The Tax Institute

WA Tax Retreat

What do you mean my client doesn’t get a small business concession?

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1. Introduction

Small business CGT concessions

Provided that clients satisfy the basic tests to access the small business CGT concessions, they may choose to reduce any capital gain happening in relation to their CGT assets (after applying the 50% general discount if applicable) by:

- 50% under the small business 50% reduction (Subdivision 152-C); and/or
- applying the small business retirement exemption for its CGT concession stakeholders (Subdivision 152-D); and/or
- applying the small business roll-over (Subdivision 152-E).

Alternatively, provided that the basic tests to access the small business CGT concessions as well as the requirements for the 15-year exemption (under Subdivision 152-B) are satisfied any capital gain will be disregarded.

The small business CGT concessions are extremely generous however the rules relating to them can be quite complex and there are a lot of traps, particularly in determining whether the requirements to access the concessions are satisfied.

The February 2018 rules relating to CGT events occurring in relation to shares in companies and units in unit trusts have added further complexity, not only when determining whether the basic requirements are satisfied but also when providing structuring advice.

Although the eligibility to access the concessions is determined when a CGT event occurs, it is important that advisors are aware of the impact of these rules when advising clients on:

- how to structure their operations, in particular:
  - where CGT assets are owned in a separate entity to the business operations – as this can impact on the client's ability to satisfy the 'active asset test'; and
  - the impact of the February 2018 rules relating to CGT events happening in relation to shares and units;
- the ownership of companies (including the use of discretionary dividend shares); and
- how distributions from trusts are made – as this may determine who will 'control' the trust and who are the "CGT concession stakeholders".

The challenge for advisors will be:

- to consider the concessions when advising on structuring issues;
- review existing structures to identify issues which may impact on claiming the small business CGT concessions; and

- before the client triggers the CGT event advising client whether they satisfy the requirements to be eligible to access the particular concessions.

- This part of the paper will focus on the small business CGT concessions, in particular the issues which commonly arise when the small business CGT concessions are claimed.

Dealing with capital gains in companies and unit trusts

- A company or unit trust may have derived capital profits which are not taxable in the hands of the company or trust, for example, profits from the sale of pre-CGT assets or capital gains which are exempt under the small business CGT concessions.

- If these non-taxable profits are paid out to shareholders whilst the company is operating they will be paid out as dividends and therefore taxable in the hands of the shareholders as income. The further issue for shareholders is that the dividend may be unfranked as these profits have not been taxed.

- However, it may be possible to distribute or pay out certain capital profits in such a way that it will not be considered to be a dividend in the hands of the shareholders. These include:

    - distributions made to shareholders by a liquidator in the course of winding up of the company; or

    - payments to CGT concession stakeholders under section 152-125 of the 1997 Tax Act (small business 15-year exemption).

- Although the amount received may not be a dividend, it will trigger capital gains implications for the shareholders (either CGT event G1 or C2). This means that the capital gains provisions (including access to the small business CGT concessions) will need to be considered.

- When making payments out of a unit trust which were non-assessable to the trustee (for example, non assessable gains), it will be important to consider whether there will be tax implications for the unitholders, in particular:

    - CGT event E4 – capital payment for a trust interest (relevant for unit trusts);

    - CGT event C2 – about redemption of units

- This part of the paper will outline:

    - the different amounts which represent capital profits;

    - strategies to pay out amounts which represent capital profits to shareholders;

    - issues to consider when paying out non assessable amounts from a unit trust.

- In this paper references to:

    - '1997 Tax Act' means Income Tax Assessment 1997 (Cth)

    - '1936 Tax Act' means Income Tax Assessment 1936 (Cth).

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

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

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

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

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

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

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

- Taxation implications under Division 40

  - Generally, the decline in value (depreciation) for depreciating assets is deductible using the methods provided for in Subdivision 40-B of the 1997 Tax Act (such a prime cost or diminishing value) and based on the effective life of the assets.

  - A balancing adjustment event occurs when a taxpayer ceases to hold, to use or have installed ready for use a depreciating asset which is deductible under Subdivision 40-B.

  - The balancing adjustment (profit on sale) is calculated under Subdivision 40-D and is equal to the amount by which the termination value is higher than its adjustable value (written down value).[3]

    The termination value will be:

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

- Note:

  - Some of the intangible assets may have a high value but low cost, especially patents, copyright and mining rights.

  - Some plant and equipment retains its value, for example, helicopters and planes may have a much higher value than their depreciated value.

  - If the profit is assessable under Division 40 of the 1997 Tax Act, the capital gain provisions (including the general 50% discount and small business CGT concessions) will not apply.

2.2 Trading stock (Division 70)

- If an item of trading stock is disposed of outside the ordinary course of a business (for example, the disposal of all stock as part of the transfer of a business), then the taxpayer includes in their assessable income the market value of the item of trading stock.[6]

- Trading stock includes standing or growing crops (such as fruit), crop-stools and trees planted and tended for sale[7].

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

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

2.3 Capital gain provisions re transfer of business assets

- Assets which may be subject to the capital gain provisions include real estate, goodwill and other intangible assets (except for those which are defined to be depreciating assets) such as trademarks, rights to business names, domain names, and facebook pages.

- In relation to any capital gain on post-CGT assets, a company will not be entitled to apply the 50% general discount under Division 115 of the 1997 Tax Act (a discount of 50% for those assets which are held at least 12 months).

  This is because a company is not a type of entity which can apply the 50% general discount.

- A company may be able to reduce any capital gain under the small business CGT concessions contained in Division 152 of the 1997 Act, provided that:

  - either:

    - the net market value of the assets of the company and any connected entities just before entering into the sale agreement are less than $6 million; or

    - the company was a CGT small business entity (that is, it carried on business in either the current and had a turnover of less than $2 million in the current year or previous year [provided it carried on business in the previous year]); and

  - the CGT asset was used by the company (or a connected entity) in carrying on a business for at least half the time the company owned the asset.

- Under the small CGT concessions, the company may choose to reduce the capital gain:

  - by 50% under the small business 50% reduction under Subdivision 152-C; and/or

  - by applying the small business retirement exemption for its CGT concession stakeholders (Subdivision 152-D); and/or

  - by applying the small business roll-over (Subdivision 152-E).

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

- Retained profits

  Any profit on the sale of the business assets will form part of the retained profits which will need to be paid out of the company.

- In relation to the assets of the company which were acquired pre-CGT, the company will be able to disregard any capital gain, subject to Division 149 of the 1997 Tax Act having been triggered.

- Division 149

  - Although a CGT asset may have been acquired by a company or trustee pre-CGT, it will be taken to be a post-CGT asset of Division 149 is triggered.

  - If Division 149 is triggered then the CGT asset:

    - ceases to be a 'pre-CGT asset' on the date the first Division 149 event is triggered (Division 149 Date); and

    - is taken to be acquired by the company or trustee for market value on the Division 149 Date.

    This means that the market value of the CGT asset on the Division 149 Date will form part of the first element of the CGT asset's cost base in calculating the capital gain or capital loss on any future CGT events.

  - Division 149 is triggered at the earliest time when the majority underlying interests in the asset were not held by the ultimate owners who had majority underlying interests in the asset immediately before 20 September 1985.

  - Majority underlying interests in the asset consist of:

    - more than 50% of the beneficial interests that ultimate owners have (whether directly or indirectly) in the asset (that is, capital rights); and

    - more than 50% of the beneficial interests that ultimate owners have (whether directly or indirectly) in any ordinary income that may be derived from the asset (that is, income rights).

  - A beneficiary in a discretionary trust does not have a beneficial interest in the assets of the trust. Therefore it would not be possible to trace through to individuals who have more than 50% of the beneficial interests in the income and capital of the trust. That is, any trust or company in which at least 50% of its shareholders have been trusts since pre-CGT could not have any pre-CGT assets. This is because Division 149 would have been triggered on 20 September 1985.

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

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

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

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

2.4 Capital gain provisions re transfer of shares

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

    Section 115-45 will apply if:

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

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

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

2.5 Valuation and apportionment issues

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

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

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

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

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

- Depreciating assets

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

- Capital gains provisions:

  - The capital proceeds are taken to be market value if:

    - no consideration is received;

    - the capital proceeds cannot be valued; or

    - the consideration is more or less than market value if the parties are not dealing at arm's length.[12]

  - In calculating the $6 million net asset test, the sum of the market value of the assets needs to be ascertained just before the CGT event.

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

Valuation issues

- What is market value?

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

  Griffith CJ [at 432] stated:

  > In my judgment the test of value of land is to be determined, not by inquiring what price a man desiring to sell could actually have obtained for it on a given day, i.e., whether there was in fact on that day a willing buyer, but by inquiring "What would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for a fair price but not desirous to sell?"

  and Isaacs J [at 441] stated:

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

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

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

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

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

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

  These include the following:

  - Valuation fundamentals for tax compliance

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

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

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

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

    - the data available
    - the circumstances relating to the market, and
    - industry practice and standards for the asset being valued.

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

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

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

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

    Bases of value

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

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

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

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

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

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

Valuation approach

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

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

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

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

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

The valuation approach must be:

- reasonable given the valuation asset and information available

- supported by evidence

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

- replicable, and

- well-documented.

- Who can determine market value?

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

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

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

Apportionment issues

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

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

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

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

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

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

3. Small business CGT concessions

3.1 Introduction

- Provided that clients satisfy the basic tests to access the small business CGT concessions, they may choose to reduce any capital gain happening in relation to their CGT assets (after applying the 50% general discount if applicable) by:
  - 50% under the small business 50% reduction (Subdivision 152-C); and/or
  - applying the small business retirement exemption for its CGT concession stakeholders (Subdivision 152-D); and/or
  - applying the small business roll-over (Subdivision 152-E).
- Alternatively, provided that the basic tests to access the small business CGT concessions as well as the requirements for the 15-year exemption (under Subdivision 152-B) are satisfied any capital gain will be disregarded.

3.2 Basic conditions for accessing the small business concessions

- To access any of the small business CGT concessions, the taxpayer must meet the basic requirements of Subdivision 152-A. These are (section 152-10):
  - One of the following applies:
    - The taxpayer and its connected entities and affiliates have $6 million or less in net value of assets just before the CGT event (**NAT**).
    - The taxpayer is a CGT small business entity for the income year.
    - The asset is used by an affiliate or connected entity which is a CGT small business entity for the income year.
    - The taxpayer is a partner in a partnership, the partnership is a CGT small business entity for the income year and the CGT asset is an asset of the partnership.
    - The asset is owned by the taxpayer which is a partner and used by a CGT small business entity partnership in carrying on a business.
  - The CGT asset must meet the active asset test.
  - If the CGT asset is a share in a company or interest in a trust the following additional tests must be satisfied (see below for a summary and later in this paper for a detailed discussion):
    - Modified rules for applying the active asset test for shares (that is, the 80% look-through test).

- If the taxpayer did not satisfy NAT, that is, they are relying on the CGT small business entity test – the taxpayer must be carrying on a business just before the CGT event.
- The company or trust in which the shares (or units) are held (Object Entity) would be a CGT small business entity for the income year or satisfy NAT if the assets of each entity which the Object Entity controlled (assuming the control percentage is 20%) were included.
- CGT concession stakeholder test:
  - there must be a significant individual just before the CGT event and the shareholder or unitholder claiming the concession must be a CGT concession stakeholder in the company or trust; or
  - CGT concession stakeholders have a 90% interest in the entity which owns the shares or interest in the trust.

3.3 Applying the small business concessions

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

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

    that company or trust:

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

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What does 'in connection with retirement' mean?

- The Explanatory Memorandum to *New Business Tax System (Capital Gains Tax) Bill 1999* which introduced the small business CGT concessions provides that:

> 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.

- ATO publication Advanced Guide to Capital Gains Tax Concessions for Small Business

> Whether a CGT event happens in connection with an individual's retirement depends on the particular circumstances of each case. There would need to be at least a significant reduction in the number of hours the individual works or a significant change in the nature of their present activities to be regarded as a retirement. However it is not necessary for there to be a permanent and everlasting retirement from the workforce.
>
> The following are given as examples:
>
> A small business operator, over 55 years old, sells his business. Under the terms of the sale, he agrees to be employed by the new owner for a few hours each week for two years. The sale of the business would be in connection with the small business operator's retirement. He has permanently or indefinitely ceased being self-employed and has commenced gainful employment on a much reduced scale with another party, although still performing similar activities.
>
> A small business operator and spouse are both pharmacists, are both over 55 years old and carry on business through two pharmacies. They sell one (and make a capital gain) and, accordingly, reduce their working hours from 60 hours a week each to 45 and 35 hours a week respectively. There has been some change to their present activities in terms of hours worked and location – but there has not been a significant reduction in the number of hours or a significant change in the nature of their activities; therefore, there has been no 'retirement'.
>
> If, on the other hand, one spouse reduced their hours to nil (stopped working), there would be a significant reduction in the number of hours that spouse was engaged in the business activities. Therefore the sale would be in connection with the retirement of that spouse.

- In the ATO publication *Advanced Guide to Capital Gains Tax Concessions for Small Business* the Commissioner also accepts that the CGT event may be in connection with an individual's retirement even if it occurs at some time after the retirement.

Contributions to superannuation under the CGT cap limits (292-100)

- An individual can make a contribution to a complying superannuation fund under the CGT cap limits if:
  - the contribution is equal to all or part of the capital proceeds from a CGT event for which the capital gain was disregarded by the individual under section 152-105 (about the 15 year exemption for individuals) or would have been able to disregard the capital gain under section 152-105 if the asset was a post-CGT asset; and
  - The contribution is made on or before the later of:
    - The day the individual was required to lodge their tax return for the income year in which the CGT event happened; or

    - 30 days after the individual received the capital proceeds; and

  - a CGT cap election form is given to the superannuation fund in the approved form on or before the time the contribution is made.[14]

- An individual can make a contribution under the CGT cap limits if:

  - Just before the CGT event, the individual was a CGT concession stakeholder of an entity that could disregard the capital gain under section 152-110 (about the 15 year exemption for companies and trusts) or would have been able to disregard the capital gain under section 152-110 if the asset was a post-CGT asset; and

  - the entity makes a payment to the individual before the later of:

    - two years after the CGT event; and

    - 6 months after the latest time a possible financial benefit becomes or could become due under a look-through earnout right relating to a CGT asset;

  - the contribution is equal to all or part of the individual's stakeholder participation percentage (within the meaning of section 152-125(2)) of the capital proceeds from the CGT event (but not exceeding the amount of the payment made to the individual by the entity;

  - the contribution is made within 30 days after receiving the payment from the entity to the individual; and

  - a CGT cap election form is given to the superannuation fund in the approved form on or before the time the contribution is made.[15]

  Note: There are lifetime CGT cap limits which for the 2025 year is $1,780,000.

In-specie contributions to superannuation funds by individuals (15-year exemption)

- The issue is whether the transfer of property to a superannuation which triggers the capital gain which can be disregarded under the small business 15-year exemption be treated as part of the CGT cap limits under section 292-100 and excluded as being a non-concessional contribution by an individual.

- There are a number of private binding rulings which indicate that an individual can make an in-specie contribution to a superannuation fund and the transfer which triggers the disregarded capital gain can be a contribution under section 292-100.

[14] Sections 292-100 (1), 292-100 (2) and 292-100 (9) of the 1997 Tax Act
[15] Sections 292-100 (1), 292-100 (3) and 292-100 (9) of the 1997 Tax Act

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- PBR 5010102239061 (May 2024)

Question: Will the in-specie transfer of business real property to your superannuation fund qualify as a capital gains tax (CGT) small business contribution under section 292-100 of the *Income Tax Assessment Act 1997* (ITAA 1997)?

Answer: Yes.

Question 2: Will an amount that exceeds the CGT cap under section 292-105 of the ITAA 1997 be a non-concessional contribution.

Answer: Yes.

Relevant facts and circumstances

You are both over 55 years of age.

You are partners in a Partnership.

You are members of a Self-Managed Superannuation Fund (the Fund).

You jointly own Property.

The Property has been owned for more than 15 years and is a Partnership asset.

The Property has been leased to a related Company. You are the only directors and shareholders of the Company.

You have not used any of your CGT lifetime cap.

You plan to transfer the Property to the Fund in-specie and then retire. The intention is to disregard some or all of the capital gain under the CGT 15-year exemption.

Assumptions

You intend to transfer the Property as an in-specie contribution to the Fund during 2024-25 income year.

You satisfy the basic conditions to access the small business CGT concessions under Subdivision 152-A of the ITAA 1997.

Reasons for Decision

Small business 15-year exemption

In accordance with section 152-105 of the ITAA 1997 you can disregard a capital gain from a CGT event happening to a CGT asset if you:

- satisfy the basic conditions for the CGT small business concessions as per Subdivision 152A
- continuously owned the CGT asset for the 15-year period ending just before the CGT event happened.

If you are an individual, you must have been:

- at least 55 years old and the CGT event happened in connection with your retirement, or
- permanently incapacitated at the time of the CGT event.

The provisions relating to the small business 15-year exemption do not define what is meant by the phrase 'in connection with a taxpayer's retirement, nor does it give any indication of the degree of retirement required in order to take advantage of this concession. The words 'in connection with' can also apply where the CGT event occurs sometime after retirement.

In your case, the Property's use was an integral part of your business and it is reasonable to conclude that it always formed part of your retirement plan.

You satisfy the basic conditions for the CGT small business concessions and have owned the asset continuously for more than 15 years. As you are over 55 years of age you will meet the 15-year exemption due to retirement when you dispose of your property during the 2025 year of income.

In-specie contribution

The term 'contribution' is not defined in the ITAA 1997. Taxation Ruling TR 2010/1: *Income tax: superannuation contributions* outlines the Commissioner's view on the ordinary meaning of contribution, how a contribution can be made and when contributions are made for the purposes of the ITAA 1997.

Section 285-5 of the ITAA 1997 provides that a superannuation contribution can be made by transferring property to the superannuation provider (an in-specie contribution) providing the contribution is or includes the market value of the property.

Section 66 of the *Superannuation Industry (Supervision) Act 1993* prohibits the acquisition of an asset from a related party of a superannuation fund, unless it meets a specified exception.

A member is a related party of a fund.

One of the limited exceptions to this rule allows a fund trustee to acquire business real property from a related party at market value. Where a commercial property of the members is being used wholly and exclusively in a business at the time of transfer it will meet the business real property definition.

Based on the information provided the Fund will acquire property that meets the definition of business real property at market value.

CGT lifetime cap

If an individual makes an in-specie contribution of an asset to their SMSF with the intent of disregarding all or part of the capital gain under the CGT small business concessions, they may also be eligible to exclude all or part of that contribution from counting against their non-concessional cap and instead be counted against their CGT cap under section 292-105 of the ITAA 1997.

An individual's lifetime CGT contribution cap is $1,780,000 for the 2024-25 year of income and it operates separately from the non-concessional contribution cap.

Paragraph 292-90(2)(c) of the ITAA 1997 provides for certain types of contributions to be excluded from being considered a non-concessional contribution. One such contribution is a contribution covered under section 292-100 relating to certain CGT-related payments, to the extent that it does not exceed your CGT cap amount when it is made.

Subsection 292-100(1) of the ITAA 1997 states that a contribution is covered under this section if it is:

a) a contribution made by an individual to a fund in respect of the individual

b) the requirement in subsections (2), (4), (7) or (8) are met, and

c) the individual chooses to apply this section to an amount that is all or part of the contribution.

Where an individual intends to disregard any capital gain resulting from a CGT event under section 152-105 of the ITAA 1997 (15-year exemption for individuals), subsection 292-100(2) is the appropriate subsection to consider. The contribution requirement is met if:

a) the contribution is equal to all or part of the *capital proceeds from a *CGT event for which you can disregard any *capital gain under section 152-105 (or would be able to do so, assuming that a capital gain arose from the event)

b) the contribution is made on or before the later of the following days:

• the day they are required to lodge their income tax return for the income year in which the CGT event happened;

• 30 days after the day they receive the capital proceeds.

The 15-year exemption contribution relates to the capital proceeds from the sale of the property and not the actual capital gain amount.

You are eligible for the small business CGT concessions relating to the sale of the Property, as per section 152-105 of the ITAA 1997.

As you are eligible for the 15-year exemption, you may contribute all or part of the capital proceeds from the sale of the Property provided they are made within the legislated timeframe.

The choice to exclude the contribution from being a non-concessional contribution will only be valid if it is made in the approved form and given to the Fund on or before the time the contribution is made.

With regard to the in-specie contribution, the legislation does not prevent the CGT event, choice and contribution of the 15-year exempt amount from happening simultaneously.

[emphasis added]

CGT Non-concessional contributions

Where you make a personal superannuation contribution using the capital proceeds under the CGT 15-year exemption, any amount which is not excluded under the election or exceeds the CGT lifetime cap of $1,780,000 for the 2024-25 income year, will be classed as a non-concessional contribution.

From 1 July 2024, the non-concessional contributions cap is $120,000. Members under 75 years of age may be able to make non-concessional contributions of up to 3 times the annual non-concessional contributions cap in a single year.

If eligible, when you make contributions greater than the annual cap, you automatically gain access to future year caps. This is known as the 'bring-forward' option.

Your combined CGT 15-year exempt amount under the CGT lifetime cap will be 2 x $1,780,000 ($3,560,000) for the 2025 income year.
Applying the bring forward provisions, the combined maximum non-concessional contribution amount for the 2025 income year will be 2 x $360,000 ($720,000).

- PBR 5010102239061 (April 2024)

Question: Will the in specie transfer of business real property to your superannuation fund qualify as a capital gains tax (CGT) small business contribution under section 292-100 of the Income Tax Assessment Act 1997 (ITAA 1997)?

Answer: Yes.

Relevant facts and circumstances

You are over 55 years of age.

You are the sole registered proprietor of the Property.

You inherited the Property from your parent more than 25 years ago.

You are a sole member of a self-managed superannuation fund (the Fund).

From the acquisition date until now you have operated a partnership farming business on the Property with your spouse. You have worked full time in the farming business.

You are in the process of decreasing your work commitments towards retirement as a primary producer and have sold some of the land, leased some of the land to a 3rd party, significantly reducing livestock numbers and changed the business enterprise to just cattle on the remaining land due to the lower level of management input required.

Assumptions: You intend to transfer the Property to the Fund, at market value, as an in specie contribution during the 20YY-YY income year. You satisfy the basic conditions to access the small business CGT concessions under Subdivision 152-A of the ITAA 1997.

Reasons for decision

Small business 15-year exemption

In accordance with section 152-105 of the ITAA 1997 you can disregard a capital gain from a CGT event happening to a CGT asset if you:

- satisfy the basic conditions for the CGT small business concessions as per Subdivision 152A

- continuously owned the CGT asset for the 15-year period ending just before the CGT event happened.

If you are an individual, you must have been:

- at least 55 years old and the CGT event happened in connection with your retirement, or

- permanently incapacitated at the time of the CGT event.

The provisions relating to the small business 15-year exemption do not define what is meant by the phrase 'in connection with a taxpayer's retirement, nor does it give any indication of the degree of retirement required in order to take advantage of this concession. Whether a CGT event happens in connection with an individual's retirement depends on the particular circumstances of each case. There would need to be at least a significant reduction in the number of hours the individual works or a significant change in the nature of their present activities to be regarded as a retirement. However, it isn't necessary for there to be a permanent and everlasting retirement from the workforce.

In your case the Property's use was an integral part of your farming business and it is reasonable to conclude that it always formed part of your retirement plan. The fact that the CGT event will occur during your path to retirement from the business will not break this connection.

You satisfy the basic conditions for the CGT small business concessions and have owned the asset continuously for more than 15 years. As you are over 55 years of age you will meet the 15-year exemption due to retirement when you dispose of your Property during the 20YY year of income.

In-specie contribution

The term 'contribution' is not defined in the ITAA 1997. Taxation Ruling TR 2010/1: Income tax: superannuation contributions outlines the Commissioner's view on the ordinary meaning of contribution, how a contribution can be made and when contributions are made for the purposes of the ITAA 1997.

Section 285-5 of the ITAA 1997 provides that a superannuation contribution can be made by transferring property to the superannuation provider (an in-specie contribution) providing the contribution is or includes the market value of the property.

Section 66 of the Superannuation Industry (Supervision) Act 1993 prohibits the acquisition of an asset from a related party of a superannuation fund, unless it meets a specified exception.

A member is a related party of a fund.

One of the limited exceptions to this rule allows a fund trustee to acquire business real property from a related party at market value. Where a property of the member is being used wholly and exclusively in a farming business at the time of transfer, it will meet the business real property definition.

Based on the information provided the Fund will acquire property that meets the definition of business real property at market value.

CGT lifetime cap

If an individual makes an in-specie contribution of an asset to their SMSF with the intent of disregarding all or part of the capital gain under the CGT small business concessions, they may also be eligible to exclude all or part of that contribution from counting against their non-concessional cap and instead be counted against their CGT cap under section 292-105 of the ITAA 1997.

An individual's lifetime CGT contribution cap is $1,705,000 for the 20YY-YY year of income and it operates separately from the non-concessional contribution cap.

Paragraph 292-90(2)(c) of the ITAA 1997 provides for certain types of contributions to be excluded from being considered a non-concessional contribution. One such contribution is a contribution covered under section 292-100 relating to certain CGT-related payments, to the extent that it does not exceed your CGT cap amount when it is made.

Subsection 292-100(1) of the ITAA 1997 states that a contribution is covered under this section if it is:

a) a contribution made by an individual to a fund in respect of the individual

b) the requirement in subsections (2), (4), (7) or (8) are met, and

c) the individual chooses to apply this section to an amount that is all or part of the contribution.

Where an individual intends to disregard any capital gain resulting from a CGT event under section 152-105 of the ITAA 1997 (15-year exemption for individuals), subsection 292-100(2) is the appropriate subsection to consider. Paragraph 292-100(2)(b) requires an individual to make a contribution to their superannuation fund before the later of:

- the day they are required to lodge their income tax return for the income year in which the CGT event happened;

- 30 days after the day they receive the capital proceeds

You have indicated that you are eligible for the small business CGT concessions relating to the sale of the Property, as per section 152-105 of the ITAA 1997.

Where a member is eligible for the 15-year exemption, they may contribute all or part of the capital proceeds from the sale of the Property provided they are made within the legislated timeframe.

The choice to exclude the contribution from being a non-concessional contribution will only be valid if it is made in the approved form and given to the Fund on or before the time the contribution is made.

With regard to the in specie contribution, the legislation does not prevent the CGT event, choice and contribution of the 15-year exempt amount from happening simultaneously.

[emphasis added]

3.3.2 Small business 50% reduction (subdivision 152-C)

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

3.3.3 Small Business Retirement Exemption (subdivision 152-D)

- Individuals:
    - The individual must not exceed their lifetime limit of $500,000.
    - If the individual is under 55 years of age when making the choice, the retirement exemption amount must be paid to a complying superannuation fund by the time the choice is made.
    - The choice must be made in writing by the time of the lodgement of the tax return for the year in which the CGT cent occurs.
    - A CGT Cap Election Form must be given to the superannuation at or before the contribution is made to the superannuation fund, otherwise the contribution is treated as a non-concessional contribution (section 292-100).
- Companies and trusts
    - To access the retirement exemption, a company or trust must have a significant individual just before the CGT event (section 152-305(2)).
    - The small business retirement exemption allows the company or trust to pay up to $500,000 to or for the benefit of its CGT concession stakeholders (section 152-315(5)).
    - However, the company or trust must ensure that the payment of the retirement exemption to the individual will not result in them exceeding their lifetime limit of $500,000.
    - The company or trust must make the choice to use the retirement exemption in writing by the time it lodges its income tax return for the year in which the CGT event occurs (section 103-25 and 152-315(4)).

      Note, it is the taxpayer who has the capital gain which chooses to apply the retirement exemption, not the CGT concession stakeholder.
    - It must nominate who its CGT concession stakeholders are and what percentage of the small business retirement exemption it is applying to each.

- It must make the payment no later than within seven days of making the choice (section 152-325(4)).
- If the CGT concession stakeholder to whom the retirement exemption is applied is at least 55 years when the choice is made, the payment must be paid to the CGT concession stakeholder.
- If the CGT concession stakeholder to whom the retirement exemption is applied is not at least 55 years when the choice is made, the payment must be paid into a complying superannuation fund (section 152-325(7)).
- A CGT Cap Election Form must be given to the superannuation at or before the contribution is made to the superannuation fund, otherwise the contribution is treated as a non-concessional contribution (section 292-100).

Contributions to superannuation under the CGT cap limits (292-100)

- An individual can make a contribution to a complying superannuation fund under the CGT cap limits if:
  - the contribution is equal to all or part of the capital gain from a CGT event for which the capital gain was disregarded by the individual under section 152-305(1) (about the small business retirement exemption for individuals); and
  - The contribution is made on or before the later of:
    - the day the individual was required to lodge their tax return for the income year in which the CGT event happened; or
    - 30 days after the individual received the capital proceeds from the CGT event; and
  - a CGT cap election form is given to the superannuation fund in the approved form on or before the time the contribution is made.[16]
- An individual can make a contribution under the CGT cap limits if:
  - Just before the CGT event, the individual was a CGT concession stakeholder of an entity that could disregard the capital gain under section 152-305(2) (about the small business retirement exemption for companies and trusts); and
  - the entity makes a payment which satisfies the conditions in section 152-325 (about making the payment of the retirement amount to its CGT concession stakeholders); and
  - the contribution is equal to all or part of the capital gain arising from the CGT event (but not exceeding the amount of the payment made under section 152-325);
  - the contribution is made within 30 days after the payment made by the entity under section 152-325; and

[16] Sections 292-100 (1), 292-100 (7) and 292-100 (9) of the 1997 Tax Act

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- a CGT cap election form is given to the superannuation fund in the approved form on or before the time the contribution is made.[17]

Note: There are lifetime CGT cap limits which for the 2025 year is $1,780,000.

In-specie contributions to superannuation funds

- The issue is whether the transfer of property to a superannuation which triggers the capital gain to which the small business retirement exemption applies be treated as part of the CGT cap limits under section 292-100 and excluded as being a non-concessional contribution by an individual.
  - There are a number of private binding rulings that provide that section 292-10 does not contemplate that the CGT event, choice and contribution of the CGT exempt amount can happen simultaneously. Rather, each of the relevant steps must happen sequentially, therefore, that initial transfer of the property cannot also be the final contribution required under section 292-100.
  - PBR 1013139540589 (May 2017) Individual under 55 years of age transferring property to superannuation fund was not eligible for the small business retirement exemption as a contribution was not made to superannuation by the time they made the choice.

    Question: Can you utilise the small business capital gains tax (CGT) retirement exemption in relation to the capital gain arising from the in-specie transfer of a commercial property to your self-managed superannuation fund (SMSF)?

    Answer: No.

    Relevant facts and circumstances

    You are a partner in a partnership.

    The partnership owns commercial property.

    The property was purchased several years ago and used exclusively to run a business.

    The turnover of the business is under $2 million.

    You are under 55.

    The property is an active asset.

    You want to transfer the ownership of the property to a SMSF. You will make an in specie transfer with no proceeds received.

    A capital gain will be made on the property transfer.

    Reasons for decision

    Subdivision 152-D of the ITAA 1997 contains the small business retirement exemption. You may choose to disregard all or part of a capital gain under the small business retirement exemption if you satisfy certain conditions.

[17] Sections 292-100 (1), 292-100 (8) and 292-100 (9) of the 1997 Tax Act

The small business retirement exemption allows individuals the choice to disregard up to $500,000 in qualifying capital gains. To be entitled to the small business retirement exemption, an individual must satisfy the following conditions:

1. A CGT event happens in relation to a CGT asset in an income year;

2. The event would have, apart from Division 152 of the ITAA 1997, resulted in a capital gain;

3. The basic conditions in Subdivision 152-A of the ITAA 1997 are met; and

4. A choice is made to disregard all or part of the capital gain under subsection 152-305(1) of the ITAA 1997. This disregarded amount is known as the asset's 'CGT exempt amount'.

If the individual is under the age of 55 just before the choice is made, a contribution must be made to that individual's complying superannuation fund (or retirement savings account). The contribution must be equal to the asset's CGT exempt amount and paid out of the capital proceeds before the later of when the choice is made and when the proceeds are received.

Once the capital proceeds are received, the individual is able to calculate their capital gain and subsequently make the choice to disregard all or part of that capital gain. Subdivision152-D of the ITAA 1997 does not contemplate that the CGT event, choice and contribution of the CGT exempt amount can all take place simultaneously.

This is also confirmed in paragraph 292-100(7)(b) of the ITAA 1997 which states that the contribution to the superannuation fund must be made on or before the later of the following days:

a) the day you are required to lodge your income tax return for the income year in which the CGT event happened; or

b) 30 days after the day you receive the capital proceeds from the CGT event.

It is clear that these paragraphs contemplate the CGT event and the payment to SMSF happening at separate times. That is, section 292-100 of the ITAA 1997 makes it clear that a contribution made to the SMSF is made after the CGT event happened and/or the capital proceeds are received.

