Crowe Horwath (Aust) Pty Ltd
ABN 84 006 466 351
Member Crowe Horwath International

22 Walker Street
TOWNSVILLE QLD 4810

PO Box 537
TOWNSVILLE QLD 4810

Tel 07 4722 9555

www.crowehorwath.com.au

DWH: DWH

26 February 2018

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

By email: SBCGTintegrity@treasury.gov.au

Dear Sir

TREASURY LAWS AMENDMENT (MEASURES FOR LATER SITTING)) BILL 2018: IMPROVING THE SMALL BUSINESS CGT CONCESSIONS - SUBMISSION TO EXPOSURE DRAFT

We refer to the Exposure Draft Legislation, and accompanying Explanatory Memorandum, of the above. Having reviewed the Proposed Legislation and considered its possible application in a range of circumstances, we have prepared this submission for your consideration.

Our main concerns are:

1. The retrospective nature of the proposed legislation –the proposed measures go much further than those originally announced.
2. The new requirement that cash must be trading stock to be treated as an active asset.
3. The new requirement that the trust or company be carrying on a business immediately prior to the Capital Gains Tax (CGT) event.
4. That the object company must be a Small Business Entity (SBE) or pass the maximum net asset value test.

The purpose of the concessions:

Before detailing our concerns around the proposed legislation, it is worthwhile considering the changes in the context of the introduction of the small business CGT concessions historically and how the proposed changes impact.

The small business CGT concessions were introduced in recognition that business owners tended to reinvest their funds into the business and essentially rely on the sale of the business to finance their retirement. Further, it was always the intent that the concessions were to be only for small business owners.

We acknowledge that the legislative changes which have occurred since the small business CGT concessions were first enacted, including the introduction of the $2M turnover test, have gone too

far and consequently have allowed non-small business owners access to the concessions. This was particularly so when it came to selling shares in a company or unit trust.

However, in evaluating the proposed changes, many issues arise that clearly conflict with the intent of the concessions, namely the requirement:

- for cash to be trading stock;
- that the entity must be carrying a business immediately prior to the share sale; and
- that the target entity must be an SBE or pass the maximum net asset test, even where the stakeholder passes the maximum net asset test.

These changes will mean that, for many very small businesses, it will not be possible to access the concessions if they are required by regulation (as is the case in the building industry) or are prudent in holding some cash to cover forecast working capital and unforeseen expenditures. The changes will also prevent access to the small business CGT concessions for those exiting by liquidation, after the winding up of a business after sale, or if they choose to be in business with others.

The retrospective nature

We wish to first express our concern of the retrospective nature of the legislation and suggest that it would be preferred that the changes occur for CGT events occurring after, at the earliest, the release of the exposure draft, rather than 1 July 2017.

Even though the May Budget announced there would be changes, the details were scant, but the extent of the proposed changes go much further than what a reasonable person could have contemplated having reviewed all available information released at the time of the May Budget (which we note has been the only available information for the lengthy period leading to publication of the draft legislation).

In this regard, we see no issue with some retrospective changes to prevent the concessions applying to interests in large business, as this was clearly understood in the May Budget announcement. It is the additional impacts that must not be retrospective. Specifically, the requirement for cash to be trading stock, the requirement that the entity be carrying on a business immediately prior to the CGT event and the SBE requirement when the stakeholder has already met the maximum net asset test.

There are many businesses that have had to make decisions on sale or restructures since 1 July 2017, that now find themselves unable to avail themselves of the concessions. Given the passage of time from announcement to release of draft legislation (i.e. early May 2017 to February 2018), this is unreasonable given that financial and business decisions in that period have been based on the existing legislation, with no warning of these additional changes.

Cash as trading stock

The current legislation requires that, for cash held by a company or trust to be an active asset, it must be *inherently connected* to the business of that company or trust. We see no issue with the current legislative requirement, but do recognise that the concept of "*inherently connected to the business*" is somewhat subjective. If anything, perhaps the legislation could define what "*inherently connected to the business"* means or the EM provide some guidance to the Commissioner.

