the company's or trust's bank account over the period of ownership, to see whether the shares or units satisfy the additional conditions for sale of shares or interests in trusts in 152-10(2) ITAA 1997.

This is the result of having combined the following:

- New subsection 152(2A) ITAA 1997, which excludes cash at bank from being an active asset;
- Subsection 152-40(3A) ITAA 1997, which has the requirement that for shares or units to pass the active assets test, the company or trust must have 80% of its assets as active assets; and
- Subsection 152-35(1) ITAA 1997, which requires for any asset to pass the active asset test they must be active assets for half the period of ownership (or 7 ½ years if owner for more than 15 years).

It will not be known whether shares or units will pass the active asset test (for the purposes of paragraph 152(2)(a) ITA 1997 unless the value of the company's or trust's bank account is constantly monitored to see whether its value would result in the company or trust failing the 80% test for more than half the period of ownership (or 7 ½ years if owned for more than 15 years).

Recommendation 2 – The proposed changes should not be retrospective in nature

If the final legislation is not be altered to account for the issues identified in the above three examples, the amendments as far as they affect these types of situations, should not be enacted retrospectively and we recommend they apply from 1 July 2018.

If these measures are to all apply retrospectively, this means that taxpayers may have a significantly larger than expected tax bill where CGT assets have been sold after 30 June 2017, and the existing SBCGT concession rules have been applied.

The drastic increase in scope, which was not flagged in the 2017/18 Federal Budget announcements, means that the proposed retrospective provisions will adversely affect taxpayers who have sold shares in companies or interests in trusts since 1 July 2017 in reliance on the existing law and the plain meaning of the budget announcement.

BDO recommend that the changes apply from 1 July 2018 to provide small businesses with time to prepare for them.

Recommendation 3 - The requirement for the Object Entity to meet the MNAVT or small business entity test should be replaced with the simpler requirement that the relevant CGT asset have a sufficient link to the relevant small business carried on by the taxpayer

The requirement for the Object Entity to meet the MNAVT or small business entity test will exclude taxpayers who are presumably outside the integrity concern.

For example, a taxpayer owns 30% of a company with a MNAVT of $10 million, such that their interest is only worth $3 million. The taxpayer otherwise meets the MNAVT or small business entity test. They will be precluded from applying the SBCGT concessions as the Object Entity (i.e. the company) doesn't meet the MNAVT or small business entity test. This would seem to be collateral damage.

Additionally, the requirement that the Object Entity be carrying on a business just prior to the relevant CGT event would prevent taxpayers from applying the SBCGT concessions to a capital distribution received upon the liquidation or winding-up of an entity; even if the shares in the Object Entity met the active asset test for the requisite period of time. Again, this would seem to be collateral damage.

Recommendation 4 – The proposed changes should be less complex and align with the policy intent

The draft legislation is seeking to prevent the SBCGT concessions from being used by taxpayers with significant wealth in a manner which is inconsistent with the underlying policy intention.

One example of such behaviour is set out below:

> John is not carrying on a business and has a net worth of over $100 million. Among other things, John owns 25% of the shares in Trader Pty Ltd, a large private company with net assets exceeding $100 million and an annual turnover in excess of $10 million.
>
> John wishes to sell his shares in Trader Pty but does not currently satisfy the necessary tests to be eligible for the SBCGT concessions. That is, John is not a small business entity and fails the maximum net asset value test.
>
> In order to become eligible to for the SBCGT concessions, John purchases a small business in his own name, namely a corner store, with a turnover of approximately $500,000 per year.
>
> In the following income year, John decides to sell his shares in Trader Pty Ltd. As he is now a small business entity, he is able to apply to the SBCGT concessions to reduce the capital gain on the sale of his shares in Trader Pty Ltd which otherwise meet the active asset test and CGT concession stakeholder test.

While the draft legislation can be lauded for addressing the integrity issues head-on, it struggles to adhere to the underpinning policy of the SBCGT concessions of reducing the tax cost and compliance burden for small business. That is, the draft legislation adds a further degree of complexity to existing provisions which are already perceived as complex.

Of great concern, and something which afflicts tax law amendments from time to time, is that the proposed changes will exclude many genuine small taxpayers from obtaining the SBCGT concessions in an effort to prevent the troublesome few from accessing them. That is, it penalises the many for the sins of the few.

BDO recommends that the proposed changes should be less complex and align with the policy intent.