The determination of the capital proceeds, the calculation of the capital gains and the making a choice under section 152-305 of the ITAA 1997 is the correct construction of the order required for the small business retirement exemption provisions. A necessary consequence of this ordering is that the contribution of the CGT exempt amount must be made at the later of when the choice is made and when the capital proceeds are received.

In your case you cannot reduce or disregard your capital gain made in respect of the capital gain arising from the in-specie transfer of the property in accordance with the small business CGT retirement exemption. …… The legislation does not contemplate that the CGT event, choice and contribution of the CGT exempt amount can happen simultaneously. Rather, each of the relevant steps must happen sequentially, therefore, that initial transfer of the property cannot also be the final contribution required.

[emphasis added]

- PBR 1013027694578 (July 2016) Individual under 55 years of age transferring property to superannuation fund

  Question 2: Can an in-specie transfer of commercial property at market value to your self-managed superannuation fund (SMSF) be excluded from non-concessional contributions in accordance with subsection 292-90(2) of the *Income Tax Assessment Act 1997* (ITAA 1997)?

  Answer: No.

  Question 3: Can an individual over 55, utilise the small business CGT retirement exemption in section 152-305 of the ITAA 1997 in relation to the capital gain arising from the in-specie transfer of a commercial property to your SMSF?

  Answer: Yes.

  Question 4: Can an individual under 55, treat the in-specie transfer of a commercial property to their SMSF as the contribution required by paragraph 152-305(1)(b) of the ITAA 1997 and hence utilise the small business CGT retirement exemption in section 152-305 of the ITAA 1997 in relation to the capital gain arising from the transfer?

  Answer: No.

  Relevant facts and circumstances

  Member 1 and Member 2 own a commercial property (the property). Member 1 and Member 2 each have a 50% ownership interest in the property.

  Member 1 is over 55.

  Member 2 is under 55.

  Member 1 and Member 2 have been the majority shareholders of a business (the Business) from 200X-0X income year until the 2012-13 income year.

  The Business continuously based their operations from the property from the 200X-0X income year through to the 20XX-XX income year.

  The property is an active asset.

  The property has been vacant since the 20XX-XX income year and was offered for sale.

  The property is currently vacant and you will transfer it into the self-managed superannuation fund of Member 1 and Member 2 for no consideration.

  In the 2015-16 income year, Member 1 has made non-concessional contributions to the SMSF in their name.

  Reasons for decision

  Question 2

  Summary

  Member 1 and Member 2 will not be able to exclude the contribution of the property to the SMSF from being a non-concessional contribution pursuant to section 292-100 of the ITAA 1997. That is, the contribution cannot be a contribution under the CGT cap.

Detailed reasoning

Can a Transfer of Property be a Contribution?

The term 'contribution' is not defined in the ITAA 1997. Taxation Ruling TR 2010/1 sets out the Commissioner's view on the ordinary meaning of contribution, how a contribution can be made and when contributions are made for the purposes of the ITAA 1997. Under section 285-5 of the ITAA 1997, a transfer of property can be a contribution. Such a contribution is called an in-specie contribution.

Paragraph 20 of TR 2010/1 states:

A contribution by way of a transfer of an asset will be made when the superannuation provider obtains ownership of the asset from the contributor. The Commissioner accepts the superannuation provider obtains ownership of an asset when beneficial ownership of the asset is acquired and that beneficial ownership can be acquired earlier than legal ownership.

Contributions made to a fund for or by a person may be included in the person's concessional contributions or non-concessional contributions. There are also situations where the contributions may not be included in the person's concessional contributions or non-concessional contributions.

Non-Concessional Contributions

Pursuant to subsection 292-90(1) of the ITAA 1997, the amount of non-concessional contributions for a financial year is the sum of each contribution covered by subsection 292-90(2) of the ITAA 1997; each amount covered by subsection 292-90(4) of the ITAA 1997; and the amount of an individual taxpayer's excess concessional contributions (if any) for the financial year.

Will the Contribution be a Non-Concessional Contribution?

The contribution will not be included in the assessable income of the SMSF pursuant to subsection 295-190(1) of the ITAA 1997. As such, it will be treated as a non-concessional contribution pursuant to paragraph 292-90(2)(b) of the ITAA 1997 unless it falls into one of the subparagraphs of paragraph 292-90(2)(c) of the ITAA 1997.

Relevantly, subparagraph 292-90(2)(c)(iii) of the ITAA 1997 refers to a contribution covered under section 292-100 (certain CGT-related payments), to the extent that it does not exceed a taxpayer's CGT cap amount when it is made.

As paragraph 292-100(1)(b) refers to meeting the requirements in either subsection 292-100(2), 292-100(4), 292-100(7) or 292-100(8) of the ITAA 1997, it is necessary to consider which of those subsections applies in the circumstances.

Given that Member 1 and Member 2 intend to disregard the capital gain made as a result of the disposal of the property (the CGT event) under section 152-305 of the ITAA 1997, subsection 292-100(7) of the ITAA 1997 is the appropriate subsection to consider.

Paragraph 292-100(7)(b) of the ITAA 1997 states that the contribution to the superannuation fund must be made on or before the later of the following days:

(a) or the day you are required to lodge your income tax return for the income year in which the CGT event happened; or

(b) 30 days after the day you receive the capital proceeds from the CGT event.

It is clear that these paragraphs contemplate the CGT event and the payment to SMSF happening at separate times.

Application to your situation

Member 1 and Member 2 will not be able to exclude the contribution from being a non-concessional contribution pursuant to section 292-100 of the ITAA 1997. That is, the contribution cannot be a contribution under the CGT cap. **This is because, section 292-100 of the ITAA 1997 makes it clear that a contribution made to the SMSF is made after the CGT event happened and/or the capital proceeds are received.**

[emphasis added]

Question 3

Summary

Member 1 is able to utilise the small business CGT retirement exemption in section 152-305 of the ITAA 1997 in relation to the capital gain arising from the in-specie transfer of the property to the SMSF

Detailed reasoning

The small business retirement exemption under Subdivision 152-D of Part 3-3 of the ITAA 1997 allows individuals the choice to disregard up to $500,000 in qualifying capital gains. An individual may choose to disregard all or part of a capital gain under the small business retirement exemption by satisfying the conditions outlined below:

1. A CGT event happens in relation to a CGT asset in an income year;

2. The event would have, apart from Division 152 of the ITAA 1997, resulted in a capital gain;

3. The basic conditions in Subdivision 152-A of Part 3-3 of the ITAA 1997 are met; and

4. A choice is made to disregard all or part of the capital gain under subsection 152-305(1) of the ITAA 1997. This disregarded amount is known as the asset's 'CGT exempt amount'.

If the individual is aged 55 or older just before choosing the retirement exemption, they are not required to pay any amount into a superannuation fund.

Application to your circumstances

As Member 1 is over 55 and meets the basic conditions for the small business retirement exemption, Carl is able to choose all or part of their capital gain from the in-specie transfer to the SMSF to disregard, so long as they do not exceed their CGT retirement exemption limit, which is currently $500,000. This is because there is no requirement for an individual aged 55 or older to make a contribution to the superannuation fund in order to access the concession.

Question 4

Summary

Member 2 cannot treat the in-specie transfer of a commercial property to your SMSF as the contribution required be paragraph 152-305(1)(b) of the ITAA 1997 and hence utilise the

small business CGT retirement exemption in section 152-305 of the ITAA 1997 in relation to the capital gain arising from the transfer. Paragraph 152-305(1)(b) of the ITAA 1997 requires the contribution to occur after the happening of the CGT event which give rise to the capital gain.

Detailed reasoning

The small business retirement exemption under Subdivision 152-D of Part 3-3 of the ITAA 1997 allows individuals the choice to disregard up to $500,000 in qualifying capital gains. An individual may choose to disregard all or part of a capital gain under the small business retirement exemption by satisfying the conditions outlined below:

1. A CGT event happens in relation to a CGT asset in an income year;

2. The event would have, apart from Division 152 of the ITAA 1997, resulted in a capital gain;

3. The basic conditions in Subdivision 152-A of Part 3-3 of the ITAA 1997 are met; and

4. A choice is made to disregard all or part of the capital gain under subsection 152-305(1) of the ITAA 1997. This disregarded amount is known as the asset's 'CGT exempt amount'.

If the individual is under the age of 55 just before the choice is made, a contribution must be made to that individual's complying superannuation fund (or retirement savings account). The contribution must be equal to the asset's CGT exempt amount and paid out of the capital proceeds before the later of when the choice is made and when the proceeds are received.

Once the capital proceeds are calculated, the individual is able to calculate their capital gain and subsequently make the choice to disregard all or part of that capital gain. Subdivision152-D of Part 3-3 of the ITAA 1997 does not contemplate that the CGT event, choice and contribution of the CGT exempt amount can all take place simultaneously.

The determination of the capital proceeds, the calculation of the capital gains and the making a choice under section 152-305 of the ITAA 1997 is the correct construction of the order required for the small business retirement exemption provisions. A necessary consequence of this ordering is that the contribution of the CGT exempt amount must be made at the later of when the choice is made and when the capital proceeds are received.

Application to your circumstances

Member 2 cannot reduce or disregard her capital gain made in respect of the capital gain arising from the in-specie transfer of the property in accordance with the small business CGT retirement exemption. This is because an individual under 55 must make a contribution to a complying superannuation fund within 2 years of the CGT event occurring. The legislation does not contemplate that the CGT event, choice and contribution of the CGT exempt amount can happen simultaneously. Rather, each of the relevant steps must happen sequentially, therefore, that initial transfer of the property cannot also be the final contribution required.

- Note: there is a private binding ruling PBR 1051972132007 (April 2022) which indicated the legislation does not prevent the CGT event, choice and contribution of the small business retirement exempt amount from happening simultaneously for someone over the age of 55 and that any amount of the in-specie contribution that is over and above the CGT exempt amount will count as a non-concessional contribution and will be assessed against your non-concessional contribution cap for the relevant income year.

As this is not consistent with the Commissioner's view in the majority of private rulings on this point, it would be prudent to obtain a private binding ruling if your client is considering this.

3.3.4 Small business roll-over (subdivision 152-E)

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

CGT event J5

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

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

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

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CGT event J6

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

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

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

CGT event J2

When does CGT event J2 occur?

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

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

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

When is the time of the CGT event if CGT event J2 is triggered?

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

How much is the capital gain?

The capital gain is equal to:

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

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

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

3.4 Small business CGT concession re estates and death rules

CGT event happening within 2 years of individual's death (Section 152-80)

- The legal personal representative or the beneficiary or surviving joint tenant of testamentary trust is entitled to disregard a capital gain under the small business CGT concessions in the same way as the individual would have been entitled to, provided that all of the following conditions are satisfied:
  - A CGT asset forms part of the estate of a deceased individual or the asset was owned by joint tenants and one of them dies.
  - The asset devolves to the individual's legal personal representative or testamentary or passes to a beneficiary or joint tenant of the individual.
  - The individual would have been entitled to disregard a capital gain under the small business CGT concessions if a CGT event had happened in relation to the CGT asset immediately before his or her death. That is, if a CGT event happened just before the death of the deceased, the deceased:
    - would have had a capital gain; and
    - would have met the basic tests in Subdivision 152-A .
  - A CGT event happens in relation to the CGT asset within 2 years of the individual's death (or a longer time that the Commissioner allows).
- Modification to the application of the rules:
  - Retirement exemption
    - The entity claiming the retirement exemption cannot exceed the deceased's $500,000 lifetime limit.
    - There is no requirement for the retirement exemption amount to be paid into superannuation (regardless of whether the deceased or claiming entity is under 55 years of age).
  - 15 year exemption
    - Deceased needs to be 55 or over, or permanently incapacitated, at the time immediately before his or her death (no requirement that CGT event occurs in connection with retirement).
    - Deceased needs to have held the asset at least 15 years.

3.5 Connected entities and affiliates

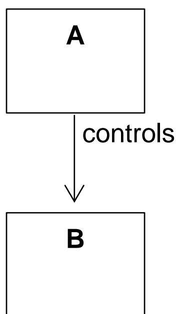
Determining whether an entity is a 'connected' entity or an 'affiliate' is relevant for the purpose of determining:

- whether an entity's assets are included for the purpose of determining NAT;
- whether an entity's turnover is included for the purpose of determining the aggregated turnover test for the purpose of the CGT small business entity tests; and
- whether the 'active asset' test is satisfied.

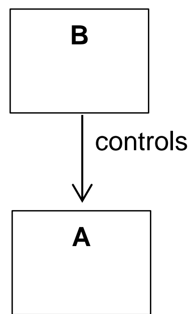
3.5.1 Who is a 'connected' entity?

- An entity is connected with another entity if:
  - an entity controls the other entity; or
  - both entities are controlled by the same third entity.[18]
- Examples – assuming A is the Taxpayer

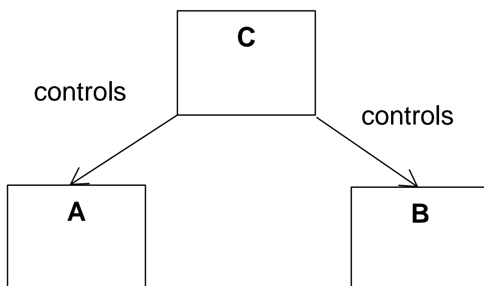
Example 1



Example 2



Example 3



[18] Section 328-125(1) of the 1997 Tax Act

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- In these Examples, A is connected with:
  - Example 1 - B because A controls B
  - Example 2 - B because B controls A
  - Example 3:
    - C because C controls A; and
    - B because A and B are controlled by C

3.5.2 When will an entity control another entity?

Control of a company

- An entity controls a company if the entity and/or its affiliates own or have the right to acquire the ownership of shares in the company that carry between them the right to at least 40% of:
  - any distribution of income; or
  - any distribution of capital; or
  - the voting power.[19]

Control of a partnership

- An entity controls a partnership if the entity and/or its affiliates own or have the right to at least 40% of:
  - any distribution of income or capital of the partnership; or
  - the net income of the partnership.[20]
- 'Tax law' partnerships
  - It is quite common for clients to own a joint interest in a passively held asset. For example, mum and dad own a share in a company jointly or the client may own a 50% interest in a rental property with their sibling.
  - Although not a general law partnership, for taxation purposes a 'partnership' includes an association of persons in receipt of ordinary or statutory income jointly.[21]
  - Section 328-125(2) as it applies to partnerships provides that an entity controls a partnership if that entity and/or its affiliates together own interests which have the right to receive at least 40% of the income or capital of the partnership or the net income of the partnership.

[19] Section 328-125(2) of the 1997 Tax Act
[20] Section 328-125(2) of the 1997 Tax Act
[21] Section 995-1(1) of the 1997 Tax Act

Question: Is a partner entitled to 'net income of a partnership' where the partnership is a tax law partnership but not a common law partnership?

- *Taxation Determination* TD 2022/7 (about aggregated turnover - application of the 'connected with' concept to partnerships, foreign hybrids and non-entity joint ventures)

  Partnerships

  44. Subdivision 328-C refers to the term 'entity'. Subsection 995-1(1) provides that, except so far as the contrary intention appears, entity has the meaning given by section 960-100. Relevantly, an entity within the meaning of section 960-100 includes, among other things, a partnership.

  45. A partnership is defined in subsection 995-1(1) to mean:

  (a) an association of persons (other than a company or a limited partnership) carrying on business as partners or in receipt of ordinary income or statutory income jointly; or

  (b) a limited partnership.

  46. Subdivision 328-C applies to a partnership as though it were an entity in its own right. For example, a person who is a partner in a partnership in an income year is not, in his or her capacity as a partner, a small business entity for the income year. Paragraph 2.109 of the Explanatory Memorandum to the Tax Laws Amendment (2009 Measures No. 2) Bill 2009 explains that the clear intention of the small business entity regime was that a partner in a partnership cannot, in their capacity as a partner, be a small business entity; it is only the partnership that can be a small business entity.

  47. In the context of the 'connected with' concept, the direct control tests in paragraph 328-125(2)(a) apply to determining direct control of a partnership.

  48. A partner will directly control a partnership if the partner, its affiliates or the partner together with its affiliates own or have the right to acquire ownership of interests in the partnership that carry between them the right to receive:

  • at least 40% of any distributions of income or capital by the partnership, or

  • at least 40% of the net income of the partnership.

  49. For the purposes of determining whether a partnership directly controls another entity under section 328-125, it is the partnership itself (being the partners collectively in their capacity as partners) that is taken to control the other entity.

  Example 1 - working out whether an entity is connected with a partnership

  15. XYZ Pty Ltd (XYZ) needs to calculate its aggregated turnover for the 2020-21 income year to determine its eligibility for the loss carry back tax offset.

  16. Under section 328-115, XYZ's aggregated turnover includes its own annual turnover, together with the annual turnover of any entity that is connected with, or an affiliate of, XYZ at any time during the income year. Therefore, to undertake this calculation, XYZ needs to identify any entities connected with it.

  17. The major shareholder in XYZ is a partnership known as ABCD Partners (the Partnership). AB Pty Ltd (AB) and CD Pty Ltd (CD) each hold 50% of the interests in the Partnership and receive equal distributions of income and capital made by the Partnership.

  18. The Partnership's assets include 51% of the ordinary shares in XYZ. These shares carry full rights to voting, capital and dividends.

19. The Partnership directly controls XYZ by virtue of holding 51% of the rights to voting, capital and dividends in XYZ, therefore satisfying the general control tests in subparagraphs 328-125(2)(a)(i) and (iii), as well as the voting control test in paragraph 328-125(2)(b).

20. As XYZ is directly controlled by the Partnership, it also needs to consider whether it is indirectly controlled by AB and/or CD. As AB and CD are each entitled to receive 50% of any distributions of income or capital made by the Partnership, they are each taken to directly control the Partnership in accordance with the general control tests in subparagraphs 328-125(2)(a)(i) and (iii). Accordingly, by virtue of the indirect control test in subsection 328-125(7), AB and CD each indirectly control XYZ.

21. Therefore, XYZ is connected with the Partnership, AB and CD, and will need to include the annual turnover of each of these entities in its aggregated turnover for the 2020-21 income year.

- *Taxation Ruling* TR 93/32 (about rental property – division of net income or loss between co-owners)

3. Co-ownership of rental property is a partnership for income tax purposes but is not a partnership at general law unless the ownership amounts to the carrying on of a business.

4. Where co-ownership is a partnership for income tax purposes only, the income/loss from the rental property is derived from co-ownership of the property and not from the distribution of partnership profits/losses.

5. Because co-owners of rental property are generally not partners at general law, a partnership agreement, either oral or in writing, has no effect on the sharing of income/loss from the property.

6. Accordingly, the income/loss from the rental property must be shared according to the legal interest of the owners except in those very limited circumstances where there is sufficient evidence to establish that the equitable interest is different from the legal title.

- *Goods and Services Tax Ruling* GSTR 2004/6 (about GST: tax law partnerships and co-owners of property)

103. We agree with the Tribunal's view that a tax law partnership does not have capital. We further take the view that partners in a tax law partnership have neither interests in the capital of a partnership, nor interests in the partnership. The only interest that a partner in a tax law partnership has is an interest in the property, coupled with a right to a share of the net income or losses in accordance with that interest.

- Private binding rulings

The Commissioner's view (as expressed in private binding rulings) is that a tax law partnership is a partnership for the purpose of section 328-125(2), and that where the entity and/or their affiliates together have a 40% in the tax law partnership, they will control the partnership, which means that 100% of the net assets of the tax law partnership are included. This will also mean that the partner will control an entity that the partnership in turn controls.

- PBR 1052103982176 (March 2023)

23. Partnerships, including 'tax law' partnerships, are treated as entities for tax purposes. Subsection 960-100(1) says 'entity' means any of a list of things - 'partnership' is included at paragraph (d). Section 995-1 gives a definition of 'partnership' which includes an association of persons (other than a company or a limited partnership) carrying on business as partners or in receipt of ordinary income or statutory income jointly. People who receive ordinary or statutory income jointly are sometimes known as 'tax law partnerships' (as opposed to people carrying on business in common, who would be recognised under the general law of partnership). ATO guidance says that co-owners of rental property are treated as partners for tax purposes because they are in receipt of income jointly. It doesn't matter whether they are joint tenants or tenants in common.

24. Here, the association known as the Property Partnership will be treated as a partnership for tax law purposes. Person B, Person A, Person C, and Person D own a commercial rental property as tenants in common. The Property Partnership received rental income from renting the property to The Trust. (We've assumed that the rental income was assessable income. ATO guidance in IT 2167 suggests rent is generally assessable income.) The Property Partnership is a partnership because the four individuals, as tenants in common, were in receipt of ordinary or statutory income jointly.

You control a partnership where, together with your affiliates, you own interests that have the right to receive at least 40% of the net income of the partnership.

25. As we mentioned in paragraph 7 of these reasons, section 328-125 is about whether entities are connected, which turns on the concept of control. Subsection 328-125(1) says an entity is connected with another entity if:

• either entity controls the other entity in a way described in the section, or

• both entities are controlled by the same third entity.

The section also has control percentage tests for entities other than discretionary trusts.

26. Broadly, an entity controls another entity (other than a discretionary trust) if it owns interests that carry between them rights to at least 40% of distributions of income, capital, or net partnership income. Paragraph 328-125(2)(a) says:

An entity (*the **first entity**) controls another entity* if the first entity, its *affiliates, or the first entity together with its affiliates:

(a) except if the other entity is a discretionary trust - own, or have the right to acquire the ownership of, interests in the other entity that carry between them the right to receive a percentage (the ***control percentage***) that is at least 40% of:

(i) any distribution of income by the other entity; or

(ii) if the other entity is a partnership - the net income of the partnership; or

(iii) any distribution of capital by the other entity; or

A tax law partnership can be controlled: we think a tax law partner will have an 'interest' in a tax law partnership consistent with their share in the jointly held property.

27. In this context, we think 'interests in the other entity' should be read to include the rights a tax law partner has in the property, which gives the partner an entitlement to income. It follows that an entity will control a tax law partnership if (together with its affiliates) it has a right to receive at least 40% of the net income of the tax law partnership.

[emphasis added]

28. We acknowledge an alternative view. The applicant in this ruling submitted that a tax law partnership isn't capable of being controlled in the relevant sense, because the relevant parties don't have 'interests' in a tax law partnership. They cited ATO guidance, especially comments in GSTR 2004/6 at paragraph 103, which suggest that partners in a tax law partnership don't have interests in that tax law partnership. While we've considered this alternative view, we think our interpretation is more consistent with how the words are used in this context.

29. The term 'interest' and the phrase 'interests in the other entity' aren't defined, which means they take their ordinary or legal meaning as affected by the context in which they appear.

30. 'Interest' has a broad range of meanings in both ordinary usage and legal usage. Dictionaries suggest 'interest' can be used to cover a range of legal or equitable rights. For example, the *Macquarie*

Dictionary suggests one meaning is a share or ownership right in property. Often, the word 'interest' is qualified by other terms - eg, legal interest, equitable interest, beneficial interest, interest in property, vested interest, interest in land.

31. Since there isn't a single ordinary or legal meaning of 'interest', we need to look to context to arrive at the most appropriate meaning. The relevant context includes the surrounding words, the scope and purpose of the section and Division 328, and other defined terms in the Act.

32. Division 328 is broadly about grouping rules relevant to working out eligibility for tax treatments or concessions. While Division 328 is ostensibly directed to 'small businesses', the rules are relevant for many purposes in tax law. For example, the connected entity test is relevant to working out whether you qualify for CGT small business concessions. CGT small business concessions may be available to non-business entities who passively hold assets used by related business entities.

33. Section 328-125 is a control test for whether 'entities' are connected for grouping purposes. Subsections (3) and (4) apply to discretionary trusts, and subsection (2) applies to entities other than discretionary trusts. There are alternative tests which apply specifically to a) companies, and b) partnerships.

34. We've also considered some related defined terms. For tax purposes, 'entity' includes some non-legal entities. Section 960-100 says that trusts and partnerships are treated as entities for tax purposes. 'Partnership' has a specific tax definition in section 995-1 which includes both 'general law' and 'tax law' partnerships. 'Net income' of a partnership is determined (and distributed between the partners) under rules in Division 5 of the *Income Tax Assessment Act 1936*.

35. We also need to consider the immediate context of surrounding words. The phrase 'interests in the other entity' is followed by paragraphs showing the interests need to carry between them rights to receive at least 40% of any distribution of income or capital, or net income in the case of a partnership.

36. In this context, we think 'interests in the other entity' will cover any rights which entitle the holder to income, capital, or partnership net income relating to the relevant tax entity. There are three steps to our reasoning.

37. First, 'entity' in section 328-125 must refer to tax entities as defined in section 960-100, not just legal entities. Specific control tests apply to trusts and partnerships, which aren't recognised at general law as legal entities. Those tests would be meaningless if they were restricted to interests in legal entities like companies.

38. Second, we don't see any compelling reason to depart from the taxation definition of 'partnership'. That definition includes tax law partnerships. We don't think the context modifies that meaning. While Division 328 is generally about 'small businesses', that doesn't suggest 'partnership' should be limited to general law partnerships. The control tests in section 328-125 aren't limited to calculating turnover (which would be limited to business entities). They are also relevant to the maximum net asset value test, which is relevant to non-business entities holding assets used in other businesses. Further, there are specific control tests for discretionary trusts, which often wouldn't be business entities.

39. Third, the phrase 'interest in an entity' is broad enough to capture rights that are closely associated with the relevant entity type. The concept of having an 'interest' in a partnership is generally legal shorthand for a broad bundle of property rights that can include rights to income and capital. Partnerships aren't legal entities, so partners in general law partnerships can't be described as having an ownership interest in a legal entity. Instead, a partners' interest in a partnership refers to equitable rights over partnership property and rights to share in income generated from the partnership's business or surplus capital on liquidation. We don't see any significant differences between general law and tax law partnerships which would be relevant to deriving income or capital, at least in this context. Tax law partners jointly own property, and each partners' ownership interest in that property gives them a share in any income which derives from that property. We think that's enough to give them an 'interest' in the relevant entity type, being a tax law partnership. We don't think the comments in GSTR 2004/6 (cited by

the applicant) should be applied outside their context - which was about the supply of a financial interest under GST regulations.

40. It follows that 'interest in an entity' covers rights relevant to partnership net income. Tax law partners have interests in jointly held property, which gives them rights to the income that property generates, and to an amount of any net income of the partnership.

41. As an aside, we think our interpretation doesn't favour one entity type over another. If subsection 328-125(2) didn't capture tax law partnerships, this may create tax incentives to prefer one entity type over another. We don't think that effect or result would be consistent with the legislative purpose of the Division 328 control tests, which limit concessions to entities which don't exceed certain group turnover or asset value thresholds.

42. Therefore, we think a tax law partnership is capable of being controlled by other entities under subsection 328-125(2). We think that a tax law partner would control a tax law partnership if they (together with their affiliates) have at least a 40% share in the underlying jointly held property. That share gives them an ownership interest in the partnership with a right to at least 40% of the net income of the partnership. This would meet the control percentage test under subparagraph 328-125(2)(a)(ii). We don't need to determine whether a tax law partnership is capable of making a 'distribution' of income or capital for the purposes of subparagraphs 328-125(2)(a)(i) or (iii).

- PBR 1051259768078 (December 2017)

The term 'partnership' is defined in subsection 995-1(1) of the ITAA 1997 to mean:

(a) an association of persons (other than a company or a limited partnership) carrying on business as partners or in receipt of ordinary income or statutory income jointly; or

(b) a limited partnership.

The first limb of paragraph (a) reflects both the general law definition of a partnership, which is the relationship which subsists between persons carrying on a business in common with a view of profit, as well as the concept of tax law partnership where property joint owners are in receipt of ordinary income (in this case, rent), jointly. That is to say, subsection 995-1(1) of the ITAA 1997 captures both common law, and tax law partnerships in the definition of partnership.

Connected entities

Subparagraph 328-125(2)(a)(ii) of the ITAA 1997 provides that:

An entity (*the **first entity***) controls another entity if the first entity, its *affiliates, or the first entity together with its affiliates:

(a) except if the other entity is a discretionary trust – own, or have the right to acquire the ownership of, interests in the other entity that carry between them the right to receive a percentage (a ***control percentage***) that is at least 40% of:

(i)…; or

(ii) if the other entity is a partnership – the net income of the partnership; …

In your case you are a member of a tax law partnership by way of your joint ownership of your rental property. As joint owners you are each entitled to 50% of the net income of the partnership, which satisfies the requirement of Subparagraph 328-125(2)(a) of the ITAA 1997 that you have a right to receive at least 40% of the partnership interests.

- Therefore, each member of your partnership is considered to be connected entities of the other by virtue of your partnership relationship.

- PBR 1013104654983 (October 2016) where BFT and G jointly acquired a rental property as tenants in common (50:50) which was rented to A. Therefore, as they received income jointly, there is a partnership for tax purposes.

Reasoning

20. A tax law partnership is an 'entity' for the purposes of sections 152-15 and 328-125 of the ITAA 1997. The entire value of the rental property and building jointly owned by G and the BFT has to be included for the purposes of the maximum net asset value test under section 152-15.

21. The taxpayer has contended that a tax law partnership is not an 'entity' for the purposes of section 152-15 and section 328-125 of the ITAA 1997. The taxpayer argues that only a general law partnership operating a small business can be a connected entity for the purposes of section 328-125. This view is premised on the fact that subparagraph 152-10(1)(c)(iii) and subsection 152-10(1B) refers to a partnership that is a small business entity and that the connected entity rules are contained in the same Subdivision in the ITAA 1997 which defines what is a small business entity, which requires the entity to be carrying on a business.

22. The Commissioner does not agree with the above taxpayer view for the following reasons.

23. A general law partnership is a relationship between parties carrying on a business with a view to a profit.

24. The term 'entity' is defined in section 960-100 of the ITAA 1997 as including a 'partnership'. The term 'partnership' is defined in subsection 995-1(1) of the ITAA 1997 as:

(a) an association of persons (other than a company or a limited partnership) carrying on business as partners or in receipt of ordinary income or statutory income jointly.

25. The first limb of paragraph (a) of the above definition of 'partnership' refers to 'an association of persons (other than a company or a limited partnership) carrying on business as partners' and therefore reflects the general law definition of a partnership. The second limb of paragraph (a) which includes as a partnership entities which are 'in receipt of ordinary income or statutory income jointly' refers to a tax law partnership.

26. It is the Commissioner's opinion that the BFT and G, as co-owners who receive rental income jointly from the rental property they own, would fall within the second limb of paragraph (a) and therefore be a tax law partnership.

27. In the Commissioner's opinion, the taxpayer's view that only a general law partnership (and not a tax law partnership) can be considered a relevant 'entity' for the purposes of section 152-15 and the connected entity test under 328-125 of the ITAA 1997, has no legal basis.

28. Section 152-15 of the ITAA 1997 states:

You satisfy the maximum net asset value test is, just before the *CGT event, the sum of the following amounts does not exceed $6,000,000:

(a) the *net value of the CGT asset of yours;

(b) the net value of the CGT assets of any entities *connected with you;

(c) the net value of the CGT assets of any *affiliates of your or entities connected with your affiliates (not counting any assets already counted under paragraph (b)).

29. The meaning of 'connected with' an entity is set out in subsection 328-125(2) as follows:

An entity (the first entity) controls another entity, if the first entity or its *affiliates, or the first entity together with its affiliates:

(a) except if the other entity is a discretionary trust - own, or have the right to acquire the ownership of, interests in the other entity that carry between them the right to receive a percentage (the control percentage) that is at least 40% of:

(i) …

(ii) if the other entity is a partnership - the net income of the partnership; or …

30. In the Commissioner's opinion, there is no reference, express or implied, in either section 152-15 or section 328-125 that the term 'partnership' is limited only to general law partnerships. Indeed, in the Commissioner's view, to limit the term 'partnership' in section 328-125 to only general law partnerships, would be contrary to the clear wording of the legislation and if the draftsman intended to limit the term they could have easily have used the words general law partnership instead of partnership.

31. The Commissioner also points out that neither the Explanatory Memorandum (Tax Laws Amendment (Small Business) Bill 2007) to section 328-125 or any case law supports the contention made by the taxpayer.

32. It is also the Commissioner's view that the taxpayer's reference to subparagraph 152-10(1)(c)(iii) and subsection 152-10(1B) has no relevance, as these provisions only establishes that a partnership that is a small business entity would meet one of the basic conditions in section 152-10. These provisions do not have any relevance as to which entities are connected with another entity for the purposes of sections 152-15 and 328-125 of the ITAA 1997.

33. As the BFT is entitled to more than 40% of the net income of the partnership, it is the Commissioner's view that the partnership is a connected entity of the BFT for the purposes of subparagraph 328-125(2)(a)(ii) of the ITAA 1997. As the BFT is a connected entity of the taxpayer (as it owns all its units), the partnership is also a connected entity of the taxpayer under paragraph 328-125(1)(b) of the ITAA 1997.

34. As the partnership is a connected entity of the taxpayer for the purposes of section 328-125, the entire net value of the partnership's CGT assets has to be included in determining if the maximum net asset value test in section 152-15 of the ITAA 1997 has been satisfied. This is in accordance with the plain wording of section 152-15, which requires 'the net value of the CGT assets of any entities connected with you' to be included in determining whether the $6 million threshold has been exceeded.