Cash is an important part of the business and many businesses fail due to cash flow shortages. Therefore, a prudent business owner would ensure that they maintain sufficient cash to not only cover the businesses working capital requirement, but also a number fixed costs and wages for a period to handle down-turns and unexpected liabilities. In certain industries, for example construction, it is also mandatory for businesses to maintain cash coverage requirements.

The proposed legislation limits when cash may be an active asset by introducing the requirement that the cash **must also be trading stock**. Clearly this is far too narrow for a typical small business and should only relate those types of businesses (financial services) contemplated in the draft legislation at 152-10(2A)(a). The reason is immediately obvious as many small businesses operating out of companies and/or trusts would struggle to pass the active asset test due to their cash holdings.

For example:

A business worth $1M would fail the active asset test if it had $200,000 cash and any other non-active asset – for example, a small debt owed to it. This is despite the cash being needed to continue running its business, bearing in mind that the value of the business is not necessarily reflective of its turnover.

It is suggested that the trading stock requirement be restricted to the financial services type businesses and the existing 152-40(3)(b)(iii) "inherently connected" rule for cash be maintained either unchanged, or alternatively legislative or extrinsic guidance introduced to clarify the existing "inherently connected to the business" requirement.

The trust or company be carrying on a business immediately prior to the CGT event.

Whilst at first glance this may appear to have some merit, it unfairly denies the concessions to those small business owners who exit by winding up their business and liquidating their company.

A simple scenario to illustrate the unfairness of this requirement is the situation in which, after unsuccessfully attempting to sell its business, a company ceases activities and sells off its assets during a liquidation. In such circumstances, and having regard to the original intentions of the small business CGT concessions, shareholders should be able to avail themselves of the concessions (providing the company meets the 80% active asset test over the years).

Furthermore, and again going to the original purpose of the small business CGT concessions in enabling business owners to finance their retirement, it is common for a company or trust to sell its business and access the retirement exemption (for example), such that the shareholder(s) can access the remainder of the funds or put into superannuation.

Yet, under these proposed changes, a company with a history of carrying on business(es), and which would otherwise meet all of the requirements for the retirement exemption or 15 year exemption (as relevant), would not be able to access the concessions in providing for the retirement funding of its shareholders.

On this basis we submit that the proposed requirement that the trust or company be carrying on a business immediately prior to the CGT event is unfair. We further submit that if this requirement is considered imperative to the operation of the small business CGT concessions, provision should be made to deem businesses to be carried on immediately prior to the CGT event where companies are in liquidation.

The requirement that the object company be an SBE or meet the maximum net asset test

This new requirement unfairly captures those that choose to run a business with others and their individual net assets are less than $6M. Under the current law, if:

- you hold at least 20% of the shares in an entity, and
- that entity had at least 80% active assets, and
- your interest in that entity combined with your business and investment assets were less than $6M,

you can access the small business CGT concessions on the sale of the shares. Access to the concessions under this scenario has always been contemplated since the introduction of the significant individual test.

The proposed legislation requiring the target entity to be a SBE or to meet the maximum net asset test significantly reduces access to the small business CGT concessions than what was intended with the introduction of the significant individual test/CGT stakeholder test.

It would be more appropriate for the proposed legislation to allow access under the maximum net asset test at the CGT stakeholder level. Failing that, then **and only then**, would it be appropriate that the target entity be a SBE or itself meet the maximum net asset test. To achieve this, proposed paragraph 152-10(2)(d) should be adjusted to add a third option, namely that "you satisfy the maximum net asset value test". This would ensure that the original intent of the significant individual test/CGT stakeholder test would be preserved, but access to the concessions would be limited (we say appropriately) where, for example, someone holds a 20% interest in an entity that has a value of $30M ie 20% of $30M equals $6M, providing no other investment assets are owned by the stakeholder.

For those shareholders who fail the maximum net asset test, and so must rely on being an SBE, we see no argument against the proposal to allow access to the concessions only where the target entity is an SBE or it meets the maximum net asset test.

Thank you for the opportunity to provide this submission. Please do not hesitate to contact the writer on 07 4722 9705 if you wish to discuss any of the points raised in greater detail.

Yours sincerely
Crowe Horwath (Aust) Pty Ltd

David Hall
ASSOCIATE PARTNER – SPECIALIST TAX ADVISORY