35. The ATO document 'Capital gains tax concessions for small business 2016' supports the above view with the inclusion of the following example:

If you are a partner in a partnership and the CGT event happens in relation to an asset of yours or a CGT asset of the partnership (for example, disposal of a partnership asset) the maximum net asset value test would include:

• all the assets of the partnership if you are connected with it, and you would exclude the value of your interest in the partnership, or

• only your interest in the partnership if you are not connected with it, and you would not count the assets of the partnership as a whole.

36. It is therefore the Commissioner's view that the partnership's entire net value of its CGT assets (ie the rental property and factory that it owns) needs to be included in the maximum net value asset test in section 152-15 of the ITAA 1997 in order to determine whether this test has been satisfied and whether the taxpayer is eligible to claim any concession within Division 152.

- Example of the issue: Assume mum and dad are not otherwise 'affiliates'. In Structure 1, mum and dad will be tax law partnership and therefore each of mum and dad control the partnership and because the partnership controls ABC Pty Ltd, each of mum and dad control ABC Pty Ltd. In Structure 2, neither mum nor dad control ABC Pty Ltd.

Structure 1 Structure 2

Mum and Dad (jointly held share)

45%

ABC Pty Ltd

Mum

Dad

22.5%

22.5%

ABC Pty Ltd

Mum and Dad each control ABC Pty Ltd Mum and Dad do not control ABC Pty Ltd

Control of a unit trust

- An entity controls a unit trust if the entity and/or its affiliates own or have the right to acquire the ownership of units in the unit trust that carry between them the right to at least 40% of:
  - any distribution of income; or
  - any distribution of capital.[22]

Control of a discretionary trust

- An entity controls a discretionary trust if:
  - the trustee acts or could reasonably be expected to act, in accordance with the directions or wishes of the entity and/or its affiliates; or
  - the entity and/or its affiliates received at least 40% of the distributions of income or capital in any of the previous four years.[23]
- The trustee may act in accordance with the directions or wishes of a person other than the director

  Gutteridge v Commission of Taxation [2013] AATA 947

  Mr Gutteridge's daughter was the sole director of the trustee company. Mr Coffey was the appointor of the trust. Mr Gutteridge attended the meetings of directors of the company. Mr Gutteridge's daughter gave evidence that it was effectively Mr Gutteridge's business and that she acted in accordance with his wishes. MrCoffey gave evidence that the trust was known as Mr

[22] Section 328-125(2) of the 1997 Tax Act
[23] Sections 328-125(3) and (4) of the 1997 Tax Act

Gutteridge's trust and that no action would be taken in relation to the trust unless it was in accordance with Mr Gutteridge's wishes.

AAT held that Mr Cutteridge alone controlled the trustee for the purpose of section 328-125(3)

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.* (2011]) 81NSWLR 47 . Hodgson, Young and Whealy JJA The court considered the terms of the same definition in s 9 of the Corporations Law as the relevant events occurred before the commencement of the Corporations Act The following principles can be derived from the discussion of the scope of the words *accustomed to act in accordance with wishes limb*[9] director of a company or other body means: (b) unless the contrary intention appears, a person who is not validly appointed as a director if: …. (ii) the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes. Subparagraph (b)(ii) does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity, or the person's business relationship with the directors or the company or body. in that definition:

(a) 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; (2011) 81 NSWLR 47 at 51[9] Hodgson JA

(b) it is not necessary that the behaviour be universal, at least some decisions, one or more important decisions, would be enough, (2011) 81 NSWLR 47 at 51[10] Hodgson JA some or all decision making is the focus; (2011) 81 NSWLR 47 at 74 [208] Young JA (with whom Hodgson and Whealy JJA agreed) endorsing Finn J in ASC v AS Nominees Ltd (1995) 62 FCR 504

(c) 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; (2011) 81 NSWLR 47 at 70/71 [192] Young JA (with whom Hodgson and Whealy JJA agreed).

(d) 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; (2011) 81 NSWLR 47 at 70 [187] Young JA (with whom Hodgson and Whealy JJA agreed). and

(e) it is necessary to undertake a critical assessment of the way in which the trustee is managed. Gordon J in Australian Securities and Investments Commission v Murdaca [2008] FCA 1399 at [11] as endorsed in a corporate law context in Buzzle Operations Pty Ltd (In Liq) v Apple Computer Australia Pty Ltd [2011] NSWCA 109 at 74[203] Young JA (with whom Hodgson and Whealy JJA agreed).

21. 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.

22. The statutory test calls for an examination of all of the circumstances of a case. If it were needed, support for that proposition is found in the Explanatory Memorandum to Tax Laws Amendment (Small Business) Bill 2007 (C'th) at [2.52] Formal occupation of offices, such as a director of a company that is a trustee, and documented terms of instruments, such as limitations on trustees' ability to have regard to an entity's wishes or directions, do not prevent an examination of the actual circumstances when addressing the question posed by s 328-125(3). If the actual circumstances are that a formal office holder does not control a trust, or that the terms of an instrument are not observed, the conclusion that the controller is found in the person occupying the office or the person identified by the terms of the instrument does not necessarily follow. As noted by Gordon J in a parallel context, it is necessary to undertake a critical assessment of the way in which the Trust is managed. Gordon J in Australian Securities and Investments Commission v Murdaca [2008] FCA 1399 at [11] as endorsed in a corporate law context in Buzzle Operations Pty Ltd (In Liq) v Apple Computer Australia Pty Ltd [2011] NSWCA 109 at 74[203] Young JA (with whom Hodgson and Whealy JJA agreed). This is an enquiry into activities and decision making, and the circumstances in which they occur, not an enquiry into occupation of offices or terms of instruments per se.

> 23. The circumstances of the present case call for conclusions that the Trust was not accustomed to act in accordance with Ms McKenzie's wishes independently of her father's wishes in circumstances where her wishes and directions were her father's. She was acting as the director of the trustee in circumstances where the trustee could be removed at the will of Mr Coffee and Mr Coffee regarded himself bound by the wishes and directions of Mr Gutteridge. Further, if it were necessary to find that Ms McKenzie was a puppet director, or that Mr Gutteridge was a shadow or de facto director, there is ample material on which to rest such a finding.
>
> 24. The facts as found above require a finding that Mr Gutteridge alone was the person who controlled the Trust within the meaning of s 328-125(3) of the 1997 Assessment Act.

- An exempt entity or deductible gift recipient will not control a trust if it receives at least 40% of the income or capital of the trust (section 328-125(5)).
- An entity is also 'connected' with the trust, if the entity controls the trust and another entity.

  That is, if

  - A controls Trust; and
  - A controls a Company; then
  - A and the Company will each be 'connected' with the Trust.

  Therefore, be careful when distributing to children as this may bring the children and their respective entities in as 'connected' entities for the purpose of NAT and CGT SBE tests.

Indirect control[24]

- An entity will control an entity if it controls an entity which controls that entity.
- For example: If an entity (A) controls another entity (B) and B controls another entity (C), then A will be taken to control C.

Commissioner's Discretion[25]

- If the control percentage is at least 40% **but less than 50%,** then **the Commissioner** may determine that the entity does not control the other entity if the Commissioner thinks that the other entity is controlled by another entity or entities.
- *Taxation Determination* TD 2023/5 (about aggregated turnover and connected entities – Commissioner's discretion that an entity does not 'control' another entity)

> ***Relevance of who has responsibility for managing day-to-day business***
>
> 11. Sole or primary responsibility for the day-to-day management of the affairs of the test entity, while not irrelevant to the question of who controls that entity, does not of itself constitute control for the purposes of the Commissioner's discretion in subsection 328-125(6). The context of the aggregated turnover rules in Subdivision 328-C, and the concept of 'control' that underpins the primary control tests, support this view.

[24] Section 328-125(7) of the 1997 Tax Act
[25] Section 328-125(6) of the 1997 Tax Act

Context of aggregated turnover tests

12. Turnover testing is used to determine eligibility for certain tax concessions. Sometimes it will be necessary to aggregate the turnovers of separate entities, recognising that they ought to be regarded as a single unit. Aggregation will be necessary when there is a connection between the entities based on 'control as described in section 328-125, the primary tests for which look to the following matters:

- who owns interests carrying rights to the economic benefits flowing from the entity in the form of income and capital distributions (relevant for business entities generally)
- who owns relevant interests carrying rights to exercise, or control the exercise of, voting power (relevant for companies)
- who controls those responsible for managing the affairs of the business entity (relevant for companies and discretionary trusts[]).

Concept of 'control'

13. Having regard to the statutory context, the nature of control relevant for the Commissioner's discretion is control over those matters typically associated with ownership of a business entity. That is, entitlements to income and capital of the entity as well as participation in decision-making on key matters affecting the entity's constitution, funding, structure and management. The latter would ordinarily include matters such as:

- decision-making on the composition and oversight of the management team
- amending the entity's constituent documents
- deciding on capital and entity restructuring proposals, the issue of new ownership interests or winding up, and
- authorising significant changes in the direction of the entity's business operations.

14. Other ways in which an entity may be said to be 'controlled', such as the control exercised by managers with responsibility for the day-to-day conduct of the business of the entity, do not of themselves constitute control of the entity in the sense contemplated by the aggregation rules. It is necessary to distinguish control of *an entity* from powers in respect of the conduct of *an entity's business.*

15. Managers or directors with responsibility for the day-to-day conduct of a company's business may have considerable autonomy in making significant business decisions, but this of itself is not considered 'control' of the entity for the purposes of subsection 328-125(6).

16. Example 2.10 of the Explanatory Memorandum to the Tax Laws Amendment (Small Business) Bill 2007 (EM) illustrates when the discretion might be exercised to disregard a control percentage of between 40% and 50% on the basis of a conclusion that a third entity controls the test entity. The example refers to a manager of the test entity with a 58% shareholding in that entity, and another person with a 42% shareholding who has no dealings at all with the manager.

17. We consider that, in these circumstances, the significance of who manages the business of the test entity stems from the relative ownership interests which confer the power to determine who performs the managerial function (see also Examples 1 and 2 of this Determination). The identity of who actually performs the managerial function is generally of limited relevance to the question of control of the test entity in subsection 328-125(6). The manager in Example 2.10 of the EM, with the 58% shareholding, would not cease to control the test entity merely because they decided to appoint a new manager with full responsibility for the day-to-day conduct of the business of the entity.

18. We also consider that Example 2.10 of the EM illustrates circumstances in which we would be likely to conclude that the test entity is controlled by a third entity (the 58% shareholder) and the Commissioner's discretion to disregard the 42% shareholding would be exercised accordingly. The holding of interests carrying rights to more than 50% of the income, capital and voting power in a company is consistent with control of the company for the purposes of subsection 328-125(6). Assuming that the majority ordinary shareholding is sufficient to decide most or all of the fundamental matters relating to the test entity, we would think there is control by the third entity unless the third entity's control through its majority ordinary shareholding is in some way qualified or compromised by other circumstances or arrangements.

Third entity can hold less than 40% interest

19. Ownership of a majority of interests carrying relevant rights is a likely basis for concluding that a third entity controls the test entity for the purposes of subsection 328-125(6). However, in considering whether to exercise the Commissioner's discretion under subsection 328-125(6), the Commissioner is not confined to identifying a third entity with the requisite control percentage under the primary tests for control (that is, in subsections 328-125(2) to (4)).

20. The language of subsection 328-125(6), which requires the Commissioner to 'think' there is a controlling third entity (or entities), is consistent with the Commissioner needing to form a view on actual control by reference to all relevant circumstances.[10] In providing for this enquiry, subsection 328-125(6) does not limit the Commissioner to a class of potential controllers having a control percentage of 40% or more under the primary tests. This view is supported by paragraph 2.60 of the EM which states:

The Commissioner may think that another entity controls the entity either based on fact or on a reasonable assumption or inference. Whether or not the third entity has a 40 per cent interest may assist in determining whether the third entity controls the other entity, but it is not decisive.

21. This does not mean, however, that a different concept of 'control' than that contemplated by subsections 328-125(2) to (4) applies to determine that a third entity controls the test entity for the purposes of subsection 328-125(6). The focus remains on control of the test entity in the sense described in paragraph 13 of this Determination. That is, control over those matters typically associated with ownership of a business entity.

22. It, therefore, may be possible to control an entity in the relevant sense by means other than formal ownership of interests carrying relevant rights. For example, an owner of shares carrying a certain percentage of the voting power in a company may effectively surrender those rights by legal agreement with a third entity.

23. We might readily infer that the third entity controls the test entity from legally enforceable arrangements of this kind (see Example 3 of this Determination). However, we would closely scrutinise assertions that a third entity controls the test entity on the basis of informal arrangements, practices or patterns of behaviour alone. This is especially if they appear inconsistent with the legal interests held by entities in the test entity.

Control by more than one 'third' entity

- 24. The exercise of the Commissioner's discretion is based on a conclusion that the test entity is controlled by a third entity (or entities) that does not include the first entity or any of its affiliates. This is clear from the statutory text.

25. We do not accept as correct that an entity's control percentage of between 40% and 50% should be disregarded on the basis that the remaining interest holders together necessarily control the test entity, irrespective of their number or relationship to each other. While we may look beyond a single third entity for relevant control, the discretion would not be exercised merely on the basis of identifying a group of unrelated entities that, when individual control percentages are aggregated, holds interests in the test entity amounting to a control percentage of more than 50%.

26. For example, a pattern of consistent voting behaviour by a group of unrelated minority shareholders in a widely-held company would not constitute control of that company by those shareholders, even if collectively they held more than 50% of the total shares.

27. In order to form a view that a group of third entities controls the test entity, we would expect to see that the group has agreed to operate, and does operate, as a single controlling mind when it comes to decision-making generally in respect of the test entity. This might be in accordance with proxy arrangements that put voting power in the hands of one member of the group, or other legal arrangements under which the entities are broadly bound to act jointly in respect of the affairs of the test entity.

28. While control by a group of entities could be established without the existence of a formal agreement to act jointly, strong evidence would be required to support assertions that there is joint control in such circumstances. We would closely scrutinise the nature of the relationship between the entities and ongoing patterns of behaviour in relation to the test entity to determine if there is a sound evidentiary basis for the Commissioner to think there is control of the test entity by a group.

29. The conclusion that there is a single controlling mind is more readily reached in these circumstances if the group consists of associated entities in terms of common ownership or close familial relationships. Mere alignment of purpose (for example, shareholders wanting to maximise profits) or agreement to act cooperatively on certain issues by otherwise unrelated entities would rarely, if ever, be a sufficient basis to determine that there is control of the test entity by a group of third entities (see Examples 1 and 4 of this Determination).

Example 1 – widely-held company

30. *ABC Co holds 43% of the ordinary shares in listed XYZ Co. The remaining 57% of ordinary shares are held by various, unrelated institutional and other investors. None of the other shareholders holds more than 5% of the shares in their own right. XYZ Co's board of directors makes all strategic decisions for the company and delegates the day-to-day decisions to the executive management team. None of the individual directors or members of the executive management team owns more than a small percentage of the shares in XYZ Co.*

31. *ABC Co satisfies the test for control of XYZ Co in subsection 328-125(2) as it holds at least 40% of relevant interests. ABC Co seeks the exercise of the Commissioner's discretion to disregard its control percentage in XYZ Co on the basis that:*

- *the directors and executive management team control XYZ Co because they carry out all of the functions relating to the strategic and day-to-day management, operation and administration of the company's business, or*
- *the shareholders who own the remaining 57% of shares in XYZ Co control the company.*

32. *In this case, the Commissioner would not think that the directors or executive management team controls XYZ Co in the relevant sense because although they manage the strategic and day-to-day business affairs of XYZ Co:*

- *they do not have controlling stakes in the income, capital or voting in respect of XYZ Co, and*
- *ultimately they would be accountable to the shareholders, of which ABC Co is clearly the most significant, in performing the management function.*

33. *On these facts, the question of who is responsible for the day-to-day management of XYZ Co is of no particular relevance to the question of control in subsection 328-125(6).*

34. *The Commissioner also would not think that XYZ Co is controlled by the remaining 57% of shareholders. There is no evidence that each shareholder is not acting independently in respect of their ownership rights in XYZ Co. A history of, or potential for, shareholders to act in unison on particular issues would not alter this conclusion.*

35. *There is no basis for the Commissioner to think that any entity other than ABC Co controls XYZ Co.*

Example 2 – third entity owning more than 50% of shares

36. *Tech Pty Ltd carries on a business of selling a software product it has developed. Mr W, who started Tech Pty Ltd, owns 56% of the shares in the company. The remaining 44% is owned by Ms Q, a passive investor who had provided capital for Tech Pty Ltd as a start-up entity. Mr W manages all aspects of the business of Tech Pty Ltd and his majority shareholding enables him to unilaterally approve ordinary resolutions on all matters concerning the company, apart from those where a special resolution is required by law. Tech Pty Ltd seeks an exercise of the Commissioner's discretion to ignore Ms Q's control percentage in the company for the purpose of calculating its aggregated turnover.*

37. *The Commissioner would conclude that Mr W controls Tech Pty Ltd in this case and exercise the discretion accordingly. Mr W's management of the day-to-day affairs of Tech Pty Ltd is relevant to the extent that it reflects his actual control of the company through his majority shareholding.*

Example 3 – effect of shareholder agreement

38. *Assume the same facts as for Example 2 of this Determination, except the 44% interest is owned by Finance Co which has entered into a Shareholders' Agreement with Mr W. The agreement specifies many matters relating to the business affairs of Tech Pty Ltd that require approval by a special resolution (that is, the approval of the holders of at least 75% of all shares). This includes matters relating to business funding, significant new transactions and changes in the nature of the existing business. Tech Pty Ltd seeks an exercise of the Commissioner's discretion to ignore Finance Co's control percentage for the purpose of calculating its aggregated turnover, on the basis that Mr W has actual control.*

39. *Depending on the nature and extent of matters to be dealt with by special resolution under the Shareholders' Agreement, the Commissioner may not think that Mr W actually controls Tech Pty Ltd for the purposes of subsection 328-125(6). This is notwithstanding his majority shareholding and responsibility for managing the business of Tech Pty Ltd. If his rights in respect of Tech Pty Ltd have been substantially compromised by the special resolution requirements, it is likely that the Commissioner will reach this conclusion and not exercise the discretion to ignore the control percentage of Finance Co. (Note that if this were the case, Tech Pty Ltd would work out its aggregated turnover by including the annual turnovers of Mr W and Finance Co. There is no scope for the exercise of the Commissioner's discretion to ignore Mr W's interest as his control percentage exceeds 50%.)*

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Example 4 – third entities with total shareholding of more than 50%

40. *Cellnet Pty Ltd carries on a business of developing products to be used in connection with mobilephones. Cellnet Pty Ltd was originally started by Ms A and Mr B who now each own 28% of the company. The remaining 44% is owned by an unrelated company, MobTel Pty Ltd. Cellnet Pty Ltd has 3 directors, Ms A, Mr B and Mr C (arepresentative of MobTel Pty Ltd). Ms A and Mr B meet regularly to discuss operational and strategic matters relating to Cellnet Pty Ltd, and have a history of reaching agreement on decisions relating to Cellnet Pty Ltd. Ms A and Mr B are otherwise unrelated and independent of each other. Cellnet Pty Ltd seeks an exercise of the Commissioner's discretion to ignore the control percentage of MobTel Pty Ltd for aggregated turnover purposes.*

41. *The Commissioner in this case would not exercise the discretion as it would not be concluded that Cellnet Pty Ltd is controlled by Ms A and Mr B. Although they have a history of agreement on issues relating to the company:*

- *they are not bound to act jointly, and*
- *each would require the support of MobTel Pty Ltd or its representative to prevail in decision-making if not supported by the other.*

42. *In the absence of arrangements or circumstances of the kind described in paragraphs 27 or 28 of this Determination, it would not be concluded that Ms A and Mr B control Cellnet Pty Ltd for the purposes of subsection 328-125(6).*

Example 5 – more than one entity satisfies the control percentage test

43. *Entity A and Entity B each hold 45% of the ordinary shares in ABC Co and each satisfies the test for control in subsection 328-125(2) for their respective interests. Entity C holds the remaining 10% of shares in ABC Co. ABC Co seeks the exercise of the Commissioner's discretion on the basis that either Entity A or Entity B actually controls ABC Co, but not both, because they each have a control percentage of at least 40% in ABC Co.*

44. *In the absence of further facts, the Commissioner would not conclude that either Entity A or Entity B actually controls ABC Co, merely because they satisfy a primary control test by having a control percentage of at least 40%. To exercise the discretion, the Commissioner must think that ABC Co is actually controlled by either Entity A or Entity B. It is possible in the circumstances that neither Entity A nor Entity B actually controls ABC Co for the purposes of subsection 328-125(6), in which case both will be connected with ABC Co for aggregation purposes.*

- Private binding rulings
  - PRB 1052260857050 (June 2024)

Question: Will the Commissioner exercise the discretion in subsection 328-125(6) of the *Income Tax Assessment Act 1997* (ITAA 1997) and determine that, Company A as trustee for Trust A (Trust A) did not control Company B because Company B was controlled by Company E?

Answer: Yes.

Relevant facts and circumstances

You are a unit trust.

Your corporate trustee is Company A

You sold your interest in Company B to Company C

You made a capital gain from the sale of your shares in Company B to Company C.

You are now considering whether you would be entitled to small business capital gain tax relief under Division 152 of ITAA 1997 for that capital gain and have formed a view that this may be affected by whether you are taken to control Company B for the purpose of those provisions.

History of Company B

Company B was incorporated.

Shares on issue in Company B comprise of ordinary shares, held by the following:

• Company D held more than 50% of the issued shares

• Company A held at least 40% but less than 50% of the issued shares.

In accordance with Company B's Constitution, each ordinary share has the following rights attached:

• the right to vote at all meetings of the Company

• the right to participate in any dividend declared on the class of shares held

• the right to participate in any division or distribution of any surplus assets or profits of the Company.

The Shareholders' Agreement was executed by the shareholders detailing their obligations.

It is noted that the Shareholders' Agreement states where any inconsistency exists between the Constitution of Company B and the Shareholders' Agreement, the Shareholders' Agreement will prevail.

The Shareholders' Agreement makes provision for the shareholders on the total number of directors they can appoint according to the percentage of shares held. A director can only be removed by the appointing shareholder.

Consistent with the provisions in the Shareholders' Agreement the majority shareholder:

• must approve in writing any chairperson and managing director before appointment

• is to ensure that the formation of the company, appointment of officers and execution of documents occur.

The Shareholders' Agreement states there is a unanimous resolution of the board of directors that is required on the disposal of the Company if the directors are unable to declare a dividend to Company A of not less than a certain amount per share.

A new shareholder of the company must, before registration of the transfer of shares, enter into an adherence deed with the other parties to the Shareholders' Agreement, agreeing to be bound by the Shareholders' Agreement as if named as a party and a shareholder.

The original directors of Company B were Person A and Person B. Person A was also the secretary.

Person C was appointed as director of Company B when Person B ceased their directorship.

Company B was established as a Special Purpose Vehicle for a specific project.

Trust A

Company A beneficially holds the shares in Company B on your behalf.

The units in Trust A are owned by Trust B.

Company F is the sole shareholder of Company A.

Company F shareholding is owned by Trust B.

Person D is the sole director of Company A and Company F.

Company D

Company D was incorporated.

Shares on issue in Company D comprise of ordinary shares, held by the following:

- Person E held X
- Company G held XX

Person A and Person C are the directors of Company D.

Company D transferred its ordinary shares held in Company B to Company E.

Company E

Company E was incorporated.

Shares on issue in Company E comprise of ordinary shares, held by the following:

- Person E held XX
- Company H held XX
- Person C held XX
- Person B held X

Person A and Person C are the directors of Company E.

Company E executed a deed of adherence to the Company B Shareholders' Agreement.

Day to day management of Company E

Other

Person A and Person C (the two directors of Company B and the board of directors) were responsible for:

- the day-to-day management of Company B

- all legal, commercial, financial, programming and contracting decisions, and
- negotiating and arranging development funding for the project.

All decisions affecting Company B were made by and under the control and direction of Person A and Person C in their capacity as directors of the company sitting on the board of directors.

When necessary, Person A and Person C consulted with industry experts and the minority shareholder to be able to make fully informed decisions on matters affecting the project.

Commissioner's discretion

If the control percentage in a company is at least 40%, but less than 50% the Commissioner may determine that the first entity does not control the other entity if the Commissioner thinks that the other entity is controlled by a third entity, or by entities that do not include, the first entity or any of its affiliates.

The statutory condition for exercising the Commissioner's discretion requires that the Commissioner positively conclude that there is actual control by a third entity or entities. It is not sufficient to merely show that the first entity is not a controller.

Taxation Determination TD 2023/5 Income tax: aggregated turnover and connected entities - Commissioner's discretion that an entity does not 'control' another entity (TD 2023/5) provides guidance on particular issues that have emerged from the administration of the discretion in subsection 328-125(6) of the ITAA 1997 to determine that an entity does not 'control' another entity.

Sole or primary responsibility for the day-to-day management of the affairs of the entity, while not irrelevant to the question of who controls that entity, does not of itself constitute control for the purpose of the Commissioner's discretion in subsection 328-125(6) of the ITAA 1997.

Having regard to the statutory context, the nature of control relevant for the Commissioner's discretion is control over those matters typically associated with ownership of a business entity, namely, entitlements to the income and capital of the entity as well as participation in decision-making on key matters affecting constitution, funding, structure, and management. The latter would ordinarily include matters such as:

- decision making on the composition and oversight of the management team
- amending the entity's constituent documents
- deciding on capital and entity restructuring proposals, the issue of new ownership interests or winding up, and
- authorising significant changes in the direction of the entity's business operations.

Other ways in which an entity may be said to be 'controlled', such as the control exercised by managers with responsibility for the day-to-day conduct of the business, does not, of itself, constitute control of the entity in the sense contemplated by the aggregation rules. It is necessary to distinguish control of an entity from powers relating to the conduct of business.

Managers or directors with responsibility for the day-to-day conduct of a company's business may have considerable autonomy in making significant business decisions, but this of itself is not considered 'control' of the entity for the purpose of subsection 328-125(6) of the ITAA 1997.

Example 2.10 of the Explanatory Memorandum to the Tax Laws Amendment (Small Business) Bill 2007 (EM) illustrates when the discretion might be exercised to disregard a control percentage interest of between 40% and 50% on the basis of a conclusion that a third entity controls the text entity. The example refers to a manager of the test entity with a 58% shareholding in that entity, and another person with a 42% shareholding who has no dealings at all with the manager.

We consider that, in these circumstances, the significance of who manages the business of the test entity stems from the relative ownership interests which dictate who has the power to determine who performs the managerial functions. The identity of who actually performs the managerial function is generally of limited relevance to the question of control of the test entity. The manager in Example 2.10 of the EM, with the 58% shareholding, would not cease to control the test entity merely because they decided to appoint a new manager with full responsibility for the day-to-day conduct of the business of the entity.

We also consider that Example 2.10 of the EM illustrates circumstances in which we would be likely to conclude that the test entity is controlled by a third entity (the 58% shareholder) and exercise the discretion to disregard the 42% shareholding accordingly. The holding of interests carrying rights to more than 50% of the income, capital and voting power in a company is consistent with control of the company for the purposes of subsection 328-125(6) of the ITAA 1997. Assuming that the majority ordinary shareholding is sufficient to carry the vote on most or all of the fundamental matters relating to the test entity, we would think there is control by the third entity unless the third entity's control through its majority shareholding is in some way qualified or compromised by other circumstances or arrangements.

Application to your circumstances

In this case, Trust A held at least a 40% but less than 50% shareholding in Company B just prior to the sale of the shares. At this time, Trust A, and its controller Person D, were not involved in the day-to-day operations of Company B.

According to the Company B Constitution Company E via Person C and Person A controlled this responsibility for managing the affairs of Company B. Company E controls the board of directors of Company B and Trust A plays no role in managing the affairs of Company B nor does it have any representation on the board of Company B.

It is acknowledged that Trust A as the minority shareholder was consulted from time to time to make fully informed decisions on matter affecting the project. Company E's control of Company B is not in any way compromised by the consultation with Trust A.

Based on the information provided, the Commissioner will exercise the discretion in subsection 328-125(6) of the ITAA 1997 to determine that Trust A does not control Company B because Company B is controlled by Company E.

3.5.3 When will an entity be an 'affiliate'?

- An individual or a company is an affiliate of an entity if the individual or company acts, or could reasonably be expected to act, in accordance with the entities directions or wishes, or in concert with the entity, in relation to the affairs of the business of the individual or company.[26]
- Important issues*:*
  - A spouse and a child under 18 years of age is not automatically an affiliate.
  - The definition refers to 'acting in accordance with directions, wishes or in concert … in relation to the affairs of the business of the individual or company'.

    This indicates that to be an affiliate, the individual or company needs to be carrying on a business.

[26] Section 328-130 of the 1997 Tax Act

- Partnerships, trusts and superannuation funds cannot be affiliates of another entity.

- The Explanatory Memorandum to the Tax Laws Amendment (Small Business) Bill 2007 states that only an individual or company can be an affiliate of another entity. Entities (for tax purpose) such as trusts, partnerships, and superannuation funds are not capable of being affiliates of entities (paragraph 2.40).

  The explanatory memorandum outlines a number of factors which may have a bearing on whether an individual or company is an affiliate of an entity to the extent that they show that two or more entities are acting in concert. However, none of the following factors are determinative in their own right:[27]

  - family or close personal relationships;
  - financial relationships or dependencies;
  - relationships created through links such as common directors, partners, or shareholders;
  - the degree to which the entities consult with each other on business matters; or
  - whether one of the entities is under a formal or informal obligation to purchase goods or services or conduct aspects of their business with the other entity.

- The ATO publication "Commissioner's Advanced guide to capital gains tax concessions for small business" states:

  - Whether a person acts, or could reasonably be expected to act, in accordance with the taxpayer's directions or wishes, or in concert with the taxpayer, is a question of fact dependent on all the circumstances of the particular case. No single factor will necessarily be determinative.
  - Relevant factors that may support a finding that a person acts, or could reasonably be expected to act, in accordance with the taxpayer's directions or wishes, or in concert with the taxpayer, include:
    - the existence of a close family relationship between the parties
    - the lack of any formal agreement or formal relationship between the parties dictating how the parties are to act in relation to each other
    - the likelihood that the way the parties act, or could reasonably be expected to act, in relation to each other would be based on the relationship between the parties rather than on formal agreements or legal or fiduciary obligations
    - the actions of the parties.

[27] at paragraph 2.36

- *Taxation Ruling* TR 2002/6 (withdrawn) considers the meaning of 'in concert' for the purpose of the definition of 'STS affiliate' – which is substantially the same as the definition of affiliate in section 328-130. The following extracts from the ruling are relevant

> Meaning of 'in concert'
>
> 57. Under the definition of *STS affiliate, an entity will be your *STS affiliate if it acts in concert with you, or could reasonably be expected to do so, in relation to the affairs of its *business.
>
> 59. To ensure that the 'in concert' test in the *STS affiliate definition only operates to group entities that are sufficiently related to warrant grouping….
>
> 60. The overall degree of that connection must be such that the potential *STS affiliate cannot be viewed as operating independently of the other entity.
>
> Determining if two entities are acting in concert
>
> 63. The following table describes some factors that are relevant to determining whether the potential *STS affiliate's business has the required degree of dependence and/or connection with the other entity's business.
>
> 65. No factor is decisive, nor does each one necessarily have to be given the same weight. Rather, determining whether the potential *STS affiliate is acting in concert with the entity in relation to the business affairs of the former will be a matter of overall impression. Nonetheless, factors (G) to (I) inclusive will not be sufficient in themselves, to conclude that two entities are relevantly acting in concert with each other.

Factor	**'for' there being a substantial connection**	**'against' there being a substantial connection**
A. Nature and extent of commercial dealings between the two entities	Goods and/or services supplied by the potential *STS affiliate to the other entity account for a large percentage of the potential *STS affiliate's business and/or a large proportion of its income.	No supplies or a low level of supplies from the potential *STS affiliate to the other entity.
B. Common resources, facilities or services	The two entities share a number of facilities or services necessary for the operation of the businesses. For example, the entities share business premises, or staff, or management and accounting services, or income producing assets. The more facilities or resources that are shared, the stronger the indication that the two businesses have a substantial connection.	The two entities share no or few common resources and operate from separate business premises, use different assets, employ different staff, are managed by different individuals and/or use different accounting services.
C. Involvement in managerial decisions and day to day management	The entity actively participates in the potential *STS affiliate's day to day management and/or decision making processes. For example, it actively takes part in meetings of a company's board of directors or a partnership's partners' meetings.	The entity plays no part in the management of the potential *STS affiliate's business.

D. Financial interdependencies	The potential *STS affiliate is dependent on the other entity for access to loans or guarantees. Alternatively, the two entities could share common banking facilities such as a joint account or the same account signatories.	The potential *STS affiliate obtains its financial support from other sources. The entities maintain separate banking arrangements.
E. Common flow of profits	The profits from the businesses carried on by the two entities are ultimately received by the same entities.	The profits from the businesses carried on by the two entities are received by unconnected entities.
F. Common ownership/capital	The entities share the same owners, for example the same shareholders. The source of the capital underpinning the two entities is the same. For example, two partnerships sharing the same partners.	The ownership or capital backing of the two businesses can be traced to different sources.
G. Shared purchasing of goods or services	The two entities coordinate their orders for goods or services. Alternatively, the potential *STS affiliate is under an obligation to order through the other entity. A further alternative is where the entity determines which goods or services the potential *STS affiliate should order and/or orders on its behalf.	The two entities purchase goods or services independently of each other.
H. Common customers	The entities agree to share a customer's overall business. The entity directs customers to the potential *STS affiliate or uses it to obtain custom.	The entities maintain a separate client base. The entities do not seek to pursue marketing opportunities through each other.
I. Similar kind of business	The entities provide identical or similar goods or services.	The nature of the business carried on by the potential *STS affiliate is inherently different to that of the other entity.

- PBR 1012740087229 – 11 January 2015

  Facts

  A family group had a single company (A Pty Ltd) as the trading entity to the family business.

  Land used by company A were owned by the taxpayer, his parents, his wife and a family trust.

  The taxpayer was actively involved in the business.

  Business decisions were made almost exclusively by the taxpayer and his father.

There were no written agreements outlining these arrangements between the family members.

Different family members had borrowed funds to acquire properties used in the business operations. Irrespective of who actually borrowed the funds, the parties allocated the family debt to the different properties on a 'per acre basis' and all interest was paid by the company.

The parents had a controlling interest in the company.

Decision

The taxpayer (son) was an affiliate because he acted in concert with the company.

The fact that there was a close family relationship between the individuals and no formal agreement in relation to the company or the business indicated that they acted in concert rather than in accordance with formal legal or fiduciary obligations.

Land that the individual owned was used for the benefit of the company.

The taxpayer was a guarantor for loans taken out by other parties in respect of property that he did not own but which was used for the purposes of the company business.

Most business decisions were made in conjunction with the taxpayer's father.

- PBR 90261 – 11 September 2009

Facts

You own an interest in a property. The remaining interest in the property is owned by your sibling W.

The property was transferred to W and yourself pursuant to a contract dated later than 19 September 1985 as part of a family farm succession plan.

As part of a further family farm succession plan, you propose to sell your interest in the property to W.

The sale price of your interest will be greater than the value of the interest when the property was transferred to you.

Ever since the property was transferred it has been used in the business of a partnership.

The partners in the partnership are:

- your parent X;
- your parent Y;
- your sibling W;
- your sibling Z

There has never been any lease in place between yourself and W as landowners and the partners of the partnership.

There has never been any other formal written agreement in place between the parties.

All of the members of the family have had regular meeting where all major decisions regarding the property (as well as the family's other properties), its development and the running of the business have been discussed.

There are regular discussions about the future directions of the property and its potential and challenges, most notably the drying climate and challenging times for the rural economy.

At times, all family members have challenged other party's thinking on a matter regarding the property, but these issues are resolved so that the property plan is discussed and amended so that all parties agree to the manner in which activities related to farming are conducted.

You live a short distance from the family farm. You moved there some time ago and live there with your spouse and children. Work has prevented you from day to day management of the farm business with W, X, Y and Z but you continued to be involved in the planning meetings.

You have worked for a number of years in the natural resource management field. Central to the ideals of your previous employers is rural land protection and improvement.

From your work experience you have introduced the latest research about sustainable management of the environment and the land, to aid the family business care for an improve the property in very testing times.

The family, although initially slow to recognise the need for these activities, have now embraced many of the proposals that you have suggested in the following ways:

· amendment to grazing regimes to protect native grasses;

· planted new areas for biodiversity and erosion protection;

· protected waterways through limiting stock access by fencing and increased vegetation cover around waterways to provide habitat for fish; and

· protected remnant trees by fencing them off and allowing areas of native vegetation to regenerate.

The business of farming is intimately related to the land's capacity on which it is carried out. Decisions on land management affect the business of farming particularly from a strategic point of view. All members of the family are working together to deliver a long term plan to maintain existing activities and for future improvements.

The primary managers of the partnership business are X, W and Z.

Decision

Whilst a partnership cannot be your affiliate, a partnership is not a separate legal entity. Hence, it is necessary to examine whether the individual partners are your affiliates.

Whether a person acts, or could reasonably be expected to act in accordance with your directions or wishes, or in concert with you is a question of fact dependant on all the circumstances of the particular case. No one factor will necessarily be determinative. Relevant factors summarised from Taxation Determination (TD) 2006/79 that may support a finding that a person is your affiliate include:

· the existence of a close family relationship between the parties;

· the lack of any formal agreement or formal relationship between the parties dictating how the parties are to act in relation to each other;

· the likelihood that the way the parties act, or could reasonably be expected to act, in relation to each other would be based on the relationship between the parties rather than on formal agreements or legal or fiduciary obligations; and

· the actions of the parties.

In your case, whilst you are not actively involved in the farming business, you do have a significant input. In particular, you actively participate in meetings with your parents and brothers about the business operation.

Specifically, your personal interests lie in the sustainable management of the land and environment. You made suggestions to your family about how the farming operation could adopt some of the sustainable practices that were both important to you personally and could also benefit the long term viability of the farming business. Whilst your family may have been reluctant at first to adopt some of the practices, they have now embraced many of the proposals that you put forward.

The adoption of these sustainable farming techniques shows that your family have also been acting in accordance with your wishes and directions. Furthermore, the fact that these sustainable practices also have long term benefits for the farming business indicates that the partners are acting in concert with you.

Other factors pointing to your parents and brothers being affiliates include:

· the close family relationship between the parties;

· lack of formal agreements;

· the way that the parties act in relation to one another would have been heavily influenced by family considerations.

Accordingly, your parents and two siblings are your affiliates in accordance with subsection 328-130(1).

- PBR 1012099897959 – 17 April 2012

  Facts

  You have been farming for a number of years and purchased the relevant property after 20 September 1985. You farmed this property for a few years and have since been leasing it to your child. You remain living on the property.

  You are now considering transferring the property to your child.

  There are no formal agreements between you and your child, either in relation to business or financial arrangements; however they pays you lease payments.

  You commenced a primary production activity on the land when you purchased it and your child carries on the same operation that you started.

  During busy work times you have maintained a keen working involvement in the business activities.

  You have placed no restrictions on your child as to how they run the business but they continues to run the business in the same manner that you started.

  You have no financial control over your child's activities and do not control the business however; you provide support in farming processes.

  Your child makes the major decisions about his business but if they want to change any of the processes already in place they always discuss them with you first before implementing them.

  Decision

  In your case, you purchased the land a number of years ago. You commenced farming on the land but then you passed on the farming of the land to your child.

We accept that there is a close family relationship between the parties. You live on the property and help out in times of need.

Your child discusses with you any new ideas or processes but you do not direct him to carry on his business in any particular way nor do you have any financial control.

Whilst you may be involved, connected to or participate in your child's business you do not act together in pursuit of a common goal or purpose and you do not direct him in the carrying on of his business. Overall, your child operates his business as they wish. The requirements for an entity to be an affiliate within the meaning of the term in section 328-130 of the ITAA 1997 are not met as you do not meet requirement (c) of the definition.

As your child is not your affiliate the property was not an active asset of yours for the years it was leased to your child. The property was only an active asset for the period that you farmed it. As this was less than 7 years, the active asset test is not satisfied. You are therefore unable to qualify for the small business CGT concessions as you do not meet basic condition (d) in subsection 152-10(1) of the ITAA 1997.

3.6 Maximum net asset value test (NAT)

3.6.1 How is NAT satisfied?

- To satisfy NAT, the sum of the net value of the CGT assets of the following entities (NAT Entities) must not exceed $6 million:
  - The entity that has the CGT event (taxpayer).
  - Entities 'connected' with the taxpayer.
  - Entities who are 'affiliates' of the taxpayer.
  - Entities connected with the affiliates.[28]
- The net value of the CGT assets of an entity is the amount obtained by subtracting from the sum of the market values of the assets of NAT Entities, the sum of:
  - the liabilities of the NAT Entities that are related to the assets; and
  - provisions made by the NAT Entities for annual leave, long service leave, unearned income and tax liabilities.[29]
- In calculating NAT, if the NAT Entity is **an individual**, then the following assets are disregarded:
  - Assets being used solely for the personal use and enjoyment of the individual or the individual's affiliate (except a dwelling that is the individual's main residence).
  - The main residence of the individual unless the dwelling has been used during the ownership period to derive assessable income, in which case a reasonable amount of the market value

[28] Section 152-15 of the 1997 Tax Act
[29] Section 152-20(1) of the 1997 Tax Act

of the residence must be included having regard to the extent that interest has been or would have been deductible.

- A right to, or to any part of, any allowance, annuity or capital amount payable out of a superannuation fund or an approved deposit fund.
- A right to, or to any part of, an asset of a superannuation fund or an approved deposit fund.
- A policy of insurance on the life of an individual.[30]

- In calculating NAT, if the entity is an 'affiliate' or an entity which is connected with the taxpayer because of the 'affiliate', the only assets which are used or held ready for use in the carrying on of a business by the taxpayer or an entity connected with the taxpayer are included.31

3.6.2 Issues and traps with calculating NAT

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

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

- The taxpayer needs to identify 'connected entities' and 'affiliates'.
  - Quite commonly we find that not all of the entities who are connected with the taxpayer who has had the CGT event have been identified or that only the taxpayer's ownership interest in the connected entity's assets has been taken into account.
  - Note: Where an entity is a 'connected' entity, 100% of the net assets of that entity are included in determining NAT.

[30] Section 152-20(2) of the 1997 Tax Act
[31] Sections 152-20(3) and 152-20(4) of the 1997 Tax Act

- All CGT assets (other than those specifically excluded) must be included.
  - CGT assets as defined in section 108-5(1) of the 1997 Tax Act includes any kind of property.
  - This means that CGT assets to which a capital gain would not normally apply must also be included (e.g. depreciating business assets, trading stock, bank accounts, cash, debtors and loans will need to be taken into account).
- Assets owned by individuals and used solely for personal use and enjoyment by the individual or their affiliate are excluded.

  (Commissioner's view and AAT decision)

  - Interest earning bank accounts are not used solely for personal use and enjoyment (ATO ID 2009/33).
  - Vacant land on which the individual intends to construct a house is not used for any purpose, therefore is not used solely for personal use and enjoyment (ATO ID 2009/34).
  - The use of the asset over its ownership period is taken into account, not just the use 'just before the CGT event' (ATO ID 2011/37). Holiday home which has been rented at some point is not used solely for personal use and enjoyment (ATO ID 2011/41). This is not consistent with the legislation nor the AAT decision of Altnot.

    Altnot Pty Ltd v FC of T [2013] AATA 140: Home had been rented out until 31 January 2007. In December 2006 the decision was made to use the home as a holiday home. ATO argued that you needed to look at the use of the property through-out the ownership period. AAT – only needed to look at the use of the property just before the CGT event, however although the home was not being rented and was available for use as a holiday home, it was not being used for that purpose just before the time of the CGT event (which occurred in March 2007).

  - Holiday home (which had never been rented) used for the personal use and enjoyment of the individual, their spouse and children under 18 years of age will be considered to be for personal use and enjoyment (ATO ID 20011/39).
  - Holiday home (which had never been rented) used for the personal use and enjoyment of the individual's relatives and friends will be considered to be for personal use and enjoyment (ATO ID 20011/40).
- Where the CGT asset is currently an individual's main residence, that home is only excluded to the extent that it has never been used to derived assessable income.

  Therefore, it is important to ask the client about the history of the use of the home.
- How to determine the market value of the assets?

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

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- Market value of loans

  In the Federal Court decision of *Breakwell & Anor v FC of T* [2020] FCA 1471, the Court held that a pre-1988 loan owing by Mr Breakwell to a trust of which he was the trustee did have value on the following basis.

    Section 35(a) of the Limitations of Actions Act 1936 (SA) (**LLA**) did not prohibit an action being brought to recover a debt after six years have elapsed. Instead, the section created a defence which can be raised by a respondent.[32]

    It was questionable whether Mr Breakwell would have raised the defence against the trust of which he was the trustee.[33]

    The action to recover the pre-1988 loan would be an action to recover trust property which means that under section 32(1) of the LLA there would be no limitation period.

3.6.3 NAT and treatment of unpaid present entitlements (UPEs)

- In determining NAT, the market value of the CGT assets of the entity are reduced by the liabilities of the entity that are related to those assets.[34]
- In relation to UPEs, the issues when determining NAT as follows:
    - Is the UPE an asset of the beneficiary?
    - If the UPE is an asset of the beneficiary, can it be excluded under section 152-20(2) of the 1997 Tax Act on the basis that it is an interest in an entity connected with the beneficiary?
    - Is the UPE a liability of the trust which is related to the trust's assets and therefore reduces the market value of the trust's assets.

Where a beneficiary is 'connected' with the trust

- The Commissioner's view as to the treatment of UPEs where the beneficiary is connected with the trust is outlined in Taxation Ruling TR 2015/4. The treatment depends on whether the:
    - funds representing the UPE are set aside on a separate trust (sub-trust);
    - funds representing the UPE are not set aside on sub-trust (no sub-trust); or
    - where the UPE is an absolute entitlement to one or more trusts (absolute entitlement).

Sub-trust

- Where the funds representing the connected beneficiary's UPE have been set aside on a separate trust (the sub-trust), the net asset value calculation for the main trust will include the following:

[32] at paragraph 26
[33] at paragraph 34
[34] Section 152-20(1)(b) of the 1997 Tax Act

- in the net value of the CGT assets of the main trust - no amount is taken into account in respect of the UPE; the funds representing the UPE are not relevant assets of the trust and the trustee does not have any liability related to trust assets in respect of the UPE
- in the net value of the CGT assets of the sub-trust (which is an entity connected with the main trust within the meaning of section 328-125) - the funds representing the UPE form part of the sub-trust's assets that are taken into account, without any corresponding liability, and
- in the net value of the CGT assets of the connected beneficiary - in these circumstances, the value of the UPE is not taken into account, being an asset that is disregarded under paragraph 152-20(2)(a).[35]

No sub-trust

- Where funds representing the connected beneficiary's UPE have not been set aside on sub-trust, the net asset value calculation for the main trust will include the following:
  - in the net value of the CGT assets of the trust - the value of the funds representing the UPE are included in the trust's assets, but for the purposes of paragraph 152-20(1)(a) are reduced by a corresponding liability of the trustee to pay the amount of that entitlement, and
  - in the net value of the CGT assets of the connected beneficiary - the UPE is an asset of the beneficiary that is not disregarded under paragraph 152-20(2)(a).[36]

Absolute entitlement

- Where a connected beneficiary's UPE is an absolute entitlement to one or more trust assets, paragraphs 5 and 6 of this Ruling do not apply and the net asset value calculation for the trust will include the following:
  - in the net value of the CGT assets of the trust - no amount is taken into account in respect of the UPE: any asset that the connected beneficiary has an absolute entitlement to receive is taken not to be a relevant asset of the trust and the trustee does not have any liability related to trust assets in respect of the UPE, and
  - in the net value of the CGT assets of the connected beneficiary - provided that it is not disregarded under subsection 152-20(2), the value of any asset to which the connected beneficiary is absolutely entitled to receive is taken into account as an asset of that connected beneficiary.[37]

  Note: The effect of TR 2015/4 is that if the UPE is treated as an asset of the beneficiary it is treated as a liability of the trust except where the UPE is an absolute entitlement to one or more trust assets in which case it is only treated as an asset of the beneficiary. That is, the effect is to avoid double counting.

  However, Taxation Ruling TR 2015/4 only deals with UPEs where the beneficiary is connected with the trust.

Where a beneficiary is not 'connected' with the trust

- It is not uncommon to have UPEs owing to beneficiaries who are not connected with the trust because they have not received a distribution from the trust in one of the previous four years.
- In these cases the entity cannot rely on TR 2015/4.

[35] at paragraph 5
[36] at paragraph 6
[37] at paragraph 7

- In these cases there are two issues:
    - Whether the UPE owing by the trust is a liability for the purpose of section 152-20(1) of the 1997 Tax Act?
    - Whether the UPE relates to the trust assets for the purpose of section 152-20(1) of the 1997 Tax Act?

Is the UPE owing by the trust is a liability for the purpose of section 152-20(1) of the 1997 Tax Act?

- Liabilities' is not a defined for the purpose of section 152-20(1), however in *Taxation Determination* TD 2007/14, the Commissioner states [at paragraph 18] that:
- In the context of subsection 152-20(1), 'liabilities' extend to legally enforceable debts due for payment and to presently existing legal or equitable obligation to pay either a sum certain or ascertainable sums….
- The UPE would be a liability of the trust for the purpose of section 152-20(1) as it is at the very least a presently existing equitable obligation to pay an amount to a beneficiary.

Does the UPE relate to the assets of the trust for the purpose of section 152-20(1)?

- In the Full Federal Court decision, *Bell v FC of T* 2013 FCAFC 32 (Bell's case), Justices Jessup, Jagot and Robertson were of the view that an unpaid entitlement owing by a trust did relate to the assets of the trust even though a beneficiary did not have the right to call for any specific trust asset.

  The resolution to distribute created a liability, and the trustee was required, by the terms of the resolution, to fund the resolution from capital. The liability did, therefore, relate to the assets of the Trust, notwithstanding the appellant's inability to call for any specific asset of the Trust to be advanced, or paid over, to him pursuant to the resolution.[38]

- Although Bell's case related to a distribution of capital, a resolution to distribute income also creates a liability which the trustee is required to fund from capital. Therefore, based on the view of the Full Federal Court in Bell's case, the UPE owing would be a liability which relates to the assets of the trust for the purpose of section 152-20(1).
- The Taxpayer was not successful in Bell's case for the following reasons:
    - At the time of the CGT event the UPE was extinguished using borrowed funds.
    - The Full Federal Court held that if the trustee then borrowed funds which were then used to extinguish the unpaid present entitlement rather than using the existing resources of the trust, then the borrowings would not be considered to be a liability which relates to the general assets of the trust.
- In *Taxation Determination* TD 2007/14, the Commissioner confirms [at paragraph 22] that the 'liabilities of the entity that are related to the assets' also include liabilities that, although not directly related to one particular asset, are related to the assets of the entity more generally, for example, a

[38] at paragraph 33

bank overdraft or other short term financing facility that provides working capital for the operation of the business.

- Therefore whilst the UPE remains unpaid, it should be considered to be a form of financing being used by the trust for working capital.
- Identifying the liabilities which relate to the assets which are included. For example liabilities can only be counted if they relate to assets which are included. For example, if the main residence is excluded, then the liability related to that main residence is excluded.

3.7 CGT Small Business Entity

3.7.1 What is a CGT small business entity?

- An entity is a CGT small business entity (CGT SBE)[39] for an income year if it:
  - carries on business in the income year; and
  - at least one of the following applies:
    - it has an aggregated turnover of less than $2 million for the income year (worked out at the end of the year);
    - it carried on business in the previous year and had an aggregated turnover of less than $2 million for the previous income year; and/or
    - its aggregated turnover for the current year is likely to be less than $2 million (provided that if it carried on business for the previous two years its aggregated turnover for those two years was not $2 million or more).
- 'Aggregated' turnover requires that the ordinary income derived from carrying on a business of the taxpayer's group must be less than $2 million.
- If an entity is winding up a business, it will be taken to be a small business entity if it were a CGT SBE in the year it stopped carrying on a business.

3.7.2 Carrying on a business

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

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

Example 1 - inactive company with retained profits

62. InactiveCo is a company incorporated in Australia. InactiveCo carried on a trading business that was wound up in the 2015-16 income year. InactiveCo has $400,000 of retained earnings which it holds in a bank account.

63. In the 2016-17 and later income years, the company's income has consisted solely of interest of $12,000 a year. InactiveCo has no intention of resuming its trading business. InactiveCo pays an annual company review fee of $254 to ASIC. The company's income is consistently greater than its expenses. As a result, the company has made a profit in each income year from 2016-17.

64. InactiveCo's activities have both a purpose and prospect of profit. InactiveCo is carrying on a business.

Example 2 - company is engaged in preliminary activities invests its assets in producing income

65. Future Co is a newly incorporated company. Its activities consist of investigating whether it would be viable to carry on a particular business in the future and investing its $300,000 in share capital in income producing bank accounts. No decision has been made to carry on the business under investigation. However, it derives $9,000 a year in interest from its bank accounts. While Future Co's activities of investigating the potential business may be preliminary in nature and not a business, it nonetheless carries on a business as a result of its activity of investing for profit.

Example 3 - property investment company

66. InveproCo is a company incorporated in Australia. InveproCo owns a commercial property, which it rents to a third party at a market rate on normal commercial terms. InveproCo provides no other services in relation to the property and conducts no other activities. InveproCo has produced a profit in each of the income years it has rented out the property. InveproCo is engaged in ongoing activities that have a purpose and prospect of profit, including letting out the property.

Possibility A

67. InveproCo engages a professional property manager to manage the property, find tenants and do all the maintenance and ongoing inspections in relation to the property.

68. InveproCo carries on a business.

Possibility B

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

70. InveproCo carries on a business.

Example 4 - share investment company

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

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

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

Possibility A

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

Possibility B

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

Example 5 - Company leases multiple boats to unrelated party

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

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

Possibility A: CharterCo self manages its leasing activity

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

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

Possibility B: CharterCo engages a management company

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

Example 6 - holding company

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

Possibility A: holding company only holds shares in subsidiary

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

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

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

84. HoldCo's income consists of dividend income derived from the shares it holds in SBE Co. While it does not derive a direct return on the loan or provision of equipment, these enhance SBE Co's profitability and improve the return on Holdco's shares in SBE Co. The profits are distributed by HoldCo to its shareholders.

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

- Share Farming Agreements

  Whether a land owner is carrying on a business under a share farming arrangement will depend of what activities and level of control is with the land owner. For example, if the land owner has limited involvement, the fact that a share of the proceeds of the crop are received would not amount to the carrying on of a business. (*Taxation Determination* TD 95/62).

- Agistment Agreements

  Whether the activities of the land owner who receives agistment amounts to the carrying on of a business will depend on the level and involvement and responsibility undertaken by the land owner.

  If the land owner merely receives an amount per head for agistment and has limited involvement, this would not amount to the carrying on of a business. This can be compared with the facts in Private Binding Ruling Number 78516.[40]

  Facts

  Backgrounding contract entered into based on available pasture at the time. Taxpayer intends to enter into further contracts based on feed availability.

  Taxpayer carries out regular activities to maintain the cattle, incurs expenditure in this process and is subject to risks.

  Activity can potentially produce a profit (shown by consultants' figures and own budgets).

  Regulation and repetition in the activity.

  The income derived is based on the weight gained by the cattle.

  Although the taxpayer does not own the cattle, the activity is carried on in a similar manner to a cattle fattening business.

  Activity carried out in business-like manner (keep records and seek advice from consultants).

  Substantial scale of activity.

  Decision

  The backgrounding of cattle in this case is different from normal agistment in that as well as providing the assets the taxpayer takes on full responsibility, care and protection of the cattle, will have to meet expenses. and is liable for deaths. Payment was based on the weight gain of the cattle.

3.7.3 Who must be the CGT SBE?

- CGT SBE Test 1

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

- CGT SBE Test 2

  All of the following occur:

  - the taxpayer is a partner in a partnership; and

[40] Note Private Binding Ruling Numbers 105180044381 and 1051801635471.

  - the partnership is a CGT SBE; and
  - the CGT asset is an asset of the partnership.
- CGT SBE Test 3

  All of the following occur:

  - the taxpayer's affiliate or an entity connected with the taxpayer is a CGT SBE for the income year; and
  - the taxpayer does not carry on a business in the income year (other than in partnership); and
  - if the taxpayer does carry on business in partnership – the CGT asset is not an interest in an asset of the partnership; and
  - the SBE referred to above is the entity that at a time in the income year uses the asset or holds it ready for use in the course of carrying on a business.
- CGT SBE Test 4

  All of the following occur:

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

3.7.4 What is Aggregated Turnover[41]

- Aggregated Turnover is the sum of the annual turnover for the income year:
  - of the entity; and
  - an entity which was a connected entity at any time during the income year; and
  - an entity which was an affiliate at any time during the income year.
- However, any amounts derived in the income year:

[41] Section 328-115 of the 1997 Tax Act

- between the entity, the connected entity and the affiliate whilst they are 'connected' or affiliates are excluded;
- by the connected entity or affiliate whilst it is not connected with or an affiliate of the entity are excluded.

- 'Annual Turnover' is the total ordinary income that the entity derives in the income year in the ordinary course of carrying on a business.[42]
  - 'Ordinary income' is income as defined by section 6-5 of the 1997 Tax Act.
  - 'Annual Turnover' only includes ordinary income derived in the ordinary course of carrying on a business.
    - Items of income which are statutory income, such as net capital gains and dividends will not be included.
    - Income from assets which form part of the sale of the business will not be included. For example, sale of stock or depreciating assets.
  - The GST component is not included in annual turnover.
  - Any income derived from an associate of an entity must be included as the amount the entity would have derived if they were dealing at arm's length.
  - Meaning of 'in the ordinary course of carrying on a business'

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

    > 2.14 The phrase `in the ordinary course of carrying on a business' is not defined in income tax law. It must therefore be interpreted according to its ordinary meaning.
    >
    > 2.15 In general, income is derived in the ordinary course of carrying on a business if the income is of a kind that is regularly or customarily derived by the entity in the course of carrying on its business, arising out of no special circumstance or event. Similarly, the income is derived in the ordinary course of carrying on a business if the income although not regularly derived, is a direct result of the normal activities of the business.
    >
    > 2.16 Ordinary income may be derived in the ordinary course of carrying on a business even if it is not the main type of ordinary income derived by the entity. Similarly, the income does not need to account for a significant part of the entity's overall receipts. It is sufficient that the ordinary income is of a kind derived regularly or customarily in the carrying on of a business.
    >
    > Where trading stock is sold as part of the sale of a business, it would not be made in the ordinary course of business (Private Binding Ruling PBR 1013036077107).

  - Private Binding Ruling 1051708495139 in relation to 'in the ordinary course of carrying on a business' (additional sales of livestock because of bushfires

    Annual Turnover of the Operating Trust

    In this case, the business carried on by the Operating Trust is a primary production business involving the sale of sheep, cattle and wool. In respect to the sale of livestock, the normal activities of the Subject

[42] Section 328-120 of the 1997 Tax Act

Business involve the Operating Trust retaining livestock until such time as a commercial decision is made that they are suitable for sale to an abattoir.

Severe bushfires impacted large parts of Australia from late 20ZZ. On 30 December 20ZZ, bushfires destroyed 'significant areas' of the Subject Land. The fires effected X kilometres of fencing that would normally contain cattle. As a result of this fencing being destroyed the cattle could no longer be kept on the Subject Land. Due to the consequential lack of dry feed and destroyed fencing, the Operating Trust was forced to sell livestock in the year ending 30 June 20YY that would normally have been sold in the year ending 30 June 20XX.

The forced nature of the sales is demonstrated by the fact that the Operating Trust sold their livestock cattle at a much earlier stage. It was customary, that the livestock would be sold at around XX months of age, ordinarily weighing approximately XXXkg. Instead as a result of the fires the cattle were sold at a younger age and lower weight then they would have ordinarily been sold at. A further number of cattle were sold to a feedlot (as opposed to the trust's usual abattoir customer), each weighing less than they ordinarily would have at the time of sale.

As a result of the livestock sales brought forward, $X,XXX (excluding GST and selling costs such as sales commission, insurance and levies) was included as ordinary income derived for the year ended 30 June 20YY. This amount of income or similar would normally been derived as ordinary income during the year ended 30 June 20XX on account of the livestock being sold in the latter income year.

In these circumstances, to determine whether this amount is included in the annual turnover of the entity, we need to consider if the income is of a kind that is regularly or customarily derived by an entity in the course of carrying on its business, arising out of no special circumstance or unusual event.

Income from the disposal of livestock is of a kind that is customarily or regularly derived by a cattle farming business, however in this case the disposal of the livestock occurred primarily due to the severe bushfires. As discussed above, the Operating Trust would not have made the $X,XXX of livestock sales in the income year ending 30 June 20YY if the bushfires had not occurred. That is, the income from the disposal was the result of an unusual event or special circumstance. The sale of the livestock by the Operating Trust is not a disposal in the ordinary course of business and is instead a disposal of the assets of the business due to an unusual event or special circumstance.

Further, the income from the livestock sales were not derived as a direct result of the normal activities of the business. The normal activities of the Operating Trust involve retaining livestock until such time as a commercial decision is made that they are suitable for sale to an abattoir. Due to the severe fires which effected the Subject Land, the Operating Trust was unable to retain the livestock until it was commercially suitable to sell them. The cattle were sold at a different age, weight and in some instances to a different end customer. Therefore, it cannot be said that, the income from the sale of cattle, in this case, is derived as a direct result of the normal activities of the business.

As a result, the annual turnover of the Operating Trust for the purposes of section 328-120 of the ITAA 1997 does not include the $X,XXX of livestock sales that was derived as result of the bushfires.

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

  ATO ID 2009/49

  The taxpayer operated two businesses during the year:

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

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

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

Is this view correct??

3.8 Active Asset Test

- When does an asset satisfy the active asset test?
    - There are two parts to the active asset test:
        - the asset must be an active asset; and
        - the asset must meet the active asset test.
- A CGT asset satisfies the active asset test if the asset was an active asset of the taxpayer for the following periods (section 152-35):
    - if the asset is owned 15 years or less, then half the period:
        - beginning when the asset was acquired (which is the generally the date of the contract for the acquisition of the asset); and
        - ending at the time of the CGT event (or at the time of the cessation of the business if the business ceased in the last 12 months (or a longer period that the Commissioner allows));
    - if the asset is owned more than 15 years, then the asset must be active for a total of at least 7.5 years of the period:
        - beginning when the asset was acquired; and
        - ending at the time of the CGT event (or at the time of the cessation of the business if the business ceased in the last 12 months (or a longer period that the Commissioner allows)).
- An asset is an active asset at a given time if, at that time the taxpayer owns it; and the asset (section 152-40):
    - is used, or held ready for use, in the course of carrying on the taxpayer's business; or
    - it is an intangible asset that is inherently connected with a business that the taxpayer carries on (for example, goodwill or the benefit of a restrictive covenant); or
    - it is used, or held ready for use, in the course of carrying on a business by:
        - the taxpayer's affiliate; or
        - an entity connected with the taxpayer.

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3.8.1 Assets which cannot be 'active assets'[43]

- Shares or units unless they are covered by section 152-40(3), (3A) or (3B) (sections 152-40(4)(a), (b) and (c)).
- Financial instruments (such as loans, debentures, bonds, promissory notes, futures contracts, forward contracts, currency swap contracts and a right or option in respect of a share, security , loan or contract) (section 152-40(d)).
- An asset whose main use is to derive interest, an annuity, rent, royalties or foreign exchange gains cannot be an 'active asset' unless:
  - the asset is an intangible asset and has been substantially developed, altered or improved by the taxpayer so that its market value has been substantially enhanced; or
  - its main use for deriving rent was only temporary.[44]
- Royalties (*Law Companion Ruling* LCR 2019/5):
  - Ordinary meaning (cases):
    - It is a payment made in return for the right to exercise a beneficial privilege or right (e.g. to remove minerals or natural resources such as timber, to use a copyright, or to produce a play).
    - The payment is made to the person who owns the right to confer that beneficial privilege or right.
    - The consideration payable is determined on the basis of the amount of use made of the right acquire.
  - Ordinary meaning of royalties expanded under the definition in section 6(1) of the 1936 Tax Act.

> The definition includes as royalties amounts paid or credited for:
>
> (a) the use of, or the right to use, any copyright patent, design or model, plan, secret formula or process, trademark, or other like property or right;
>
> (b) the use of, or the right to use, any industrial, commercial or scientific equipment;
>
> (c) the supply of scientific, technical, industrial or commercial knowledge or information (e.g. know-how payments);
>
> (d) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in paragraph (a), any such equipment as is mentioned in paragraph (b), or any such knowledge or information as is mentioned in paragraph (c);
>
> (e) the use of, or the right to use, motion picture films, films or video tapes for use in connection with television, or tapes for use in connection with radio broadcasting; or

[43] Section 152-40(4) of the 1997 Tax Act.
[44] Section 152-40(4)(e) of the 1997 Tax Act

> (f) a total or partial forbearance in respect of the use of, or the granting of the right to use property of any of the kinds referred to in paragraphs (a), (b) or (e), or the supply of knowledge, information or assistance of any of the kinds referred to in paragraphs (c) or (d).

- An intangible asset owned by a company whose main use is to derive royalties will not be an active asset of the company unless it has been substantially developed, altered or improved by the taxpayer so that its market value has been substantially enhanced.

- Is income from hire equipment royalties?

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

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

    - PBR No 1051573620646 – company in business of leasing equipment which is of an industrial or commercial nature. Hire income was a royalty and therefore BREPI.

- Although a company may be considered to be carrying on a business in a general sense as described in *Taxation Ruling* TR 2019/1, if an asset's main use is to derive rent or interest (unless the asset is used by a 'connected' entity or affiliate in carrying on a business) the asset will not be an active asset (*Taxation Determination* TD 2021/2).

    Example: property investment company (from TD 2021/2)

    2. InveproCo is a company incorporated in Australia. InveproCo owns a commercial property, which it has rented to third parties at market rates on normal commercial terms since its inception. InveproCo provides no other services in relation to the property and conducts no other activities. InveproCo has produced a profit in each of the income years it has rented out the property. InveproCo is engaged in ongoing activities that have a purpose and prospect of profit, including letting out the property.

    3. In this situation, the company has derived rental income from the leasing of a property. Accordingly, the company carries on a business in a general sense described in TR 2019/1. However, the main (only) use of the property is to derive rent and it is therefore excluded from being an active asset under paragraph 152-40(4)(e) regardless of whether the activities constitute the carrying on of a business in a general sense. Therefore, the investment property would not satisfy the active asset test in section 152-35 and InveproCo would not meet the requirement in paragraph 152-10(1)(d) to be eligible for the CGT small business concessions in Division 152 in relation to the disposal of the investment property.

- AAT decision *Del Castillo and Commissioner of Taxation* [2022] AATA 4233 which was handed down in December 2022:

    - The taxpayer argued that the exception in section 152-40(4)(e) about assets where the main use was to derive rent should only apply in relation to passive assets and not where the activities of the taxpayer amounted to a business (that is, a rental property business).

- The Tribunal held that section 152-40(4)(e) was clear and applied to assets whose main use was to derive rent regardless of whether the activity of deriving the rent was considered to be a business. Deputy President McCabe at paragraph 28:

> There is no contextual basis for concluding the parliament intended the words 'main use …to derive .. rent' in s 152-40(4)(e) to comprehend anything other than a reference to real estate assets used to drive payments under a lease – a description which neatly captures what the application was doing, whether as part of a small business or not. She clearly does not fall within the scope of the exception to the exception. If parliament had intended to provide a more named treatment of leased assets, it presumably would have done so in express terms.

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

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

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

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

26. If an asset is used partly for business and partly to derive rent at any given time, it will be a question of fact dependent on all the circumstances as to whether the main use of the asset at that time is to derive rent. No one single factor will necessarily be determinative, and resolving the matter is likely to involve a consideration of a range of factors such as:

- the comparative areas of use of the premises (between deriving rent and other uses); and
- the comparative levels of income derived from the different uses of the asset.

Example 5: mixed use

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

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

> 22. Whether an asset's main use is to derive rent will depend on the particular circumstances of each case. The term 'rent' has been described as follows:

- the amount payable by a tenant to a landlord for the use of the leased premises (*C.H. Bailey Ltd v. Memorial Enterprises Ltd* [1974] 1 All ER 1003 at 1010, *United Scientific Holdings Ltd v. Burnley Borough Council* [1977] 2 All ER 62 at 76, 86, 93, 99);

- a tenant's periodical payment to an owner or landlord for the use of land or premises (*The Australian Oxford Dictionary*, 1999, Oxford University Press, Melbourne); and

- recompense paid by the tenant to the landlord for the exclusive possession of corporeal hereditaments. .... The modern conception of rent is a payment which a tenant is bound by contract to make to his landlord for the use of the property let (Halsbury's *Laws of England* 4th Edition Reissue, Butterworths, London 1994, Vol 27(1) 'Landlord and Tenant', paragraph 212).

23. A key factor therefore in determining whether an occupant of premises is a lessee is whether the occupier has a right to exclusive possession (*Radaich v. Smith* (1959) 101 CLR 209; *Tingari Village North Pty Ltd v. Commissioner of Taxation* [2010] AATA 233 at paragraphs 44-46, 2010 ATC 10-131, 78 ATR 693 and associated Decision Impact Statement 2008/4646 & 2008/4647). If, for example, premises are leased to a tenant under a lease agreement granting exclusive possession, the payments involved are likely to be rent and the premises not an active asset. On the other hand, if the arrangement allows the person only to enter and use the premises for certain purposes and does not amount to a lease granting exclusive possession, the payments involved are unlikely to be rent.

24. If premises are operated as a boarding house, the issue arises as to whether an occupant of part of the premises is a tenant or alternatively only a lodger/boarder with a licence to occupy. Similarly, if residential units are operated as holiday apartments, the issue arises as to whether the occupants of the apartments are tenants/lessees or only have licences to occupy.

25. Ultimately, these are questions of fact depending on all the circumstances involved. Relevant factors to consider in determining these questions (in addition to whether the occupier has a right to exclusive possession) include the degree of control retained by the owner and the extent of any services provided by the owner such as room cleaning, provision of meals, supply of linen and shared amenities (*Allen v. Aller* (1966) 1 NSWR 572, *Appah v. Parncliffe Investments Ltd* [1964] 1 All ER 838 and *Marchant v. Charters* [1977] 3 All ER 918).

Example 1: rental properties

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

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

Example 2: commercial storage

4. Christine carries on a business of providing commercial storage space. The storage facility comprises 50 storage sheds which are available for hire for periods of 1 week to 2 years or more. Christine provides office facilities and 24 hour on-site security. She also provides various items of equipment for sale or loan to clients such as trolleys, cardboard boxes, brooms, tape,

pens, locks, bolt cutters, torches and shelves. A cleaning service is also provided and charged for.

5. Christine enters into a storage agreement with each client. The agreements provide that in certain circumstances she can relocate the client to another space or enter the space without consent and that the client cannot assign the rights under the agreement.

6. The arrangements entered into in this situation indicate that the users of the storage sheds do not have the right to exclusive possession but rather only the right to enter and use the sheds for certain purposes. Some of the arrangements entered into were short term and a range of services were provided to the users. There was also no intention by the parties to grant a lease.

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

Example 3: boarding house

8. David owns an 8 bedroom property which he operates as a boarding house. He resides on the premises. Boarders enter into arrangements to occupy single rooms with the average length of stay being 4-6 weeks. No notice is required to quit the rooms. There are rules requiring visitors to leave the premises by a certain time and David retains the right to enter the rooms. David pays for all utilities (gas, electricity, water) and provides the following services and facilities to boarders:

- room cleaning and general maintenance;
- linen and towels; and
- common areas such as a TV/lounge room, kitchen, bathrooms, laundry and a recreation area.

9. In this example, the services and facilities provided to boarders are relatively significant and the average length of stay is relatively short. David retains a significant degree of control over the premises through being on the premises most of the time. The arrangements entered into indicate that those staying in the boarding house do not have the right to exclusive possession of a room but rather only a right to occupy the room.

10. These circumstances indicate that the relationship between David and those staying at the boarding house is not that of landlord/tenant under a lease agreement. Accordingly, the income derived is not 'rent' and therefore the paragraph 152-40(4)(e) exclusion does not apply. If David's activities amount to the carrying on of a business, the boarding house will be an active asset under section 152-40 of the ITAA 1997.

Example 4: holiday apartments

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

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

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

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

3.8.3 What if only part of an asset is used to carry on business?

***Rus v FCT* (AAT decision 2018)**

- Facts
    - The size of the property is 16.16 hectares (39.91 acres).
    - The vast majority of the property, approximately 15 hectares, is vacant land. There had been one unsuccessful attempt to crop this area and no money was made from the cropping attempt. The Applicant had no livestock and did not use the land for agistment. When the Applicant's husband was alive he mowed the grass. The mowed grass was not turned into hay. A third party now cuts the grass for the Applicant, free of charge.
    - The land area contains two houses and a shed. The area that contains the two houses and the shed is approximately 1.619 hectares (4 acres). The shed is located on the property boundary.
    - Two houses – one used by the taxpayer and one her children.
    - The taxpayer and her husband carried on a small business partnership from June 1985 to February 1997, when the business was transferred to a company, of which the taxpayer and her husband were the directors and shareholders.
    - A plastering/housing construction business was carried on, on the property. Initially through a partnership structure and then a company.
    - Use of property
        - Property the registered address listed on the company's domestic building insurance and home warranty insurance approval.
        - There was a shed on the 1.619 hectares dimensions are 24m x 8m. It contained shelves and an office.
        - The shed is used as a warehouse to store tools, plant and equipment and three motor vehicles.
        - When the main residence was built, the office was moved to a room in the main residence.

- There are two containers outside the shed containing material supplies.
- Only a small portion of the property (shed and home office) was used in the running of the business. The vast majority of the property was not used for business purposes at all.
- The home office contained two telephone lines, a desktop computer, three laptop computers, two commercial photocopiers and filing cabinets.
- The property address has been used as the postal address for accounts payable by the company, building permits for customers, motor vehicle registration papers and home warranty insurance and domestic building insurance documents.
- The home office is manned by two staff on a full time basis (from 9am to 5pm Monday to Friday), who are paid employees.
- The property has no signage to identify it as a place of business.
- The company's website lists the property as the operations office and refers to a Bayside Office in Williamstown.
- The majority of the business activities were conducted off site. Building supplies were delivered to worksites.
- The use of the Property as security for a $1.6m line of credit for the business.
- The Property is on one title.

- Tribunal
  - Need to look at the CGT asset – which is the land
  - The activities were being carried out on a small part of the asset, less than 10% of the total land. That 10% which was used included use of the land for private dwellings. The relevant question to be answered in the present circumstances is whether the whole of the land is an active asset when only a very small part of it has been used in carrying on a business?
  - We do not accept that submission based on the facts identified in the ruling. Having regard to the nature of the CGT asset, the nature of the company's business and the relationship between the CGT asset and that business, we do not consider that the CGT asset was used in the course of carrying on the company's business. **The CGT asset is a substantial parcel of land, 90% of which is vacant. It is necessary to form a view on whether the asset as a whole can be said to have been used in carrying on the business. Unlike a business of primary production or an agricultural pursuit, the company's business did not involve the exploitation of vacant land. The nature of the company's business did not call for any greater level of activity on the land than the use of a very small proportion of it. Nor did the existence of the vacant land contribute to the conduct of the business activities of the company.**[5] **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.**

Eichmann v FCT

- Facts
  - Taxpayer own the property which was on a separate title adjacent to their family home.
  - It was not included in the facts but the land appears to be 728 square metres.
  - Their trust carried on a business of building, bricklaying and paving from the property.
  - The property has two 4m x 3m sheds, as well as a 2m high block wall and gate to secure the property.
  - The two sheds were used for the storage of work tools, equipment and materials.
  - The open space on the property was used to store materials that did not need to be stored under cover, including bricks, blocks, pavers, mixers, wheel barrows, drums, scaffolding and iron.
  - Work vehicles and trailers were parked on the property.
  - Tools and items were collected on a daily basis.
  - In some cases the property would be visited a number of times a day in between jobs depending on what each job required.
  - The property was mainly for storage as work would be done on work sites.
  - On occasion, some preparatory work was done at the property in a limited capacity.
  - There was no business signage on the property.
- Tribunal

> **The taxpayers did not hold the land passively as an investment. The use of the land was not trivial or insignificant**. It was used for the purpose of the business, to store material in the sheds; to store material outside the sheds and to store his tools, all of which were undoubtedly done for the purpose of operating of the business. Tools and items were collected from the site on a daily basis, and work vehicles and trailers were parked on the property. Sometimes the site was visited several times per day between jobs, and occasionally some preparatory work was undertaken on the property. In his evidence he explained that storing the materials and tools on the land contributed to the efficiency of the business…

- Federal Court (single judge)

> The requirement that the asset be used "in" the carrying on of the business, rather than merely "in the business" or of having some relationship to the business, indicates that the use must be in the activities of the business which are directed to the gaining or production of assessable income.
>
> **In essence, in order for an asset to be used "in" the course of carrying on a business it is necessary for the use to have a direct functional relevance to the carrying on of the normal day-to-day activities of the business which are directed to the gaining or production of assessable income.**

The business of the company was the provision of services in the nature of construction, bricklaying and paving, and the activities engaged in the course of that business would be those directed to the securing and performing of those services. To a large extent that occurred on the work sites where the services were provided.

Conversely, the uses to which the land was put were preparatory to the undertaking of activities in the ordinary course of business.. **storage itself was not an activity in the ordinary course of Eichmann & Sons' business.** Whilst it may have been a use of the land "in relation to" the carrying on of the business, it was not, of itself, an activity in the course of carrying on the business. There was no direct connection between the uses and the business activities and the uses had no functional relevance those activities. It follows that the land which was the subject of the private ruling was not "used, or held ready for use, in the course of carrying on a business" and the Commissioner was correct to conclude that the land was not an active asset.

In order for a use to be "in the course of carrying on a business", the use must have a direct functional relevance to the carrying on of the normal day-to-day activities of the business which are directed to the gaining or production of assessable income. In that sense the use must be a constituent part or component of the day to day business activities, and may in that way be described as "integral" to the carrying on of the business.

- Full Federal Court

Secondly, contrary to the Commissioner's submissions, in our view the provisions conferring small business relief should be construed beneficially rather than restrictively in order to promote the purpose of the concessions conferred by that Division:

The language used in s. 152-40(1)(a) relevantly requires one to ascertain three matters. One must determine the use of a particular asset; one must then determine the course of the carrying on of a business; and then one must see whether the asset was used in the course of the carrying on of that business. These inquiries involve issues of fact and degree. But because **s. 152-40 should be construed beneficially, no narrow approach to the consideration of these issues should be applied. We also observe that, for these purposes, the legislature has not used language which might confine these inquiries. It has not, although it could have, referred to the "ordinary" course of a business or to the "day to day" course of a business; it has not used the words "direct" or "integral" to qualify the word "in". It is sufficient if the asset is used at some point in the course of the carrying on of an identified business.**

It follows from the foregoing, and with very great respect to the learned primary judge, that in our view s. 152-40(1)(a) does not require the use of the relevant asset to take place within the day to day or normal course of the carrying on of a business. Nor does the provision require a relationship of direct functional relevance between the use of an asset and the carrying on of a business. Such narrowing qualifications to the statutory test are not supported by the language of the provision, and are inconsistent with the need to construe that language beneficially.

In our view, the ruling makes it clear that the appellant's property was being used on a day to day basis as part of the business of building, bricklaying and paving. This is made clear from the following references in paras. 12-14 of the ruled facts: (a) to the tools and items being "collected on a daily basis"; (b) to the appellant's property being "visited a number of times a day in between jobs"; (c) to the number of such visits "depending on what each job required"; (d) to the occasional undertaking of "preparatory work" on the appellant's property; and (e) to the very nature of the items kept on the appellant's property. They are all aptly directed to the business of building, bricklaying and paving.

That is because the nature of the business carries with it a clear implication or inference that it needed a place to store necessary tools and materials. Here, that place was the appellant's property. In our view, it is obvious that an ability to secure overnight on a daily basis, and otherwise store, necessary tools and materials is an element of the particular business here of building, bricklaying and paving. It follows that it cannot be said that the appellant's property was used outside of the course of carrying on the business of building, bricklaying and paving. Being a part of that activity, the use here took place "in" the carrying on of that business.

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We also very respectfully disagree with the learned primary judge's characterisation of the use of the appellant's property as "preparatory" in nature if that was intended as a finding that the appellant's property was used outside the course of the carrying on of the business. In our view, the secure storage of the tools and materials of the business on a daily basis was very much part of the course of the carrying on of that business. If, however, his Honour intended to characterise that storage as preparatory to any on-site building work, then we respectfully agree with it. 50. Even if our construction of s. 152-40(1)(a) was incorrect, and the learned primary judge's construction were instead to be preferred, we would, in any event, characterise the use of the appellant's property as bearing a "direct functional relevance to the carrying on of the normal day to day activities" of the business here. The appellant's property served the function of being a secure and necessary place for the storage of the plant and equipment of the business. That function bore a direct relationship to the activities of building, bricklaying and paving. Again, the safe overnight storage of such tools and materials is, we think, a central concern of that type of business. Storage took place on a daily basis. It again therefore follows that the use of the appellant's property did not fall outside the course of carrying on the business in question.

3.8.4 "Connection" issues with a trust which has a tax loss or no taxable income

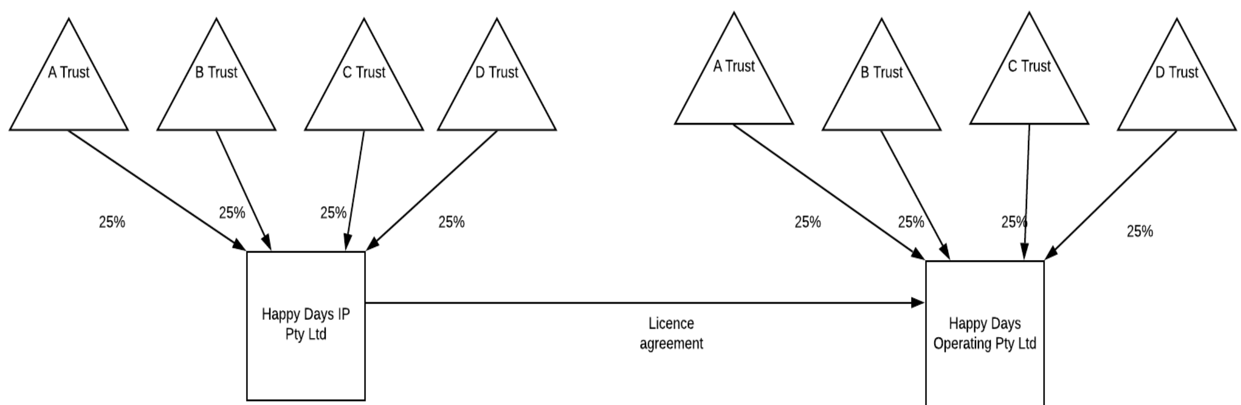
- If the trust has a tax loss or no taxable income for a year, then the trustee may nominate not more than four beneficiaries as being the controllers of the trust for those years for the purpose of determining 'control'.
- These nominated beneficiaries will be the controllers for those years (section 152-78(3)).
- The nomination must be in writing and signed by the trustee and by each nominated beneficiary (section 152-78(4)).
- Section 152-78 does not state when the nomination must be made by. The Commissioner's view (as expressed in relation to the legislation pre 1 July 2007) is that the nomination should be made by the time the entity chooses to apply the small business concessions for a particular capital gain. (ATO ID 2004/970).

- Spouse or children taken to be affiliates for passively held CGT assets
  - Section 152-47 applies if:
    - one entity (the asset owner) owns a CGT asset (whether a tangible or intangible asset); and
    - either:
      - the asset is used or held ready for use in the course of carrying on a business in an income year by another entity (the business entity); or
      - the asset is inherently connected with a business that is carried on in an income year by another entity (the business entity); and
      - the business entity is not (apart from this section) an affiliate of, or connected with, the asset owner.

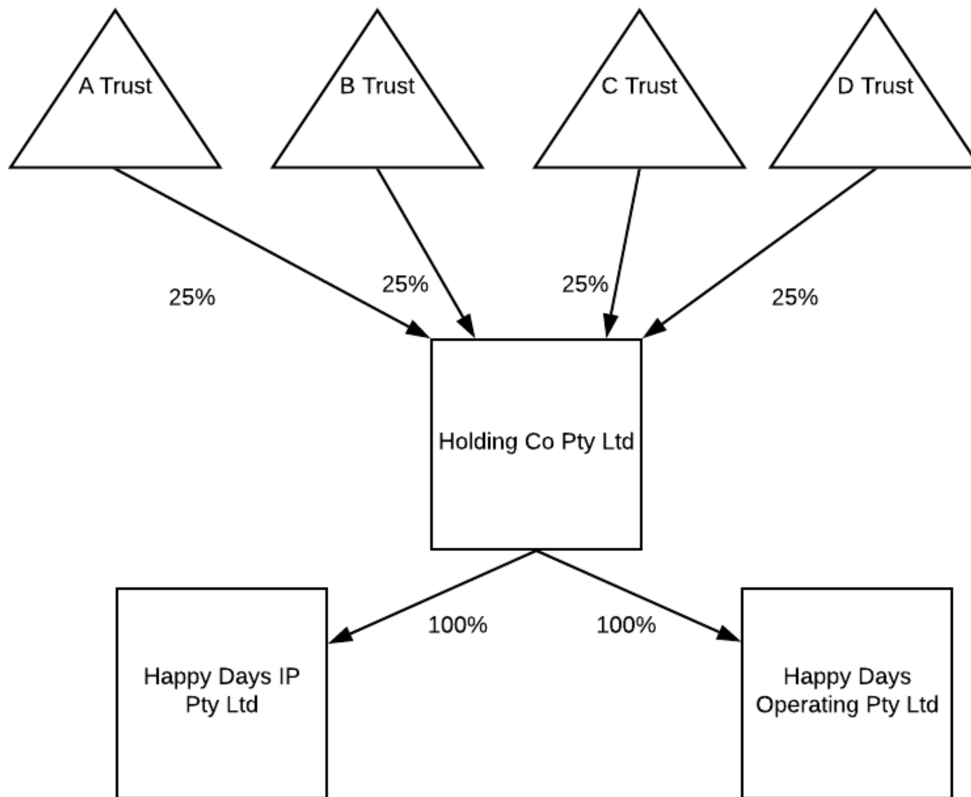
- For the purposes of Subdivision 152-A (basic conditions), in determining whether a business entity is an affiliate of, or is connected with, the asset owner, the following are taken to be affiliates of an individual:
  - a spouse of the individual; and
  - a child of the individual who is under 18 years (section 152-47(2)).
- If an entity is an affiliate of, or connected with, another entity as a result of section 152-47(2), then the spouse or child mentioned in that section is taken to be an affiliate of the individual for the purpose of:
  - Subdivision 152-A – maximum net asset test and small business entity test;
  - sections 328-110 and section 328-115 (calculating aggregated turnover for determining whether an entity is a small business entity); and
  - section 328-125 (determining whether an entity is a 'connected entity').

3.8.5 Structuring issues in relation to 'active asset test'

- Where one entity owns an asset and another uses that asset to carry on business, the asset owning entity and business entity will need to be 'connected' or affiliates for at least half of the relevant period or 7½ years (whichever is the lower).
- Below are examples of common structuring issues
  - Example 1: Happy Days IP Pty Ltd and Happy Days Operating Pty Ltd may not be 'connected' entities. Trusts cannot be 'affiliates' of each other. No one shareholder has at least 40% of voting, capital and dividend rights. Question: Can Happy Days IP Pty Ltd and Happy Days Operating Pty Ltd be affiliates??



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



- Common issues in relation to land:

  It is not uncommon (particularly with farming clients) for the land to be owned by children and the business to be operated by a parent (either alone or in a partnership of which the child is not a partner). The issue is whether the children who own the land are affiliates of the parents. It appears that if the only involvement by the children is allowing the parents (or company) to use the land rent-free, that will not be sufficient to be 'affiliates'.

  Taxation Determination TD 2006/79 (which has been withdrawn) provided examples, two of which relate to farming are reproduced below.

> Example 1
>
> 3. Mr Wood carried on a farming business on land he had owned for many years. In due course, he devised a succession plan to enable his adult children to take over the farming operations. In accordance with the plan, a company owned and directed by the taxpayer's children acquired the stock and plant, entered into a lease agreement (which imposed certain restrictions on their farming activities) for the use of the land and commenced to carry on the business.
>
> 4. With the company owning the stock and plant, the children make their own decisions relating to the farm operations. Mr Wood, however, retains financial control through provision of working capital and the use of the land via the lease agreement. Mr Wood's children consult with him before making decisions concerning the farming business. Mr Wood continues to work unpaid on the farm performing duties such as driving machinery, maintenance, fencing and general farm work.

5. Mr Wood intends to sell the land and expects to make a capital gain. To qualify for the small business concessions, the land must be an active asset at certain times.

6. Although Mr Wood is not directly using the land in a business of his own, the land can still be an active asset if it is used in the business of a small business CGT affiliate (or of a connected entity).

7. In this case, Mr Wood is able to direct the company in relation to the carrying on of its business. By retaining control through financing the company and putting constraint clauses in the lease agreement as to the use of the land, Mr Wood is able to limit the company's activities. His ability to direct the company is supported by the close family relationship he has with the controllers of the company, the provision of advice and finance and the performing of unpaid work around the farm.

8. In this situation, it is apparent that the company acts, or could reasonably be expected to act in concert with Mr Wood or in accordance with his directions or wishes. The company is therefore considered to be Mr Wood's small business CGT affiliate. Consequently, the land owned by Mr Wood but used in the company's business is an active asset. Mr Wood may qualify for the small business concessions if he satisfies the other conditions.

Example 3

16. Two brothers, Jack and Ted, each own a 50% interest in farm land. Ted has carried on a farming business on the land for many years. Jack lives and works elsewhere and has never been involved in the farming business. There is no lease agreement between the brothers and Ted does not pay Jack any rent nor any share of the profits from the business. They have an understanding that Ted pays all holding costs in relation to the land.

17. Eventually, Jack and Ted decide to sell the farm. Although Jack and Ted have a close family relationship and Jack allows Ted to conduct the farming business on the whole property rent free, Jack has never had anything to do with the farm. They have not acted together in pursuit of a common goal or purpose nor has Jack ever advised Ted in the conduct of the business. Therefore it could not be said that Ted acts, or could reasonably be expected to act, in concert with Jack or in accordance with Jack's directions or wishes.

18. Accordingly, Ted is not considered to be a small business CGT affiliate of Jack. This means that Jack's 50% interest in the land is not (and never has been) an active asset. Accordingly, Jack is not able to claim the small business concessions on any capital gain he makes.

- PBR 1012740087229 – 11 January 2015

Facts

A family group had a single company (A Pty Ltd) as the trading entity to the family business.

Land used by company A were owned by the taxpayer, his parents, his wife and a family trust.

The taxpayer was actively involved in the business.

Business decisions were made almost exclusively by the taxpayer and his father.

There were no written agreements outlining these arrangements between the family members.

Different family members had borrowed funds to acquire properties used in the business operations. Irrespective of who actually borrowed the funds, the parties allocated the family debt to the different properties on a 'per acre basis' and all interest was paid by the company.

The parents had a controlling interest in the company.

Decision

The taxpayer (son) was an affiliate because he acted in concert with the company.

The fact that there was a close family relationship between the individuals and no formal agreement in relation to the company or the business indicated that they acted in concert rather than in accordance with formal legal or fiduciary obligations.

Land that the individual owned was used for the benefit of the company.

The taxpayer was a guarantor for loans taken out by other parties in respect of property that he did not own but which was used for the purposes of the company business.

Most business decisions were made in conjunction with the taxpayer's father.

- PBR 90261 – 11 September 2009

Facts

You own an interest in a property. The remaining interest in the property is owned by your sibling W.

The property was transferred to W and yourself pursuant to a contract dated later than 19 September 1985 as part of a family farm succession plan.

As part of a further family farm succession plan, you propose to sell your interest in the property to W.

The sale price of your interest will be greater than the value of the interest when the property was transferred to you.

Ever since the property was transferred it has been used in the business of a partnership.

The partners in the partnership are:

· your parent X;

· your parent Y;

· your sibling W;

· your sibling Z.

There has never been any lease in place between yourself and W as landowners and the partners of the partnership.

There has never been any other formal written agreement in place between the parties.

All of the members of the family have had regular meeting where all major decisions regarding the property (as well as the family's other properties), its development and the running of the business have been discussed.

There are regular discussions about the future directions of the property and its potential and challenges, most notably the drying climate and challenging times for the rural economy.

At times, all family members have challenged other party's thinking on a matter regarding the property, but these issues are resolved so that the property plan is discussed and amended so that all parties agree to the manner in which activities related to farming are conducted.You live a short distance from the family farm. You moved there some time ago and live there with your spouse and children. Work has prevented you from day to day management of the farm business with W, X, Y and Z but you continued to be involved in the planning meetings.

You have worked for a number of years in the natural resource management field. Central to the ideals of your previous employers is rural land protection and improvement.

From your work experience you have introduced the latest research about sustainable management of the environment and the land, to aid the family business care for an improve the property in very testing times.

The family, although initially slow to recognise the need for these activities, have now embraced many of the proposals that you have suggested in the following ways:

· amendment to grazing regimes to protect native grasses;

· planted new areas for biodiversity and erosion protection;

· protected waterways through limiting stock access by fencing and increased vegetation cover around waterways to provide habitat for fish; and

· protected remnant trees by fencing them off and allowing areas of native vegetation to regenerate.

The business of farming is intimately related to the land's capacity on which it is carried out. Decisions on land management affect the business of farming particularly from a strategic point of view. All members of the family are working together to deliver a long term plan to maintain existing activities and for future improvements.

The primary managers of the partnership business are X, W and Z.

Decision

Whilst a partnership cannot be your affiliate, a partnership is not a separate legal entity. Hence, it is necessary to examine whether the individual partners are your affiliates.

Whether a person acts, or could reasonably be expected to act in accordance with your directions or wishes, or in concert with you is a question of fact dependant on all the circumstances of the particular case. No one factor will necessarily be determinative. Relevant factors summarised from Taxation Determination (TD) 2006/79 that may support a finding that a person is your affiliate include:

· the existence of a close family relationship between the parties;

· the lack of any formal agreement or formal relationship between the parties dictating how the parties are to act in relation to each other;

· the likelihood that the way the parties act, or could reasonably be expected to act, in relation to each other would be based on the relationship between the parties rather than on formal agreements or legal or fiduciary obligations; and

· the actions of the parties.

In your case, whilst you are not actively involved in the farming business, you do have a significant input. In particular, you actively participate in meetings with your parents and brothers about the business operation.

Specifically, your personal interests lie in the sustainable management of the land and environment. You made suggestions to your family about how the farming operation could adopt some of the sustainable practices that were both important to you personally and could also benefit the long term viability of the farming business. Whilst your family may have been reluctant at first to adopt some of the practices, they have now embraced many of the proposals that you put forward.

The adoption of these sustainable farming techniques shows that your family have also been acting in accordance with your wishes and directions. Furthermore, the fact that these sustainable practices also

have long term benefits for the farming business indicates that the partners are acting in concert with you.

Other factors pointing to your parents and brothers being affiliates include:

· the close family relationship between the parties;

· lack of formal agreements;

· the way that the parties act in relation to one another would have been heavily influenced by family considerations.

Accordingly, your parents and two siblings are your affiliates in accordance with subsection 328-130(1).

- PBR 1012099897959 – 17 April 2012

Facts

You have been farming for a number of years and purchased the relevant property after 20 September 1985. You farmed this property for a few years and have since been leasing it to your child. You remain living on the property.

You are now considering transferring the property to your child.

There are no formal agreements between you and your child, either in relation to business or financial arrangements; however they pays you lease payments.

You commenced a primary production activity on the land when you purchased it and your child carries on the same operation that you started.

During busy work times you have maintained a keen working involvement in the business activities.

You have placed no restrictions on your child as to how they run the business but they continues to run the business in the same manner that you started.

You have no financial control over your child's activities and do not control the business however; you provide support in farming processes.

Your child makes the major decisions about his business but if they want to change any of the processes already in place they always discuss them with you first before implementing them.

Decision

In your case, you purchased the land a number of years ago. You commenced farming on the land but then you passed on the farming of the land to your child.

We accept that there is a close family relationship between the parties. You live on the property and help out in times of need.

Your child discusses with you any new ideas or processes but you do not direct him to carry on his business in any particular way nor do you have any financial control.

Whilst you may be involved, connected to or participate in your child's business you do not act together in pursuit of a common goal or purpose and you do not direct him in the carrying on of his business. Overall, your child operates his business as they wish. The requirements for an entity to be an affiliate within the meaning of the term in section 328-130 of the ITAA 1997 are not met as you do net meet requirement (c) of the definition.

As your child is not your affiliate the property was not an active asset of yours for the years it was leased to your child. The property was only an active asset for the period that you farmed it. As this was less than 7 years, the active asset test is not satisfied. You are therefore unable to qualify for the small business CGT concessions as you do not meet basic condition (d) in subsection 152-10(1) of the ITAA 1997.

3.9 CGT Concession Stakeholders

3.9.1 When is a CGT Concession Stakeholder required?

- In the context of the small business CGT concessions, a CGT Concession stakeholder is important for the application of the following small business CGT concessions:
  - Where a CGT event occurs in relation to shares in a company (or units in a trust), just before the CGT event the shareholder (or unitholder) must either be a CGT concession stakeholder or CGT concession stakeholders in the company (or trust) must have a small business participation percentage of at least 90% in the shareholder.[45]
  - To access the small business 15-year exemption (Subdivision 152-B):
    - a company (or trust) must have a significant individual for at least 15 years and just before the CGT event the company must have a CGT concession stakeholder:
      - who is at least 55 years of age at that time: and the CGT event happens in connection with their retirement; or
      - is permanently incapacitated at that time[46]; or
    - if the asset is a share in a company (or interest in a trust), the company (or trust)must have had a significant individual for at least 15 years and at the time of the event the shareholder (or unitholder) was a CGT concession stakeholder:
      - who is at least 55 years of age at that time: and the CGT event happens in connection with their retirement; or
      - is permanently incapacitated at that time.[47]
  - To choose to apply the small business retirement exemption (Subdivision 152-D), a company (or trust) must have a significant individual just before the CGT event and can only choose to apply the retirement exemption in relation to individuals who were CGT concession stakeholders just before the CGT event.[48]

[45] Section 152-10(2) of the *1997 Tax Act*
[46] Section 152-110 of the *1997 Tax Act*
[47] Section 152-105 of the *1997 Tax Act*
[48] Sections 152-305(2), 152-315(2) and 152-325 of the *1997 Tax Act*

3.9.2 Who is a CGT Concession Stakeholder?

- A CGT concession stakeholder is:
  - a significant individual; or
  - a spouse of a significant individual in the company or trust provided the spouse has a small business participation percentage (small business participation percentage) in the company or trust at that time that is greater than zero.[49]
- A significant individual of a trust is an individual who has a small business participation percentage in the company or trust of at least 20%.[50]
- An entity's small business participation percentage is the total of:
  - the entities direct small business participation percentage; and
  - the entities indirect small business participation percentage.

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

Legislation: Direct small business participation percentage

Section 152-70 of the 1997 Tax Act

An entity's *direct small business participation percentage*

In this entity:	Is:
Item 1 A company	This percentage that the entity has because of holding the legal and equitable interests in *shares in the company: (a) the percentage of the voting power in the company; or (b) the percentage of any *dividend that the company may pay; or (c) the percentage of any distribution of capital that the company may make; of, if they are different, the smaller or smallest.
Item 2 A trust (where entities have entitlements to all the income and capital of the trust)	This percentage: (a) the percentage of any distribution of income that the trustee may make to which the entity would be beneficially entitled; or (b) the percentage of any distribution of capital that the trustee may make to which the entity would be beneficially entitled; or, if they are different, the smaller.

[49] Section 152-60 of the *1997 Tax Act*
[50] Section 152-55 of the *1997 Tax Act*

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

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

3.9.3 Legislation: Indirect small business participation percentage

Section 152-75 of the 1997 Tax Act

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

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

(b) the sum of:

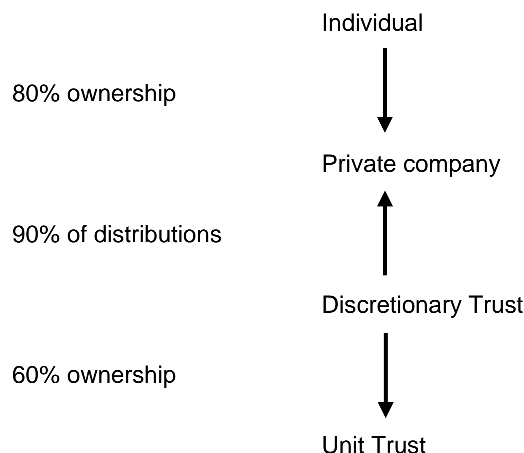
(i) the intermediate entity's direct small business participation percentage (if any) in the test entity at that time; and

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

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

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

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



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

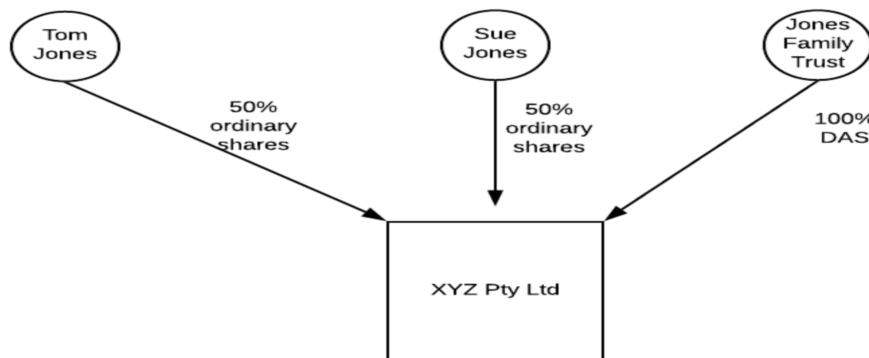
If the individual had a direct small business participation percentage of 10% in the unit trust, that would be added to the individual's indirect small business participation percentage to produce a small business participation percentage in the trust of 53.2%

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

3.9.4 CGT concession stakeholders and companies

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

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



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

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

Devuba's case

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

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

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

- It was resolved that the following class of shares be inserted into the Memorandum and Articles of Association pursuant to Paragraph 4.
- The new share class is to be known as Dividend Access Shares (DIVV ACC) and will have the following rights:

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

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

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

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

- Article 129 of the Memorandum and Articles of Association allowed for dividends to be declared on one or more classes of shares to the exclusion of other classes of shares.
- The Full Court held that:
  - the dividend access shares had been created in 2007 with an entitlement to receive 'such dividends, capital or other distributions (if any) other than on a winding-up as in respect of each class the Directors may from time to time determine to pay'; however
  - the 2008 resolution took away that right and deprived the company of an ability to declare a dividend on the dividend access shares unless and until the directors first resolved that the holders of the Dividend Access Share had a right to payment of a dividend.
- The Full Court stated:[51]

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

[51] At paragraph 10

What are the implications of Devuba?

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

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

      Yes. All classes of shares (other than redeemable shares) issued by a company are taken into account in determining if the company has a significant individual under section 152-55 of the *Income Tax Assessment Act 1997* (ITAA 1997).[52]

      Example 4

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

      10. The redeemable preference share has voting rights equal to the ordinary shares, preferential dividend rights, a return of capital right but no right to participate in surplus capital on winding up. The ordinary shares have voting rights, dividend rights and rights to participate in surplus capital on winding up.

      11. In this situation, the redeemable preference share is ignored for the purpose of determining if XYZ Co has a significant individual. Accordingly, as Michelle has the right to exercise at least 20% of the voting power in the company and receive at least 20% of any distribution the company may make (excluding redeemable shares), she is a significant individual of XYZ Co.

[52] At paragraph 1

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

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

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

ATO ID 2015/8

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

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

Facts:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Issues

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

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

- ATO ID 2012/99

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

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

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

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

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

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

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

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

  Reasons for Decision

  Background

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- Recharacterising income for the purpose of determining who is a 'significant individual' or 'CGT concession stakeholder':
    - There is a real risk that reclassifying amounts as income would attract the attention of the ATO especially where the apparent reason for the reclassification was to ensure that the CGT concession stakeholder requirements were satisfied.
        - For example: assume that the trust deed defined income as section 95 net income excluding notional amounts (but the trustee had a discretion to adopt a different definition) and the deed allowed for the trustee to make an interim capital distribution.
            - Assume that during the year the trustee had a CGT event and could reduce its capital gain of $1,000,000 to nil if it had a CGT concession stakeholder. The trustee also had a franked dividend of $4,000,000 (which it would like to distribute to a company).
            - The trustee defines income to be section 95 (excluding franking credits) and to also include the gross capital gain.

              The trust income is therefore $5 million.
            - In the trustee resolution, the company is made specifically entitled to the franked dividend and Tom receives 100% of the balance of the trust income.

              This means that the company is taxed on the $4 million dividend. Tom will be a CGT concession stakeholder as he has received 20% ($1 million/$5 million) of trust income.

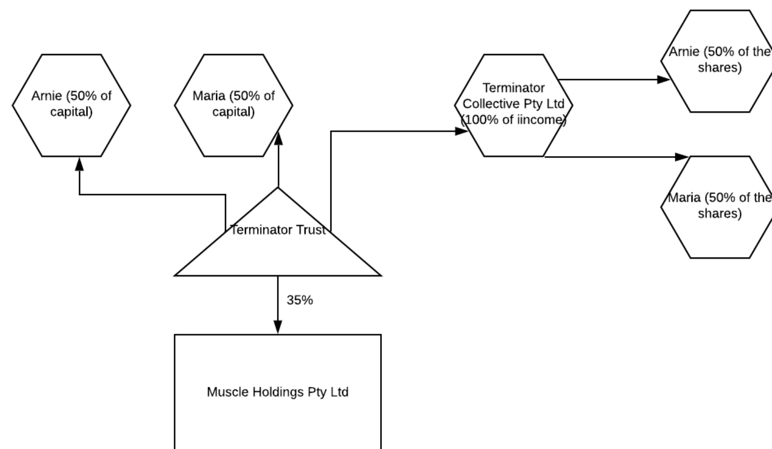
              This allows the trustee to choose to apply the small business retirement exemption in relation to Tom which has the effect of reducing its capital gain to Nil. The section 95 net income is $4 million.

        - Alternative to recharactising income (if capital gain can be reduced to nil)
            - Define income to be section 95 (excluding franking credits).
            - Distribute 100% of the income to the corporate beneficiary.
            - Assume corporate beneficiary is owned by a trust (Shareholder Trust).
            - Shareholder Trust makes a distribution of at least 20% of income and/or capital to an individual.
            - Trustee does not make a distribution of capital.

              Individual is a significant individual of the trust – 20% [individual's small business participation percentage in Shareholder Trust] x 100% [Shareholder Trust's small business participation percentage in corporate] x 100% [corporate's small business participation percentage in trust] = 20% (note, trust which had capital gain did not make a capital distribution).

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

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



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

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

3.9.7 CGT concession stakeholder tips

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

- active asset reduction; and
- roll-over.

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

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

4.1 Introduction

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

  That is:

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

4.2 CGT small business entity test of shareholder

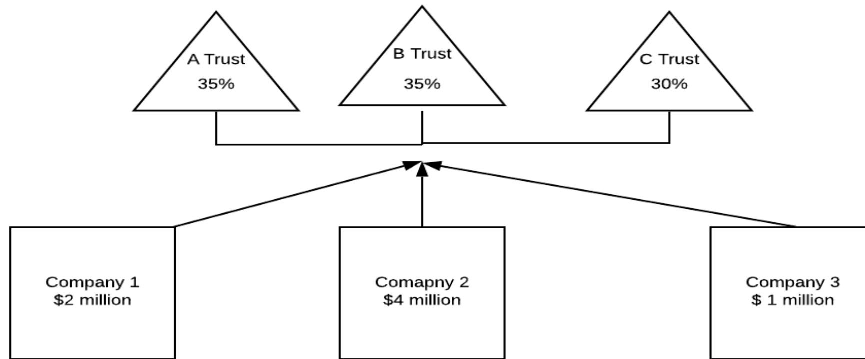
If the taxpayer (that is, shareholder or unitholder) did not satisfy the $6 million net asset test, that is, they are relying on the CGT small business entity test – the taxpayer must be carrying on a business just before the CGT event.

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

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

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

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

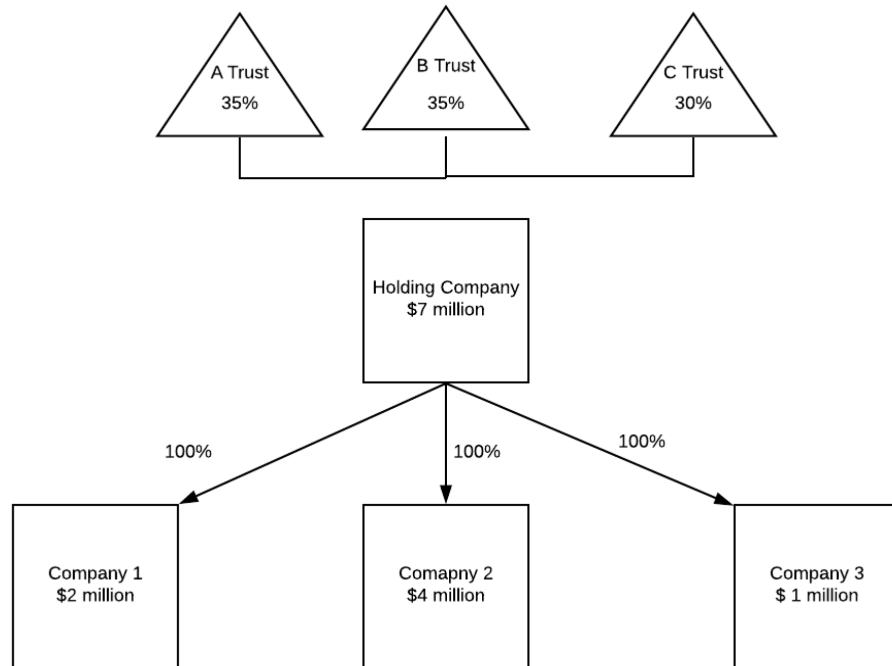


    - Shareholder A disposes of its shares in each of the companies. Shareholder A only has a 35% interest in the respective companies, and therefore for the purpose of section 152-10(1) only needs to include the net value of its interest (not 100% of the net value of each company). That is, $2,450,000 ([35%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

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

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

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

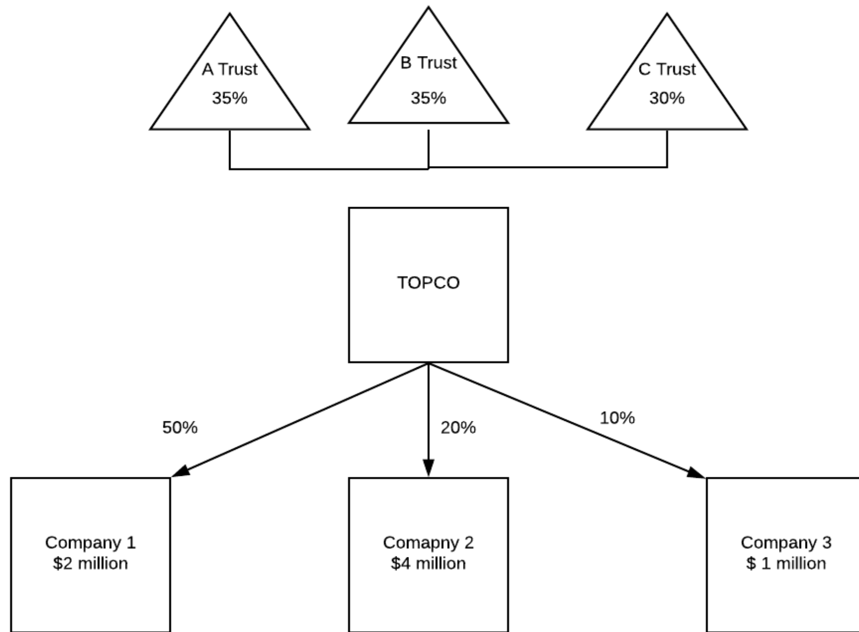


- Shareholder A disposes of its shares in Holding Company. Shareholder A only has a 35% interest in holding company, and therefore for the purpose of section 152-10(1) only needs to include the net value of its interest (not 100% of the net value of holding company). That is, $2,450,000 (35% of $7 million)

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

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

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



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

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

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

4.4 Active asset test (modified for shares and units)

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

> Section 152-40(3) provides that a CGT asset is also an active asset at a given time if, at that time, you own it and:
>
> (a) It is either a share in a company that is an Australian resident at that time or an interest in a trust that is a resident trust for CGT purposes for the income year in which that time occurs; and
>
> (b) The total of:
>
> (i) The market value of the active assets of the company or trust; and
>
> (ii) The market value of any financial instruments of the company or trust that are inherently connected with a business that the company or trust carries on; and
>
> (iii) Any cash of the company or trust that is inherently connected with such a business,
>
> is 80% or more of the market value of all of the assets of the company or trust.

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

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

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

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

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

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

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

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

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

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

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

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

> Inherent connection requires more than just some form of connection between the cash or financial instrument and the business. Examples of things inherently connected to a business include:
>
> - when it is a permanent or characteristic attribute of the business, for example, goodwill, or trade debtors
> - excess funds the business has as a result of a temporary spike in trading activity or the sale of a business asset
> - a financial instrument that is inherently connected with a business that the owner of the financial instrument carries on, rather than any business a related entity carries on.
>
> Example 2: Loan to a related company
>
> Archimedes Pty Ltd is a manufacturing business. It lends $300,000 to a related company, Galileo Pty Ltd, to acquire various assets for use in the businesses of both companies.
>
> Although the loan is made between members of a corporate group as part of the overall financing of the group, it is not a permanent or characteristic attribute of the business (which is manufacturing, not the acquisition of assets).
>
> The loan is included in the total market value of all the assets, but not included as an active asset.

- Are loans 'active assets'?

  Loans from Object Entity to subsidiaries

  - The loans from Object Entity to subsidiaries are likely to be 'financial instruments'. In order for these to qualify as active assets it is necessary that they are 'inherently connected with a business' carried on by Object Entity[53].
  - There are arguments that Object Entity is carrying on a business (being a holding company) and that loans made by it to subsidiaries will be assets inherently connected with that business and therefore active assets.
  - In American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue[54], Lord Diplock stated that:

> in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of assets prima facie amounts to the carrying on of a business…. The carrying on of 'business' no doubt, usually calls for some activity on the part of whoever carries it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between[55]

[53] Section 152-40(3)(b)(ii) of the 1997 Tax Act
[54] [1978] 3 All ER 1185
[55] Page 1188

- A company can carry on the business of a holding company, even if the holding company is not involved in the active management[56].
- The Commissioner in *Taxation Ruling* TR 2019/1 accepts that (for the purpose of section 328-110 of the 1997 Tax Act and section 23 of the Income Tax Rates Act 1986) companies are typically formed for the purpose of carrying on a business and are unlike individuals or trusts whom may have multiple purposes for undertaking activity other than to make a profit or carry on a business (at paragraph 23)
- In Private Binding Ruling Authorisation Number 80022, the ATO accepted that a loan was inherently connected with a business that a holding company carried on as it was lent by the parent to fund stock and debtors of the subsidiary company.
- While these arguments support the contention that the loans from a holding company to a subsidiary will qualify as active assets there is still some degree of uncertainty about what approach the Commissioner would take in particular circumstances or should it apply to all loans to 'later entities'.

ISSUE: What about loans to other entities?

- Are bank accounts inherently connected with the business?

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

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

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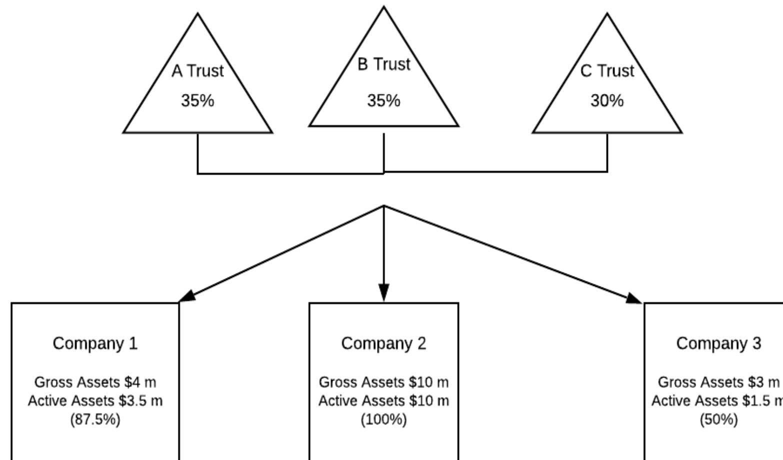
Examples – assume each entity has a turnover in excess of $2 million.

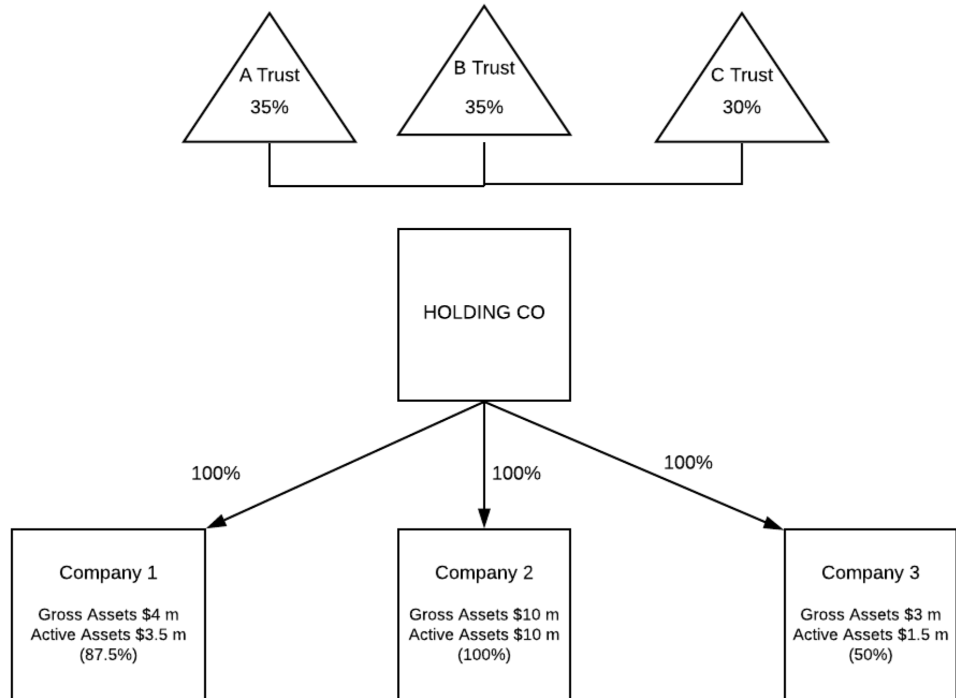
- Example: Shareholders A, B and C own 35%, 35% and 30% respectively in the issued capital of Company 1, 2 and 3. For half the time the shares have been owned the market value of the gross assets and active assets have always been as follows.



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

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

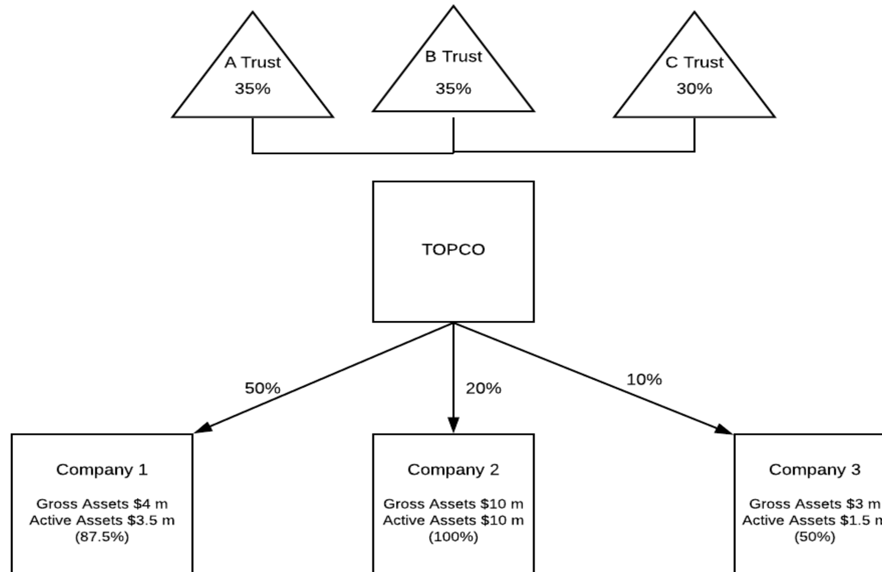
Example: Shareholders A, B and C own 35%, 35% and 30% respectively in the issued capital of Holding Coy. For half the time the shares have been owned the market value of the gross assets and active assets have always been as follows.



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

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

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



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

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

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

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

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

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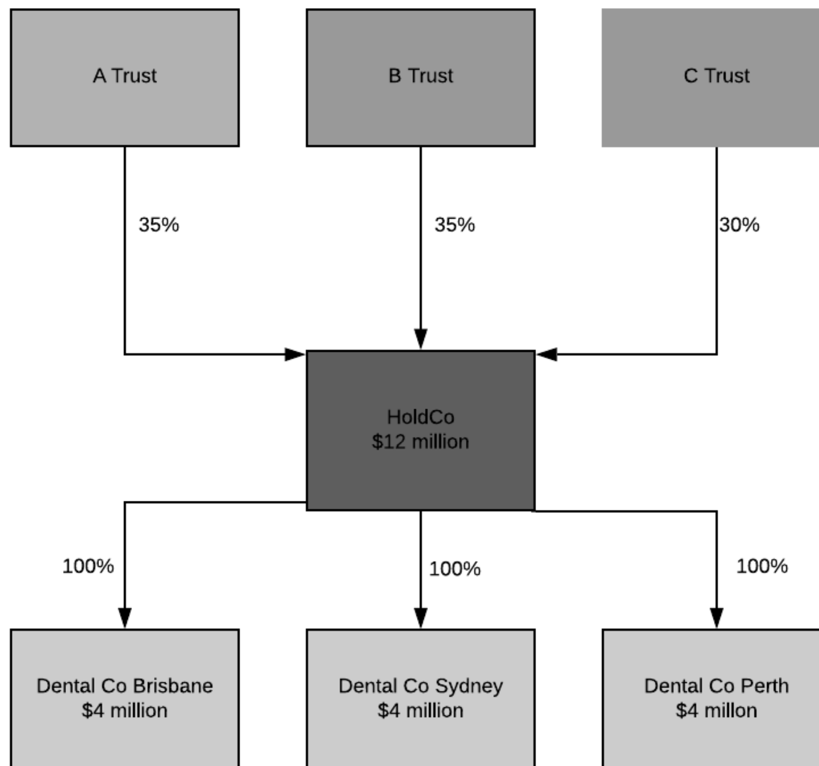
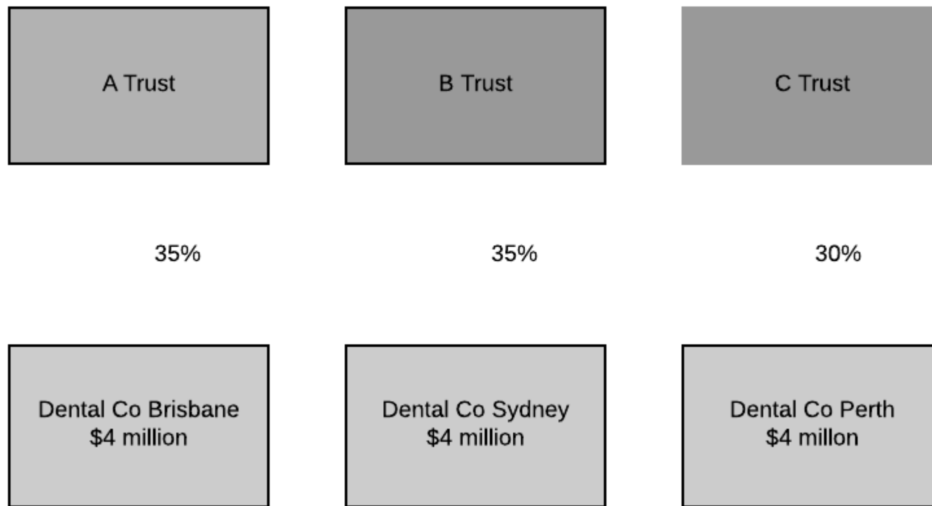
4.6 Structuring issues with respect to February 2018 rules (shares/units)

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

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



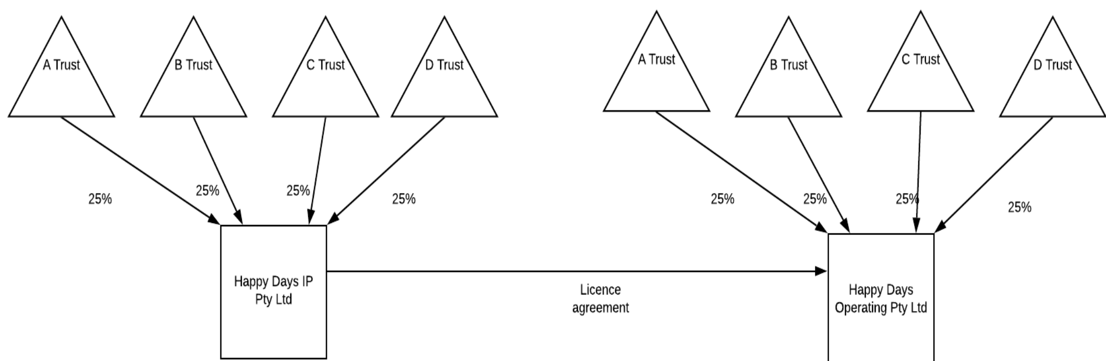
- For example: Structure B (each trust holds 35%, 35% and 30% respectively in each company.



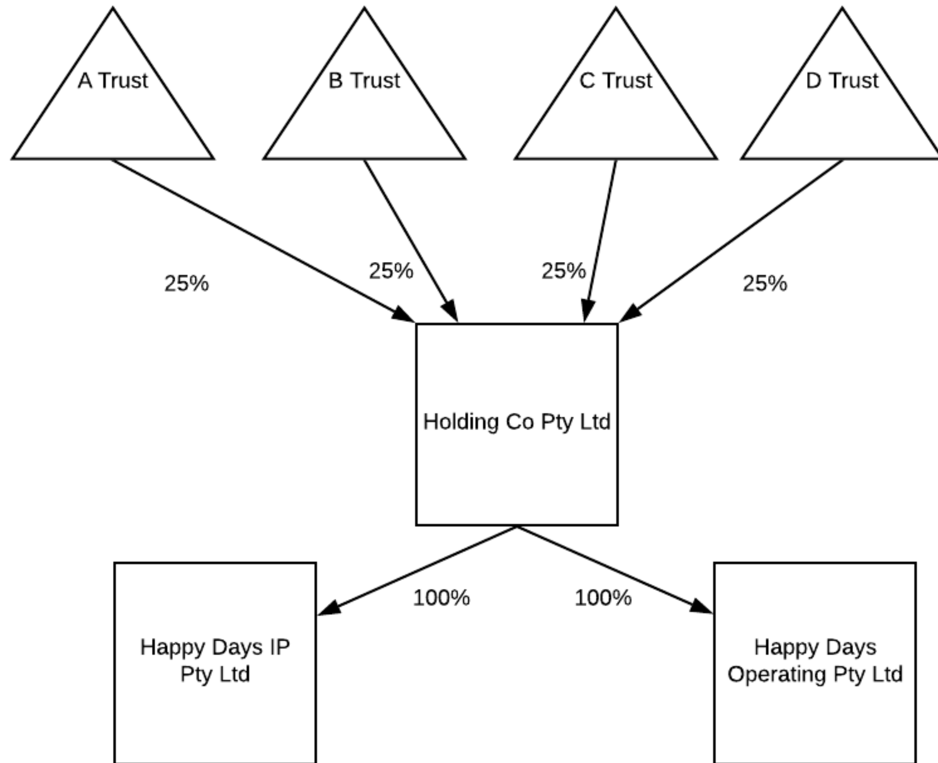
  - In both cases, the effective ownership in shares in each of the subsidiaries are the same. If the shareholders sell their shares in HoldCo (Structure A) – HoldCo fails the $6 million net asset test.
  - If the shareholders sell their shares in each of the Dental companies (Structure B), each of the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

Below are examples of common structuring issues

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



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



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

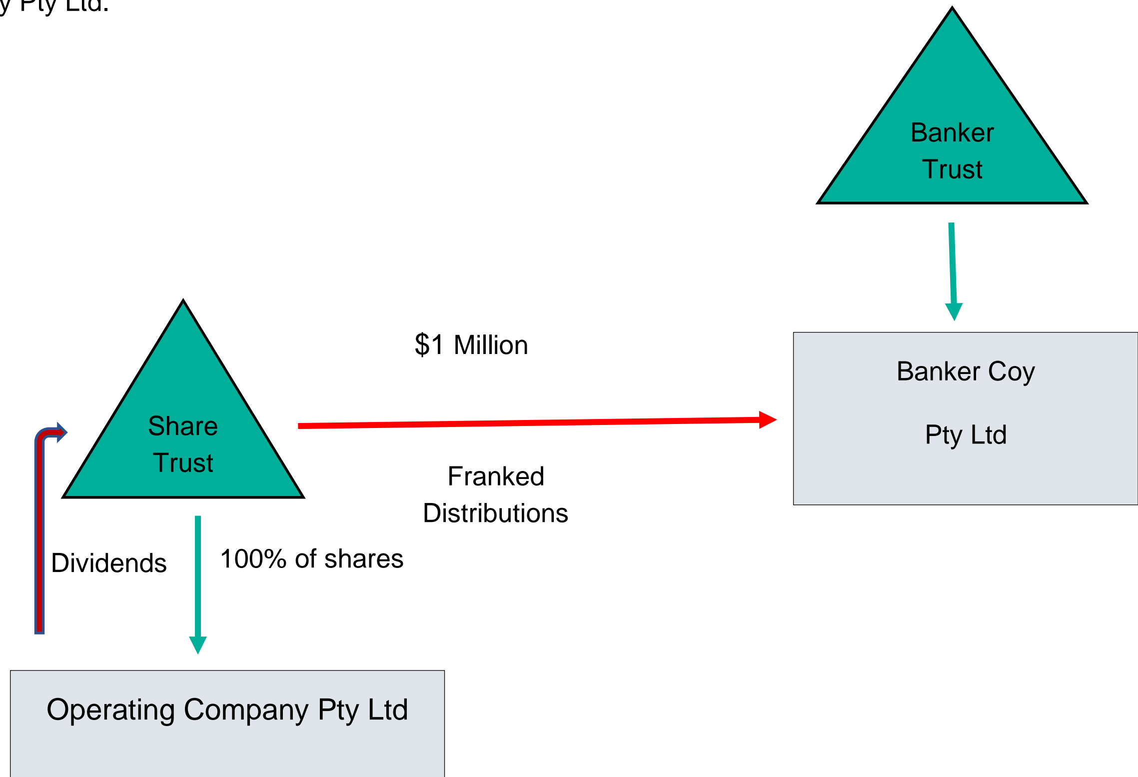
4.6.2 Structuring with the end in mind

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

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

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

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



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

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

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

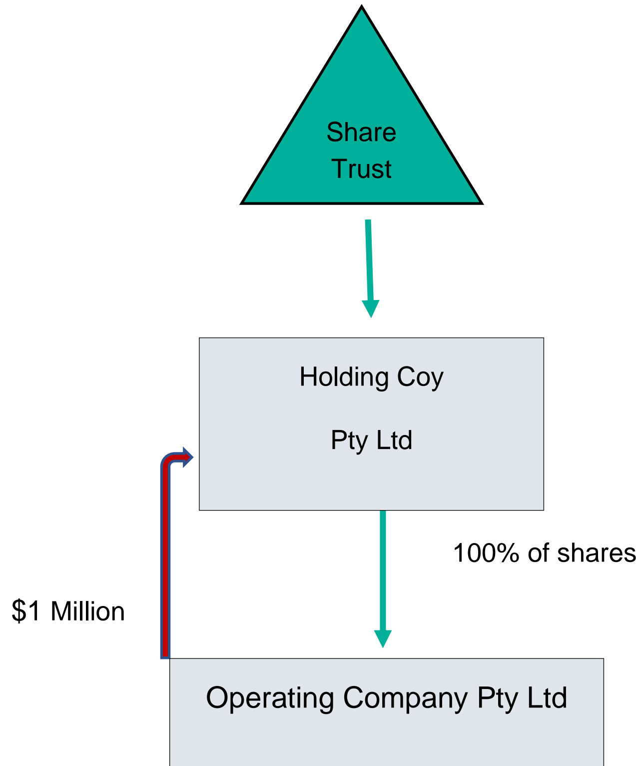
Therefore, not a BRE and rate of tax for the year is 30% (top-up tax).

- Tax payable

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

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

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



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

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

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

- Tax payable

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

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

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

5. Small business CGT concessions and Part IVA

- Clients need to be conscious that any actions taken before a CGT event which will result in the taxpayer being eligible for the small business CGT concessions is likely to result in the scrutiny of the Commissioner.
- Examples of these are:
  - dealing with dividend access shares prior to a CGT event for the purpose of ensuring that the CGT concession stakeholder test is satisfied;
  - attempting to satisfy the net market value asset test:
    - reducing net assets (see AAT decision of Track below);
    - ceasing to derive rent from houses/units and claiming properties excluded as used for personal use (refer to AAT decision of Alnot – about properties being used for personal use not just being available for personal use)
  - exploiting the definition of income to obtain favourable tax outcomes for taxable income (excluding net capital gain) and also satisfying the CGT concession stakeholder requirements.
- In *Re Track and Federal Commissioner of Taxation* [2015] AATA 45, taxpayers entered into a complex scheme where they sold a business conducted by related trusts for about $8 million on 1 July 2005. The Commissioner contended that the scheme had the purpose of enabling the trust to obtain access to the small business CGT concessions by reducing the trust's assets and increasing its liabilities to ensure its net assets at the time of the business sale were less than $5 million (the maximum net asset value at the time). These pre-sale planning measures included resolving, two days before the sale, to make capital distributions of about $2.5 million to 'protection' trusts of which related individuals were the beneficiaries, and repaying a number of loans to associated entities.

  The Commissioner argued that if the scheme was not carried out, the trust would not have been eligible for the small business CGT concessions and would have been assessed on the entire capital gain made on the sale. The trust would have included in its assessable income an additional $2,459,901 which would reasonably have been distributed to the family trusts who in turn would have distributed it to their beneficiaries.

  The Tribunal agreed that the scheme was entered into for the dominant purpose of obtaining a tax benefit, being concessional CGT treatment. It found the taxpayers' asserted subjective and objective motives of asset protection unconvincing. There had been no satisfactory explanation as to why asset protection was required or how the elaborate pre-sale steps served such a purpose. As to the manner in which the scheme was carried out, the Tribunal held:

  > …the evidence of the principals does not satisfy me that there was, in 2005, either a need for asset protection or a view, genuinely held on reasonable grounds, that there was a need for asset protection. Mr Forde, who might be thought to have the best grasp of the commercial ramifications of the transactions,

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acknowledged in his evidence that advice was sought 'in order to pay as little tax as possible' while at the same time asserting the need for asset protection.

[103] The manner in which the scheme was entered into, or carried out, points strongly to a contrivance, designed to take advantage of the small business concession threshold, in circumstances where the sale then in prospect clearly demonstrated that the assets of the business exceeded that threshold by a considerable amount. The fact of capital distributions having been made in one financial year, prior to the sale in the following financial year, merely emphasises the contrivance and that the contrivance was directed to obtaining a tax benefit in connection with the scheme.

Other factors that pointed to the purpose of obtaining a tax benefit included:

- the complexity of the scheme which was not explicable by an asset protection purpose;
- the timing of certain steps in the scheme which suggested the capital distributions were made for the dominant purpose of meeting the CGT concession threshold;
- the tax result of the scheme which allowed the trust to access the CGT concession in circumstances where it otherwise was not entitled to do so, thereby reducing the capital gain from $2,920,202 to $460,101; and
- that the beneficiaries of the protection trusts (who were also directors of the trustee company) stood to benefit from the favourable exercise of the trustee's discretion.

- It is important that advisers regularly review client's structures as the majority of clients do have legitimate asset protection concerns. Any restructuring of assets for these purposes should be done regularly and not just prior to a CGT event.

6. Dealing with capital gains made by companies and unit trusts

6.1 Identifying the components of capital profits

- The capital gains provisions are triggered when a CGT event happens in relation to a CGT asset.
- The tax treatment of any capital gain derived will depend on whether:
  - the asset was acquired pre-CGT;
  - Division 149 of the 1997 Act had been triggered in relation to an asset which was acquired prior to 20 September 1985;
  - the small business CGT concessions are available in relation to any taxable capital gains.

6.1.1 Pre-CGT assets

A capital gain from a CGT asset which the company or trust acquired prior to 20 September 1985 (pre-CGT) is generally disregarded. Therefore it is necessary to determine whether an asset (including goodwill) has retained its pre-CGT status.

6.1.2 Triggering Division 149 of the 1997 Tax Act

- Although a company or trust may have actually acquired an asset pre-CGT, if in fact Division 149 is triggered, the CGT asset will:
  - cease to be a 'pre-CGT asset' on the date the first Division 149 event is triggered (**Division 149 Date**); and
  - be taken to be acquired by the company or trust for market value on the Division 149 Date.
- This means that the market value of the CGT asset on the Division 149 Date will form part of the first element of the CGT asset's cost base in calculating the capital gain or capital loss on any future CGT events.
- Division 149 is triggered at the earliest time when the majority underlying interests in the asset were not held by the ultimate owners who had majority underlying interests in the asset immediately before 20 September 1985.
- Majority underlying interests in the asset consist of:
  - more than 50% of the beneficial interests that ultimate owners have (whether directly or indirectly) in the asset (that is, capital rights); and
  - more than 50% of the beneficial interests that ultimate owners have (whether directly or indirectly) in any ordinary income that may be derived from the asset (that is, income rights).

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- For private companies, Division 149 is generally triggered at the first time after 19 September 1985, the individuals (directly or indirectly) who held shares which had rights to the capital and income of the company at 19 September 1985 cease to hold more than 50% of those shares.
- Exceptions are:
  - If the Commissioner is satisfied, or thinks it is reasonable to assume, that at all times on and after 20 September 1985 and before a particular time majority underlying interests in the asset were held by ultimate owns who had majority underlying interests in the asset before that day.
  - Roll-over relief under Subdivision 126-A of the 1997 Tax Act (about marriage breakdowns) applied to the transfer of shares – the transferee is taken to have held the shares which the transferor held at the same time which the transferor held those shares.
  - Death of a person – the transferee is taken to have held the shares that the deceased held.
- Example of Division 149:

  ABC Pty Ltd sold an asset on 1 July 2023 for $1.5 million. ABC acquired the asset in 1970 for $200,000. On 1 July 1990 when the asset was valued at $500,000, Division 149 was triggered. This meant that ABC was taken to have acquired the asset on 1 July 1990 for $500,000. ABC will have a capital gain of $1 million ($1.5 million less $500,000). The gain equal to the difference between the cost of the asset and the market value when Division 149 was triggered being $300,000 ($500,000 less $200,000) will not be taxable to the company.

6.1.3 Post-CGT assets and small business CGT concessions

There will be capital gains implications for a company or unit trust when a CGT event occurs in relation to a post-CGT asset.

- Discount capital gain
  - A company will not be able to reduce the capital gain under Division 115 of the 1997 Tax Act (about discount capital gain) as it is not a type of entity which is entitled to the discount capital gain.
  - A unit trust will generally be able to reduce the capital gain under Division 115 of the 1997 Tax Act provided it has held the asset at least 12 months.
- If the company or unit trust satisfies the basic requirements of Subdivision 152-A to apply the small business CGT concessions it may have disregarded or reduced its capital gain by applying:
  - the small business 15-year exemption;
  - the small business 50% reduction;
  - the small business retirement exemption; and
  - the small business roll-over.

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

- If a company or trust satisfies the requirements in Subdivision 152-B it may choose to disregard the capital gain.
- This means that the capital gain will not be taxable in the hands of the company or trust, but there may be issues in paying the capital gain out to the shareholders or unitholders tax effectively.

Small business 50% reduction (subdivision 152-C)

- If the company or trust meets the basic tests, but does not meet the requirements for the small business 15-year exemption, it may choose to apply the small business 50% reduction (section 152-205 of the 1997 Tax Act).
- This means that it may reduce its capital gain by 50%.
- There are however tax implications for the shareholders or unitholders in distributing the 50% reduction out of the company.
- The company or trust can choose not to apply the small business 50% reduction. This choice will generally be made if the capital gain can be paid out to shareholders or unitholders under the small business retirement exemption (without having to apply the small business 50% reduction).

Small Business Retirement Exemption (subdivision 152-D)

- The small business retirement exemption allows a company or trust to pay an amount to or for the benefit of its significant individuals and the spouses of the significant individuals provided that the spouse has a fixed interest of greater than zero (CGT Concession Stakeholders) (section 152-315(5) of the 1997 Tax Act). The company or trust must ensure that the amount paid under the small business retirement exemption will not cause the CGT Concession Stakeholders to exceed their lifetime limit of $500,000.
- In relation to the small business retirement exemption, the amount applied is paid out of the company or trust with no further tax implications for the company or trust or the CGT concession stakeholders.

6.2 Payments on winding up of a company by a liquidator

- If the amounts representing the non taxable components of capital gains (being pre-CGT gains, disregarded small business CGT concession capital gain gains and non assessable gains from Division 149) are paid out to shareholders whilst the company is operating they will be taxed in the hands of the shareholders as dividends.

  As these amounts were not taxable to the company there may not be sufficient franking credits available and therefore they may be unfranked dividends.

- However, if the amounts are paid out on the winding up of the company they will:
  - not be deemed to be dividends; however
  - be payments made in relation to the shares.
- Liquidator Payments (formal winding up)

- Distributions by a liquidator will be deemed to be a dividend if it represents the 'income derived by the company' except to the extent that is applied to replace a loss of paid-up capital.[57]

- 'Income derived by a company' includes:

  - an amount (except a net capital gain) which has been included in the company's assessable income for a year of income; or

  - a net capital gain that would be included in the company's assessable income for a year of income calculated on the basis that the net capital gain is calculated without indexing any amount used to work out the cost base of a CGT asset and that capital losses are ignored. (section 47(1A))

- Although the capital losses are ignored for the purpose of determining 'income derived by a company', the Commissioner accepts that this may not have any practical effect as section 47(1) of the 1936 Tax Act cannot deem a higher amount than is actually distributed to be a dividend (*Taxation Determination* TD 2000/5).

For example:

Items shown in the company accounts	Distribution to shareholders	Treatment of distribution
Capital profits reserve re Pre-CGT asset: $100,000	$100,000	Will not be a dividend in the hands of the shareholders as it is not a net capital gain that would have been included in the company's assessable income. Therefore not 'income derived by the company'.
Capital profits reserve re Post-CGT assets: $50,000 made up of: - net capital gains - $75,000 - capital losses $25,000	$50,000	Only $50,000 will be a dividend in the hands of the shareholders. Although the 'income derived by the company' is $75,000 (as capital losses are ignored), the amount of the dividend is limited to what has actually been distributed.

- Note: The definition of 'income' in section 47(1A) 'includes' amounts which are included in the company's assessable income. This means that 'income' for the purpose of section 47(1A) will include 'accounting income' which may not necessarily be included as assessable income. For example, non assessable COVID-19 payments such as the cash flow boost, amounts received which were subject to family trust distribution tax (by the paying entity) and accounting gains such as where the company (as borrower) has been released from its obligations to pay a debt.

[57] Section 47(1) of the *Income Tax Assessment Act 1936* (Cth)

- This includes amounts which may be deductible for taxation purposes but not for accounting purposes, such as building write-off. Some advisers are reflecting the Investment Allowance which was an allowable tax deduction during the 2009 and 2010 years as an expense in the profit and loss statement and creating a capital profits reserve in the equity section of the balance sheet of the company. Even if the capital profits reserve representing the 'Investment Allowance' is distributed by a liquidator in the course of winding up the company, it will be deemed to be a dividend. This is because it will be 'income derived by the company' as it represents a deduction for taxation purposes rather than accounting purposes. In Private Binding Ruling Number 29469 the Commissioner considered that distributions representing building write-off and indexation allowances were dividends under section 47(1) of the 1936 Act.

  > Although these amounts are in relation to capital expenditure and are allowable deductions due to specific provisions within the ITAA 1997 and ITAA 1936, they are nevertheless part of the income derived by the company each year. The entitlement to the specific tax concessions which provide the deductions in relation to capital expenditure does not make the amounts themselves capital. Although these amounts were not part of the taxable income of the company they were part of the assessable income or profits derived by the company each year.

- However, amounts which are not 'income' or 'net capital gains' will not be taken to be a dividend when paid by a liquidator. The most common amounts which section 47(1) applies to are as follows:

  - Capital gains which are disregarded on the sale of pre-CGT assets.

  - That part of a capital gain which represents an increase in market value of a pre-CGT asset on the date which Division 149 is triggered.

  - That part of a capital gain which is disregarded under the:

    - small business 15-year exemption (Subdivision 152-B of the 1997 Tax Act); or

    - small business 50% reduction (Subdivision 152-C of the 1997 Tax Act).

- Examples of payments by liquidators

Capital (not a dividend)	**Dividend**
Pre-CGT capital gains	non-assessable COVID19 payments
Exempt gain – small business 50% reduction	amounts received which were subject to family trust distribution tax (by the paying entity)
Exempt gain – small business 15-year exemption	amounts which the company had owed, but have been released
Division 149 component relating to the difference between cost and market value at trigger date for Division 149	amounts which have been gifted to the company

- Identifying amounts which are not 'income'

- It will be important that the liquidator can clearly identify the source of the amount distributed to the shareholders.

- The principle in relation to liquidator's distributions is that, if a liquidator appropriates or sources a particular fund in making a distribution, then that appropriation will ordinarily determine the character of the distributed amount. This is known as the "Archer Brothers' Principle".[58]

- The Commissioner has outlined his view on the application of the Archer Brothers Principle in Taxation Determination TD 95/10. The Commissioner's view is that it is not essential that separate accounts are kept by the company or the liquidator provided the liquidator is able to identify a fund or profit from which a distribution is made [at paragraph 4].

  > We consider that the Archer Brother's principal applies if:
  >
  > - the company accounts have been kept so that a liquidator can clearly identify a specific profit or fund in making a distribution; and
  >
  > - it is clear from either the accounts or statement of distribution that the liquidator has appropriated the specific profit or fund in making the distribution.

- As there is sometimes a considerable number of years between when the non-taxable capital gain is derived and when the company is wound up we recommend that:

  - the capital profit is reflected as a 'capital profit reserve' in the equity section of the company's balance sheet rather than included in retained profits;

  - the source of the capital profit is clearly identified (for example 'capital profit reserve – pre-CGT asset'); and

  - the liquidator identifies the different components of the distribution.

▪ Informal winding up

  - Section 47(2A) of the 1936 Tax Act extends the application of section 47 to distributions made in the course of an informal winding up.

  - A distribution will be taken to be a distribution to the shareholders by a liquidator in the course of winding up the company if:

    - the business of a company has been or is in the course of being discontinued otherwise than in the course of a winding up of the company under any law relating to companies;

    - any moneys or property of the company is distributed otherwise than by the company to the shareholders;

    - the moneys or property distributed are not otherwise dividends; and

    - the company ceases to exist within a period of three years after the distribution or within such a further period as the Commissioner allows.

  - One of the requirements for the application of section 47(2A) is that 'the moneys or property of the company is distributed otherwise than by the company'. The issue with this requirement is that unless directors of the company distribute the money or property to the shareholders, then how do they obtain it?

[58] *Archer Brothers Pty Ltd v FCT* 90 CLR 140

- While the wording of section 47(2A) is a little ambiguous, it seems clear that it was intended to apply in circumstances where moneys or property are distributed to shareholders otherwise than by a liquidator.

- The following extracts from the explanatory memorandum to the Income Tax Assessment Bill (No 4) 1967 which introduced section 47(2A) and the second reading speech are relevant:

> Income distributions made in an informal winding-up of a company are to be taxed in the same way *as such distributions made by a liquidator in the course of a formal liquidation*
>
> [from Explanatory Memorandum]
>
> Shareholders wishing to wind-up a company sometimes do not have it formally liquidated but merely take possession of the company's tangible assets, collect and retain debts due to it and discharge debts due by it, and then treat the company as wound-up.
>
> Where this is done, distributions made out of the income of the company are not taxable although they would be if made in the course of a formal liquidation. The Bill proposes that distributions made in these informal liquidations will in future be taxed in the same way as distributions in an orthodox liquidation
>
> [second reading speech]

- The Commissioner has indicated that "section 47(2A) provides that distributions of cash or other property of a company appropriated to the shareholders, otherwise than by the company itself, in the course of an informal winding up or discontinuance of business are treated as though they are distributions by a liquidator in a formal winding up" (Private Binding Ruling Number 57078).

- A further requirement of section 47(2A) is that 'the business of a company has been or is in the course of being discontinued'. It appears that the company does not necessarily need to have actually carried on a business for this to be satisfied.

- The Explanatory Memorandum provides that distributions under section 47(2A) will taxed on the same basis as section 47 (which does not require a business to cease).

- This appears to be consistent with the Commissioner's view in Private Binding Ruling Number 78953. The facts in that ruling were that the company sold commercial land and buildings which were acquired prior to September 1985. The Commissioner accepted that the distributions made in the course of an informal winding up of the company under section 47(2A) of the pre-CGT gain on the sale of the land and buildings were not considered to be income under section 47(1A).

- In any case, there are good arguments that the commercial exploitation of the company's assets for the benefit of its shareholders does amount to the carrying on of a business by the company. (This is consistent with the Commissioner's current view in Taxation Ruling TR 2019/1)).

▪ CGT implications for the distributions which are not dividends

  - Distributions which do not represent 'income derived by the company' will be consideration received by the shareholders in respect of their shares.

- This will result in either CGT event G1 or CGT event C2 happening in relation to the shares.

▪ CGT event G1: Capital payment for shares

- CGT event G1 occurs if:
  - a company makes a payment to a shareholder in respect of their shares (except for CGT event A1 or C2 happening);
  - some or all of the payment is not a dividend or taken to be a dividend under section 47 of the 1936 Tax Act;
  - the payment is not included in the shareholders assessable income.
- CGT event G1 occurs when the company makes the payment.
- A capital gain occurs if the amount of the payment which is not a dividend (non-assessable payments) is more than cost base of the shares. The capital gain is the difference and the cost base of the shares is reduced to Nil.
- If the non-assessable payment is less than the cost base, the cost base is reduced by the non-assessable amount. A capital loss cannot occur in respect of CGT event G1 happening.
- However, any capital gain is disregarded if:
  - the shares were acquired pre-CGT; or
  - the payment is made by a liquidator provided the company ceases to exist within 18 months of the payment (in which case CGT event C2 will occur in relation to the non-assessable payment).
- At the time of lodging their tax return for the year in which they receive the non-assessable payment, the shareholder may not know whether or not the company will cease to exist within 18 months. Provided that the liquidator has not provided written advice that the company will not cease to exist within 18 months, the taxpayer can assume that it will cease to exist within 18 months (Taxation Determination TD 2001/27 at paragraph 11). If in fact that company does not cease to exist within 18 months, the taxpayer may need to amend their tax return as CGT event G1 will have occurred. In relation to any general interest charge on the underpayment of tax, [at paragraph 17], the Commissioner states:

  > We would expect, however, that the discretion to remit the general interest charge in full would ordinarily be exercised f a shareholder seeks an amendment within a reasonable time after the end of the 18 month period. In most cases, we would consider a period of one month after the end of the 18 month period to be a reasonable period but there may be circumstances where a shareholder can establish that a longer period is reasonable.

▪ CGT event C2: Cancellation of the shares

- CGT event C2 will occur at the time that the shares cease to exist.
- The Commissioner's view (in Taxation Determination 2001/27) is that CGT event C2 happens to the shares when the company ceases to exist (deregistered) in accordance with the Corporations Act. That is:
  - if the company is wound up under a members' voluntary winding up, it is deregistered three months after the liquidator lodges a return of the holding of the final meeting of members; or

    - if the company is wound up on an application (under section 601AA(1) of the Corporations Act), ASIC may deregister the company when two months have passed after ASIC publishes the notice in the Commonwealth of Australia Gazette.

  - In relation to CGT event C2, the shareholder will have:

    - a capital gain if the capital proceeds are more than the cost base of the shares; or

    - a capital loss if the capital proceeds are less than the cost base of the shares.

  - However, any capital gain or capital loss will be disregarded if the shares were acquired pre-CGT.

  - If CGT event G1 does not occur (because the company ceases to exist within 18 months of the payment), then the non-assessable payment will form part of the capital proceeds for the cancellation of the shares.

  - If CGT event G1 does occur, CGT event C2 will still occur in relation to the cancellation of the shares. However, the cost base will be reduced by the amount of the non-assessable payment.

- Applying CGT concessions to a capital gain arising from CGT event G1 or CGT event C2

  - Discount capital gain

    The shareholder will reduce any capital gain arising on a CGT event happening in relation to the shares under Division 115 of the 1997 Tax Act (about discount capital gain) provided that:

    - the shareholder is a type of entity which can make a discount capital gain (section 115-10), being:

      - an individual;

      - a trust; or

      - a complying superannuation fund; and

    - the shares were acquired at least 12 months prior to the CGT event (section 115-25).

    The discount percentage is (section 115-100) is 50% - individuals and trusts (excluding a complying superannuation fund); or 33 1/3 for complying superannuation funds.

  - Small business CGT concessions

    The shareholder may also be entitled to choose to reduce the remaining capital gain (after applying the general discount) by applying the small business CGT concessions provided that the requirements of Division 152 are satisfied.

6.3 Small business 15-year exemption payments

- Payments made by a company to its CGT concession stakeholders will be tax-free provided that the requirements of section 152-125 of the 1997 Tax Act are satisfied. The benefit of payments being made under section 152-125 is that there is no requirement to wind up the company and there are no CGT consequences for the CGT concession stakeholder in relation to the payment.

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Requirements of section 152-125

- Requirement 1: Exempt Amount

  The payment must relate to one of the following[59]:

  - A capital gain which the company disregarded under section 152-110 of the 1997 Tax Act (that is, the company disregarded the capital gain by choosing to apply the small business 15-year exemption).
  - An amount which the company could have disregarded as a capital gain under section 152-110 of the 1997 Tax Act except that the CGT asset was acquired pre-CGT.
  - An amount which the company could have disregarded as a capital gain under section 152-110 of the 1997 Tax Act if Division 149 had not applied to the CGT asset.

- Requirement 2: Payment to CGT concession stakeholders

  - The company makes one or more payments (directly or indirectly through one or more interposed entities) in relation to the exempt amount within two years after the relevant CGT event to the individual who was a CGT concession stakeholder of the company just before the CGT event.
  - Note:
    - The individual must be a CGT concession stakeholder just before the CGT event not at the time of the payment.
    - The Commissioner may extend the two year time limit. However, this would require the company to make an application to the Commissioner.
  - Consequences for the CGT concession stakeholder
    - Exempt amount not assessable
      - The exempt amount (up to the stakeholder's participation percentage as calculated below) is not a dividend or a frankable distribution. This means that it will not be included in the CGT concession stakeholder's assessable income.
      - Also, CGT event G1 (about capital payments for shares) will not apply as CGT event G1 does not apply to an amount referred to in section 152-125.[60]
      - Limit on amount treated as an amount not assessable to the shareholder (section 152-125(2))

        The limit on the amount which will not be assessable to the shareholder is calculated as follows:

        CGT concession stakeholder's
small business participation percentage X Exempt Amount
determined just before the CGT event

[59] Section 152-125(1) of the 1997 Tax Act
[60] Section 104-135(1A)(c) of the 1997 Tax Act

6.4 Paying out non assessable amounts from a unit trust

- Although an amount may not be assessable to the trustee of a unit trust, there may be an issue for the unitholders when the trustee makes a payment of that amount to its unitholders (whether as an interim capital distribution or a final distribution on termination).

- The two events which are relevant in this case are:

  - CGT event E4 – capital payment for trust interest.

  - CGT event C2 – redemption of units

CGT event E4

- When does CGT event E4 occur?

  - CGT event E4 occurs[61] if:

    - the trustee of a trust makes a payment to a beneficiary in respect of their unit or interest in the trust (except for CGT event A1, C2, E1, E2, E6 or E7 happening in relation to it); and

    - some or all of the payment is not included in the beneficiary's assessable income.

  - The payment which the trustee makes to the beneficiary must be 'in respect of their unit or interest in the trust':

    - If the trust is a normal discretionary trust, CGT event E4 will not apply, as the beneficiary does not have a 'unit' or 'interest' in the trust.

    - The Commissioner accepted in *Taxation Determination* TD 2003/28 that CGT event E4 does not apply to interim capital distributions to beneficiaries of a discretionary trust irrespective of whether they are discretionary or default beneficiaries.

    - In the determination, the Commissioner indicates that "CGT event E4 does not happen in the circumstances (of a capital distribution to a discretionary or default beneficiary) because a mere object or default beneficiary is not considered to have an "interest in the trust" of the nature or character required in paragraph 104-70(1)(a)."

    - CGT event E4 may apply in the case of a unit trust or a hybrid trust where beneficiaries have some fixed entitlement, which qualifies as an "interest".

  - CGT event E4 applies to interim distributions rather than payments on the redemption of units or as a final distribution on winding up.

    If the distribution is made on winding up the unit trust or the redemption of units, the relevant CGT event will be C2.

- Effect of CGT Event E4:

  - If the sum of the amounts of the non-assessable parts of the payments made in the income year are more than the cost base of the unit or interest, then:

    - the beneficiary will have a capital gain equal to that amount by which the non-assessable parts of the payment which exceeds the cost base; and

[61] s104-70(1) of the 1997 Act

- the cost base of the unit or interest will be nil[62].

- If the sum of the amounts of the non-assessable parts of the payments made in the income year is less than the cost base of the unit or interest, then the cost base of the unit or interest is reduced by the amount of the non-assessable parts of the payments[63].

- A capital gain in relation to CGT Event E4 is disregarded if the unit or interest was acquired prior to 20 September 1985.

- For example:

  The trustee of the unit trust makes an interim capital distribution to Sally (who is a unitholder) which consists of a non-assessable part of $2,000.

  If the cost base of Sally's unit is $500 – she will have a capital gain of $1,500.

- If the cost of Sally's unit is $3,000 – her cost base will be reduced to $1,000. This will become her cost base for calculating any future capital gains (including CGT Event E4).

▪ How to calculate the '**non assessable part**' of the payment[64]?

  The 'non assessable part' is the amount of the payment which is not included in the beneficiary's assessable income reduced by that part of the payment that represents the following:

  - Non-assessable non-exempt income

    - The list of provisions about non-assessable non-exempt income are summarised at Subdivision 11-B of the 1997 Tax Act.

      For example

      - The small business retirement exemption paid to a CGT Concession Stakeholder.

        For example if the beneficiary receives a payment of $450,000 representing the small business retirement exemption, the non assessable part will be nil (being the $450,000 payment reduced by that part of the payment representing the retirement exemption amount ($450,000)).

      - Exempt COVID-19 payments such as the cash flow boost payments or COVID-19 disaster payment.

      - Amounts which have been subject to family trust distribution tax.

    - That part of the payment that is paid from an amount that has been assessed to the trustee.

    - That part of the payment paid from an amount that is personal services income included in the beneficiary's assessable income, or another entity's assessable income under section 86-15 of the 1997 Act.

    - The amount of the payment which represents am amount referred to in section 152-125 of the 1997 Act as an exempt amount (about the small business 15-year exemption).

[62] s104-70(4) and (5) of the 1997 Act
[63] s104-70(8) of the 1997 Act

[64] S 104-71 of the 1997 Act

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That is, one of the following:

  - The trustee disregarded a capital gain (the exempt amount) under the small business 15-year exemption.
  - The asset was a pre-CGT asset and the trustee could have disregarded the capital gain (the exempt amount) under the small business 15-year exemption if the asset was acquired post-CGT.
  - The asset was post-CGT because Division 149 applied (about change of ownership) and all of the capital gain (the exempt amount) would have been disregarded under the small business 15-year exemption if the asset had actually been acquired post-CGT.

  There appears to be no requirement that the beneficiary is a CGT concession stakeholder of the trust or that the payment is made within two years of the CGT event.

- That part of the payment which represents the non-assessable portion of a capital gain made by the trustee because of the application of Division 115 (about the 50% general discount).
  - Where the beneficiary would not be entitled to claim the full benefit of Division 115 discount (e.g. companies and superannuation funds or beneficiaries with losses), the extent to which the capital distribution is excluded from the operation of CGT event E4 is adjusted to reflect that reduced entitlement.[65]
  - If a payment is made on the redemption of units, the relevant CGT event will be C2 and the distribution of the amount representing the exempt amount of the capital gain under Division 115 will not be tax free.
- Note: the payment is not reduced by the amount representing:
  - The small business reduction (active asset reduction). This means that CGT event E4 may apply when the active asset reduction amount is paid out.
  - A capital gain which was disregarded by the trustee because the asset was a pre-CGT asset (other than if the 15-year exemption could apply if the asset was acquired post-CGT).

▪ Timing of CGT event E4

- CGT event E4 generally occurs just before the end of the income year in which the trustee makes the payment.[66]
- Rather than making a distribution of a non-assessable amount, if the trustee lends the amount, then CGT event E4 will not apply as the payment will not have been made in respect of their unit or interest.
- This means that triggering CGT event E4 could be delayed until a later year.
- There may be Division 7A issues if the trustee has unitholders who are companies to whom it has UPE's owing. Subdivision EA of the 1936 Act will apply where the trustee makes a loan to a shareholder or associate of a shareholder to whom it has a UPE owing.

▪ Unit trusts and small business CGT concessions:

[65] s104-71(4) of the 1997 Tax Act
[66] s104-70(3)(a) of the 1997 Act

- If the trustee has a capital gain to which it can apply the:
  - the general discount under Division 115 if it has held the unit or interest at least 12 month; and
  - the small business CGT concessions under Division 152, it may choose not to apply the small business reduction under Subdivision 152-C if it can reduce the capital gain to nil under the small business retirement exemption.

    If the trustee is entitled to the general discount under Division 115, it must apply it. However, when the general discount is paid out the unitholders, there will be no affect under CGT event E4.

    If, the trustee chooses to apply the 50% small business reduction, when this amount is paid out to the unitholders as a distribution in relation to their units, there will be CGT event E4 issue. If however the trustee can pay the remaining capital gain (after apply the general discount) to individual's associated with the unitholders who are CGT concession stakeholders under the retirement exemption, then CGT event E4 may be avoided.
- If the trustee has a capital gain which it can disregard under the small business 15-year exemption, then all payments to unitholders of this amount will be disregarded for the purpose of CGT event E4.
- If a capital gain is triggered under CGT event E4, then, the beneficiary, may be able to reduce any capital gain by:
  - the general discount under Division 115 if it has held the unit or interest at least 12 months and it is a trust or individual; and/or
  - the small business CGT concessions provided that the conditions in Division 152 are satisfied.

CGT event C2

- CGT event C2: Redemption or cancellation of Units
  - If a distribution or payment is made on winding up the unit trust or the redemption of units, the relevant CGT event will be C2.
  - In relation to CGT event C2, the unitholder will have:
    - a capital gain if the capital proceeds are more than the cost base of the units; or
    - a capital loss if the capital proceeds are less than the cost base of the units.
  - However, any capital gain or capital loss will be disregarded if the units were acquired pre-CGT.
  - Note: A trustee should ensure that those amounts which would not trigger a CGT event E4 issue (being those amount which reduce the 'non assessable part' of the payment such as the 50% general discount) are distributed before the winding up of the trust. This will require that the trustee has the power to make an interim capital distribution under the terms of the trust deed.
- Applying CGT concessions to a capital gain arising from CGT event C2
  - Discount capital gain

The unitholder will reduce any capital gain arising on a CGT event happening in relation to the shares under Division 115 of the 1997 Tax Act (about discount capital gain) provided that:

- the unitholder is a type of entity which can make a discount capital gain (section 115-10), being, an individual; a trust; or a complying superannuation fund; and
- the units were acquired at least 12 months prior to the CGT event (section 115-25).

The discount percentage is (section 115-100) is 50% - individuals and trusts (excluding a complying superannuation fund); or 33 1/3 for complying superannuation funds.

- Small business CGT concessions

  The unitholder may also be entitled to choose to reduce the remaining capital gain (after applying the general discount) by applying the small business CGT concessions provided that the requirements of Division 152 are satisfied.

7. Case Study: "Connected" entities and NAT

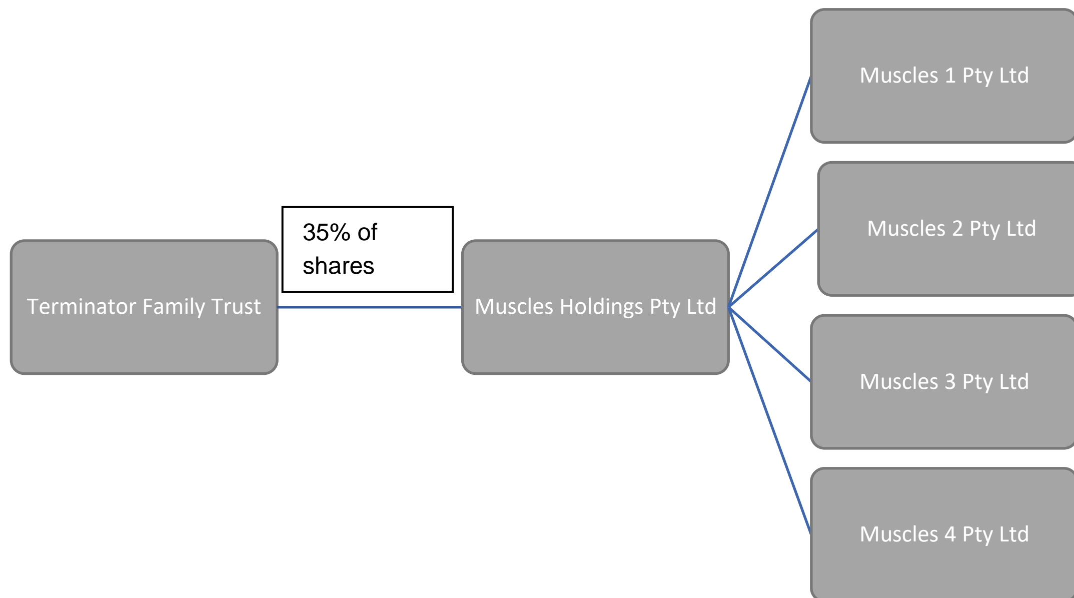
Facts

- Maria and Arnie approached their advisor in June 2023 advising him that they were looking at selling their business which was operated by the trustee of the Terminator Family Trust and that they would be signing a contract on 30 June 2023.

- The adviser considered whether the Terminator Family Trust could satisfy the $6 million net asset test to access the small business CGT concessions.

- For the years 2019 to 2022 the trustee for the Terminator Family Trust had distributed all income and capital equally to Maria and Arnie.

- The net assets of Terminator Family Trust consist of:
  - the net business assets which have a market value of $4 million;
  - the 35% shareholding in Muscles Holdings Pty Ltd.
  - The net value of the assets of Muscles Holdings Pty Ltd are $5 million. (35% of $5 million is $1.75 million)
  - Muscles Holdings Pty Ltd owns 100% of the shares in various subsidiaries.



- The advisor identifies that based on the past distributions of the trust, the assets of the following entities need to be included:
  - Terminator Family Trust; and
  - Arnie; and
  - Maria.

- The advisor calculates the net market value of the assets to be $5.75 million as follows:
  - Terminator Family Trust:
    - Business Assets - $4 million;
    - Shares in Muscles Holdings Pty Ltd - $1.75 million (based on 35% of $5 million);
  - Arnie and Maria – nil (on the basis that they only have excluded assets).
- The advisor prepares the resolution for the Terminator Family Trust for the 2023 year on the basis that the trust income and capital are distributed as follows:
  - Arnie – 20% of income and 50% of capital;
  - Maria – 20% of income and 50% of capital;
  - Muscles 1 Pty Ltd – 60% of income (as it has losses that year) and 0% of capital.
- Arnie and Maria as the directors of the trustee company sign the resolution on 28 June 2023.

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

What happens next?

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

  That is, the CGT event happened in the 2024 year.
- Who controls Terminator Family Trust?
  - Arnie – received at least 40% of distributions of income or capital in the years 2019 to 2023.
  - Maria – received at least 40% of distributions of income or capital in in the years 2019 to 2023.
  - Muscles 1 Pty Ltd – received at least 40% of distributions of income in 2023.
  - Muscles Holdings Pty Ltd – because it controls Muscles 1 Pty Ltd who in turn controls Terminator Family Trust.
- Net asset test – $9 million:
  - Terminator Family Trust – net business assets - $4 million;
  - Muscles Holdings Pty Ltd – net assets - $5 million.

8. Case Study: "Connected" entities and turnover

Facts

- The shares in Blue Ribbon Hotel Pty Ltd are owned by:
    - John Family Trust – 60%; and
    - Jack Family Trust – 40%.

  The directors of Blue Ribbon Hotel Pty Ltd are John and Jack.
- Neither John Family Trust nor any entity 'connected' with it operates a business.
- In the 2021 year, Jack Family Trust commenced operating a clothing business which Jack's wife controls.

  Jack and his wife Jill are the shareholders and directors of the trustee of Jack Family Trust.
- Blue Ribbon Hotel Pty Ltd sold the hotel business and land in the 2024 year for $9 million. (That is, its net assets were more than $6 million).
- The turnover of Blue Ribbon Hotel Pty Ltd was $1.6 million for the 2023 year and $1.8 million 2024 year (excluding the income from the sale of the hotel).
- The turnover of Jack Family Trust was $700,000 for the 2023 year and $800,000 for the 2024 year.
- John oversees the day to day operations of Blue Ribbon Hotel with very limited input from Jack.

Question

- Is Blue Ribbon Hotel Pty Ltd a CGT small business entity for the 2024 year?

Suggested Solution

- Blue Ribbon Hotel Pty Ltd will be a CGT small business entity for the 2024 income year if it:
    - carries on business in the 2024 year (which it did); and
    - at least one of the following applies:
        - it has an aggregated turnover of less than $2 million for the income year (worked out at the end of the 2024 year);
        - it carried on business in the 2023 year and had an aggregated turnover of less than $2 million for the 2023 income year; and/or
        - its aggregated turnover for the 2024 year was likely to be less than $2 million (provided that if it carried on business for the previous two years its aggregated turnover for those two years was not $2 million or more).
- 'Aggregated' turnover requires that the ordinary income derived from carrying on a business of the taxpayer's group must be less than $2 million.

- Aggregated Turnover is the sum of the annual turnover for the income year:
  - of the entity; and
  - an entity which was a connected entity at any time during the income year; and
  - an entity which was an affiliate at any time during the income year.
- Any entity who directly or indirectly controls Blue Ribbon Hotel is 'connected' with it?
  - As Blue Ribbon Hotel is a company, an entity controls it, if the entity and/or its affiliates own or have the right to acquire the ownership of shares in the company that carry between them the right to at least 40% of:
    - any distribution of income; or
    - any distribution of capital; or
    - the voting power.
  - This means that John Family Trust and Jack Family Trust each 'controls' Blue Ribbon Hotel as each of them have at least 40% of the shares.
  - Therefore, the turnover of John Family Trust and Jack Family Trust will be included with the turnover of Blue Ribbon Hotel in calculating its aggregated turnover.
  - This means that its aggregated turnover of Blue Ribbon Hotel for:
    - 2023 is $2.3 million ($1.6 million plus $700,000); and
    - 2024 is $2.5 million ($1.8 million plus $800,000)

    Therefore Blue Rand therefore it is not a CGT small business entity.

What options does Blue Ribbon Hotel have?

- If Jack Family Trust did not 'control' Blue Ribbon Hotel, then Blue Ribbon Hotel would be a CGT small business entity.
- As the control percentage of Jack Family Trust is less than 50%, then Blue Ribbon Hotel could apply to the Commissioner for a determination that Jack Family Trust does not control Blue Ribbon Hotel on the basis that it is controlled by John Family Trust.
- *Taxation Determination* TD 2023/5 (about aggregated turnover and connected entities – Commissioner's discretion that an entity does not 'control' another entity) factors:
  - John Family Trust controls the voting power.
  - John oversees the day to day operations.
  - Jack has very limited input into the operations and decision making.

What would have been a better structure for the clothing business?

- The clothing business should have been operated in a separate business (for example Clothing Co Pty Ltd).
- The shares should be held by either Jack's wife, Jill or a separate trust (Clothing Co Trust).
- Care should be taken as to how Jack Family Trust distributes its income and capital. For example, if it distributes at least 40% distributions to:
  - Jill and Jill owns the shares in Clothing Co Pty Ltd – Clothing Co Pty Ltd and Blue Ribbon Hotel will be connected entities because:
    - Jill will control Jack Family Trust;
    - Jill will control Clothing Co Pty Ltd (because she owns all of the shares) ; and
    - Jill will control Blue Ribbon Hotel (because she controls Jack Family Trust which controls Blue Ribbon Hotel.

    Therefore as Jill controls Blue Ribbon Hotel and Clothing Co Pty Ltd, they will be connected entities.
  - Jill and Jill also receives at least 40% of the distributions from Clothing Co Trust (assume it owns the shares in Clothing Co Pty Ltd) – Clothing Co Pty Ltd and Blue Ribbon Hotel will be connected entities because:
    - Jill will control Jack Family Trust;
    - Jill will control Blue Ribbon Hotel (because she controls Jack Family Trust which controls Blue Ribbon Hotel;
    - Jill will control Clothing Co Trust; and
    - Jill will control Clothing Co Trust (because she controls Clothing Co Trust which controls Clothing Co Pty Ltd.

  Therefore as Jill controls Blue Ribbon Hotel and Clothing Co Pty Ltd, they will be connected entities.

9. Case Study: $6 million net asset test

Facts

- Brian owns 50% of the shares in the Brown Brothers Pty Ltd. Simon (who is unrelated to Brian owns the other 50%).

- Brian sold his shares in Brown Brothers Pty Ltd for $2 million. That is, the net asset of Brown Brothers Pty Ltd was $4 million.

  Brian borrowed funds to acquire the shares. The loan was $1 million just before he entered into the share sale agreement (CGT event).

- Brian's other entities and assets just before the CGT event were as follows:

Asset owner	Asset	Market Value	Liability	Comments
Brian	Shares in Brown Brothers Pty Ltd	$2 million	$1 million	
Brian's Trust (controlled by Brian)	Holiday Home	$1 million	$500,000	Used solely for Brian's personal use and enjoyment
Brian	Main residence	$6 million	Nil	
Brian	Superannuation Fund	$5 million	$300,000 (funds borrowed for contribution)	
Brian	Commercial property	$1 million	$1.5 million	
Brown Brothers Pty Ltd	Loan to Brian	$300,000 (for company included in $4 million value)	$300,000 (for Brian)	Brian used funds to make superannuation contribution

- The accountant calculated Brian's $6 million net asset test as follows.

Asset owner	**Asset**	**Market Value**	**Liability**	**Net Assets**
Brian	Shares in Brown Brothers Pty Ltd	$2 million	$1 million	$3 million ($4 million less $1 million)
Brian's Trust (controlled by Brian)	Holiday Home	$1 million	$500,000	Nil
Brian	Main residence	$6 million	Nil	Nil
Brian	Superannuation Fund	$5 million	$300,000 (funds borrowed for contribution)	Nil
Brian	Commercial property	$1 million	$1.5 million	($500,000)
Brown Brothers Pty Ltd	Loan to Brian	$300,000 (for company included in $4 million value)	$300,000 (for Brian)	($300,000)
TOTAL				**$2.2 million**

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Question: Is the calculation correct?

- Apparently Brian acquired the main residence 6 years ago. He rented it out for the first 4 years and it has been his main residence for the last 2 years.
- Brian used the borrowings of $300,000 from the company to make the superannuation contribution.
- Does Brian satisfy the $6 million net asset test?

Suggested Solution

Asset owner	Asset	Market Value	Liability	Net Assets
Brian	Shares in Brown Brothers Pty Ltd	$2 million	$1 million	$3 million ($4 million less $1 million)
Brian's Trust (controlled by Brian)	Holiday Home	$1 million	$500,000	~~Nil~~ $500,000 (Personal use assets must be owned by individuals to be excluded)
Brian	Main residence	$6 million	Nil	~~Nil~~ $4 million $6 million x 4 / 6 (was used to derive assessable income therefore not 100% excluded)
Brian	Superannuation Fund	$5 million	$300,000 (funds borrowed for contribution)	Nil (Does not relate to an asset included)

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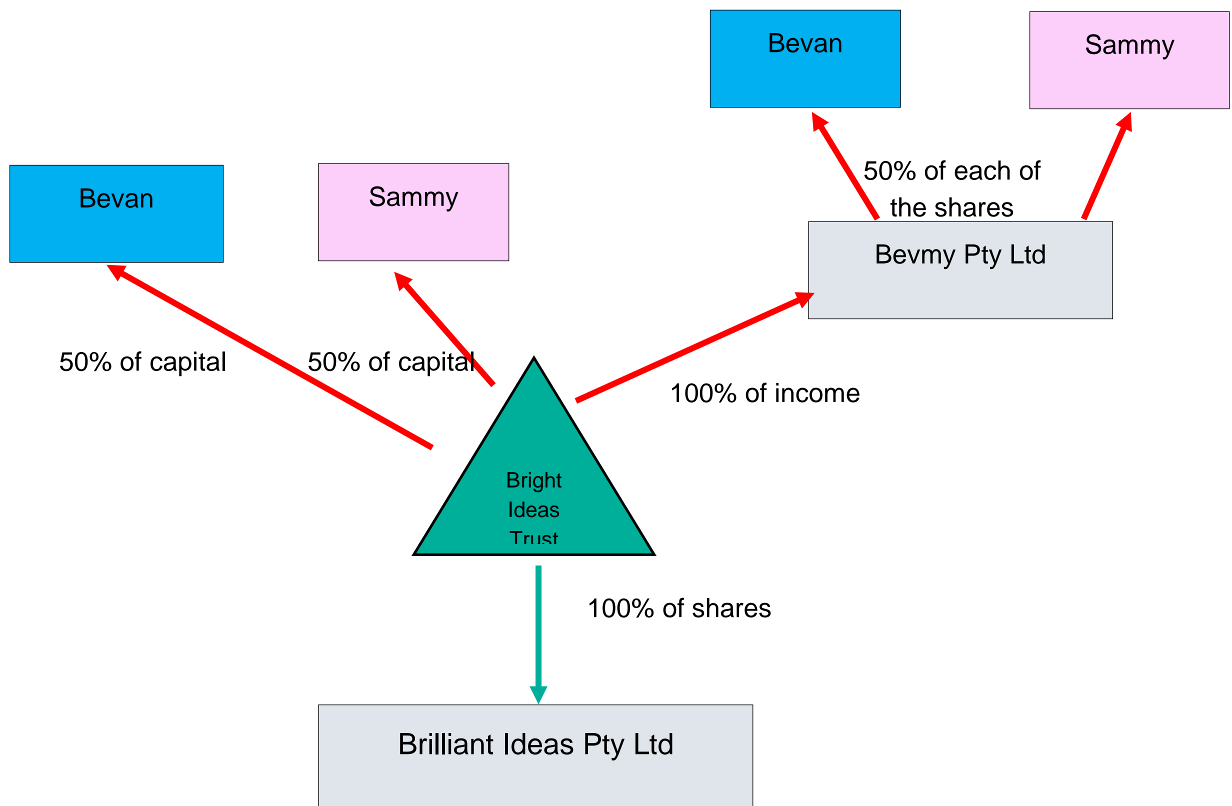
Brian	Commercial property	$1 million	$1.5 million	($500,000)
Brown Brothers Pty Ltd	Loan to Brian	$300,000 (for company included in $4 million value)	$300,000 (for Brian)	~~($300,000)~~
TOTAL				**~~$2.2 million~~** **$7 million**

10. Case Study: CGT concession stakeholder

Facts

- Before the advisor prepared the trustee resolutions for the 2024 year for Brilliant Ideas Trust he asked Bevan and Sammy whether the trustee had entered or were considering entering into any agreements to sell any assets.
- Bevan and Sammy told the advisor that they had signed a share sale agreement on 1 January 2024 to sell all of its shares (100%) in Bright Ideas Pty Ltd and that Bright Ideas Pty Ltd had paid Brilliant Ideas Trust a $2 million dividend prior to the sale of shares.
- The advisor knowing that CGT concession stakeholders of Bright Ideas Pty Ltd had to receive at least 90% of the distributions but also that there was a sizable dividend then proceeded to:
  - establish a new company, Bevmy Pty Ltd which was owned 50% by Bevan and 50% by Sammy; and
  - prepare the trustee 2024 resolution for Brilliant Ideas Trust as follows:
    - Bevan – 50% of the capital;
    - Sammy – 50% of the capital;
    - Bevmy Pty Ltd – 100% of the income.



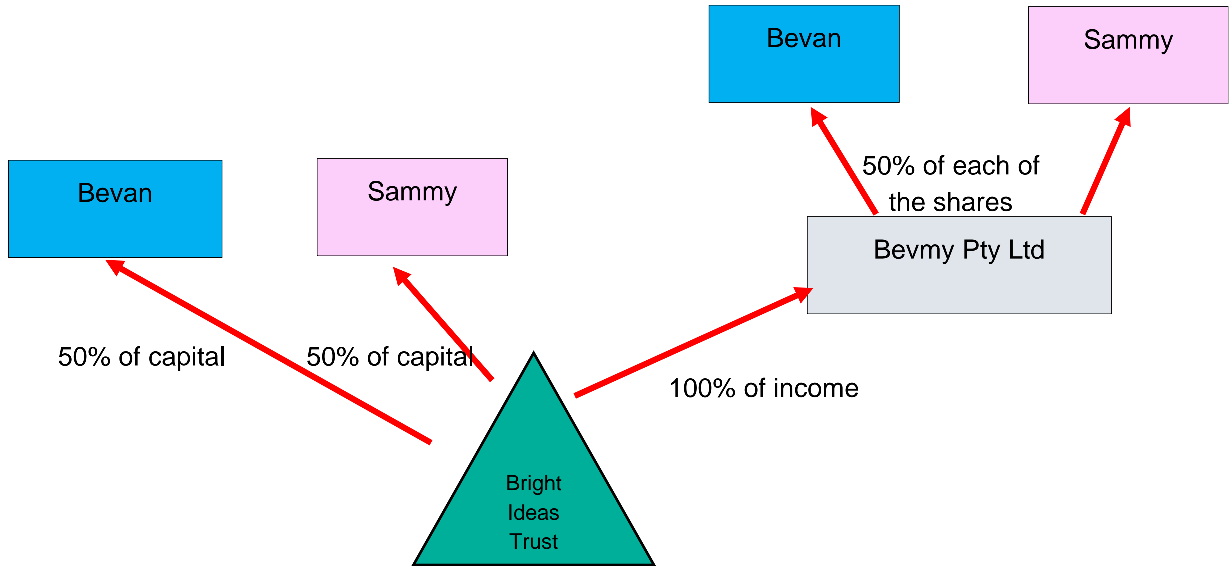
- Question: Who are the CGT concession stakeholders of Brilliant Ideas Pty Ltd for the 2024 year?

Suggested Solution

- Bevan's small business participation percentage in Brilliant Ideas Pty Ltd
  - Direct: 0% [Bevan's interest in Bright Ideas Trust being the lower of the distributions of income or capital] x 100% [Bright Idea's Trust's small business participation percentage in Brilliant Ideas Pty Ltd] = 0%
  - Indirect: 50% [Bevan's interest in Bevmy Pty Ltd] x 0% [Bevmy Pty Ltd's small business participation percentage in Bright Ideas Trust being the lower of the distributions of income or capital] x 100% [Bright Ideas Trust's small business participation percentage in Brilliant Ideas] = 0%
- Sammy's small business participation percentage in Brilliant Ideas Pty Ltd
  - Direct: 0% [Sammy's interest in Bright Ideas Trust being the lower of the distributions of income or capital] x 100% [Bright Idea's Trust's small business participation percentage in Brilliant Ideas Pty Ltd] = 0%
  - Indirect: 50% [Sammy's interest in Bevmy Pty Ltd] x 0% [Bevmy Pty Ltd's small business participation percentage in Bright Ideas Trust being the lower of the distributions of income or capital] x 100% [Bright Ideas Trust's small business participation percentage in Brilliant Ideas] = 0%
- There are no CGT concession stakeholders of Brilliant Ideas Pty Ltd. This means that Bright Ideas Trust cannot claim the small business CGT concessions in relation to the sale of its shares in Brilliant Ideas Pty Ltd.

Revised facts (a)

- Bright Ideas Trust's capital gain was derived from the sale of goodwill (not shares).



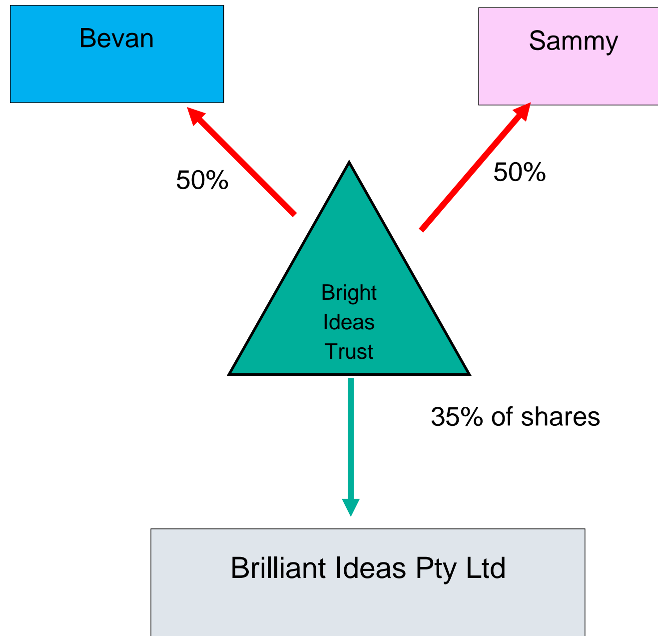
- Question: Who are the CGT concession stakeholders of Brilliant Ideas Trust for the 2024 year?

Suggested Solution (revised facts (a))

- Bevan's small business participation percentage in Bright Ideas Trust
  - Direct: 0% [Bevan's interest in Bright Ideas Trust being the lower of the distributions of income or capital] = 0%
  - Indirect: 50% [Bevan's interest in Bevmy Pty Ltd] x 0% [Bevmy Pty Ltd's small business participation percentage in Bright Ideas Trust being the lower of the distributions of income or capital] = 0%
- Sammy's small business participation percentage
  - Direct: 0% [Sammy's interest in Bright Ideas Trust being the lower of the distributions of income or capital] = 0%
  - Indirect: 50% [Sammy's interest in Bevmy Pty Ltd] x 0% [Bevmy Pty Ltd's small business participation percentage in Bright Ideas Trust being the lower of the distributions of income or capital] = 0%
- Neither Bevan nor Sammy are CGT concession stakeholders. This means that Bright Ideas Trust cannot claim the small business retirement exemption. However Bright Ideas Trust could choose to apply the small business reduction and then small business roll-over. If it does not acquire a replacement active asset within two years, CGT event will arise then (CGT event J5). In that year, Bright Ideas Trust may apply the small business retirement exemption for its CGT concession stakeholders in that year.

Revised facts (b)

- Bright Ideas Trust owns 35% of the shares in Brilliant Ideas Pty Ltd.
- Bright Ideas distributed
  - Bevan – 50% of the capital and income;
  - Sammy – 50% of the capital and income



- Question: Who are the CGT concession stakeholders of Brilliant Ideas Pty Ltd for the 2024 year?

Suggested Solution (b)

- Bevan's small business participation percentage
  - Direct: 50% [Bevan's interest in Bright Ideas Trust being the lower of the distributions of income or capital] x 35% [Bright Idea's Trust's small business participation percentage in Brilliant Ideas Pty Ltd] = 17.5%
- Sammy's small business participation percentage
  - Direct: 50% [Sammy's interest in Bright Ideas Trust being the lower of the distributions of income or capital] x 35% [Bright Idea's Trust's small business participation percentage in Brilliant Ideas Pty Ltd] = 17.5%
- There are no CGT concession stakeholders of Brilliant Ideas Pty Ltd. This means that Bright Ideas Trust cannot claim the small business CGT concessions in relation to the sale of its shares in Brilliant Ideas Pty Ltd.
- Solution: Either Bevan or Sammy needed to receive at least 58% of each of the income and capital distributions from Bright Ideas Trust (58% x 35% = 20.3%) and the other (the spouse) at least that percentage which result in them together receiving at least 90% of the distributions of income and capital in Bright Ideas Trust (say 42%, therefore 42% x 35% = 14.70)

11. Case Study: Sale of shares

Facts

- The shares in Cattle Co Pty Ltd are owed by:
  - Bob who holds 35% of the shares
  - ABC Pty Ltd who holds 35% of the shares; and
  - Tom who holds 30% of the shares.

- The shareholders sell their shares in Cattle Co Pty Ltd for $50 million (being the net market value of assets of Cattle Co Pty Ltd). Cattle Co owns substantial land holdings and cattle. Due to the drought Cattle Co's stock numbers were down and therefore it is restocking. This has resulted in the cattle sales for the year prior to the sale of shares being less than $2 million.
- Cattle Co
  - Cattle Co does not own any shares or units in other entities.
  - All of the assets of Cattle Co have always been active assets.

- Bob
  - The net market value of Bob's assets is $200 million.
  - In the year prior to selling the shares in Cattle Co, Bob acquired a fish and chip shop which has a turnover of $600,000.
  - The aggregated turnover of Bob for the year prior to the sale of the shares and the year of the sale is less than $2 million.
  - Bob's capital gain on the sale of the Cattle Co shares is $17,500,000.

- ABC Pty Ltd
  - ABC owns the shares in Cattle Co as well as a commercial property worth $10 million which it rents out.
  - The income derived from the dividends on the shares and the rent for the year prior to the sale of the shares was less than $2 million.
  - The aggregated turnover of ABC for the year prior to the sale of the shares and the year of the sale is less than $2 million.
  - ABC Pty Ltd's capital gain on the sale of the Cattle Co shares is $17,500,000.
  - Jack Trust owns 100% of the shares in ABC Pty Ltd.
  - Jack Trust distributes 100% of its income and capital to Jack in the year of the capital gain.

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- Tom
  - Tom does not carry on business.
  - The net market value of Tom's assets just before the sale of the shares was $20 million.
  - Tom's capital gain on the sale of the Cattle Co shares is $15,000,000.

Question: Who can obtain the small business CGT concessions on the sale of their shares?

Suggested solution

- Basic requirements to access the small business CGT concessions on the sale of shares:
  - Just before the CGT event, the shareholder satisfies the $6 million net asset test or is a CGT small business entity for the year of the CGT event.

    If the shareholder is a CGT small business entity, then it must carry on the business prior to the CGT event.
  - The Object Entity (Cattle Co) must satisfy the $6 million net asset test or is a CGT small business entity.
  - This is satisfied as Cattle Co is a CGT small business entity.
  - The shares satisfy the active asset test (using the modified rules).
  - The shareholder is a CGT concession stakeholder or CGT concession stakeholders in Cattle Co have a 90% interest in the shareholder.
- Bob
  - Bob fails the $6 million net asset test but will be a CGT small business entity for the year of the CGT event and he carried on the fish and chip business prior to the CGT event.
  - Cattle Co is a CGT small business entity in the year of the capital gain.
  - The shares satisfy the active asset test (using the modified rules). This is satisfied as 100% of the assets have always been active assets.
  - Bob is an individual and owns at least 20% of the voting, capital and dividend rights in Cattle Co. Therefore this requirement is satisfied.
  - Bob can access the small business CGT concessions on the sale of his shares in Cattle Co.

- ABC Pty Ltd
    - ABC Pty Ltd fails the $6 million net asset test. Will ABC Pty Ltd be a CGT small business entity for the year of the CGT event? That is, does it carry on a business and have an aggregated turnover of less than $2 million either in the year of the CGT event or the year prior.

The Commissioner in *Taxation Ruling* TR 2019/1 accepts that (for the purpose of section 328-110 of the 1997 Tax Act and section 23 of the Income Tax Rates Act 1986) companies are typically formed for the purpose of carrying on a business and are unlike individuals or trusts whom may have multiple purposes for undertaking activity other than to make a profit or carry on a business (at paragraph 23)

Example 3 - property investment company

66. *InveproCo is a company incorporated in Australia. InveproCo owns a commercial property, which it rents to a third party at a market rate on normal commercial terms. InveproCo provides no other services in relation to the property and conducts no other activities. InveproCo has produced a profit in each of the income years it has rented out the property. InveproCo is engaged in ongoing activities that have a purpose and prospect of profit, including letting out the property.*

Possibility A

67. *InveproCo engages a professional property manager to manage the property, find tenants and do all the maintenance and ongoing inspections in relation to the property.*

68. *InveproCo carries on a business.*

Possibility B

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

70. InveproCo carries on a business.

Example 4 - share investment company

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

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

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

Possibility A

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

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

Based on the above examples taken from TR 2019/1, ABC would be carrying on a business and it was carrying on the business prior to the CGT event.

- Cattle Co is a CGT small business entity in the year of the capital gain.
- The shares satisfy the active asset test (using the modified rules). This is satisfied as 100% of the assets have always been active assets.
- Jack will be a CGT concession stakeholder of Cattle Co (indirect small business participation percentage of 35%) and he has a small business participation percentage of at least 90% in Jack Trust.
- ABC can access the small business CGT concessions on the sale of its shares in Cattle Co.

- Tom
  - Tom fails the $6 million net asset test and is not a CGT small business entity for the year of the CGT event. Therefore, Tom cannot access the small business CGT concessions.
  - Even if Tom acquired Bob's fish and chip business after the sale of the shares, he still would not be able to access the small business concessions as he would have been required to carry on the business prior to the CGT event.

12. Case Study: Sale of shares

Facts

- RedCo Pty Ltd was established on 1 January 2022 with Jacqui as the sole shareholder, director and secretary.
- RedCo has always carried on a business. Its business assets consist of cash, plant and equipment, debtors and intangibles. On 1 January 2019 it started acquiring shares in listed companies.
- Jacqui is looking at selling her shares in RedCo for approximately $3 million in the 2025 year.
- The net market value of assets of RedCo is less than $6M.
- The net market value of Jacqui's assets are less than $6M.
- Question: Can Jacqui access the small business CGT concessions?

Suggested solution

- Basic requirements to access the small business CGT concessions on the sale of shares:
  - Just before the CGT event, the shareholder satisfies the $6 million net asset test or is a CGT small business entity for the year of the CGT event.
  - This is satisfied as the net market value of Jacqui 's assets is less than $6 million.
  - The Object Entity (RedCo) must satisfy the $6 million net asset test or is a CGT small business entity.
  - This is satisfied as the net market value of RedCo's assets is less than $6 million.
  - The shares satisfy the active asset test (using the modified rules).
  - Determining whether 80% of the assets of RedCo are active (80% Test) for at least half the time Jacqui has owned her shares

    In determining whether the 80% Test is satisfied the following issues are relevant:
    - The market value of the gross assets are included (including goodwill and other intangible assets which may not be recognised on the balance sheet).
    - For the period (if any) in which more than 20% of the gross market value of assets are not active assets then the 80% Test will fail (but only for that period).
    - The shares which RedCo holds in the listed companies are ignored, but RedCo is taken to own a percentage of the gross assets of the relevant listed companies equal to the percentage of shares held in those companies.
    - Practically it will be difficult to obtain the necessary information to determine whether the 80% Test can be satisfied whilst RedCo continues to hold the listed shares.
  - The shareholder is a CGT concession stakeholder or CGT concession stakeholders in Red Co have a 90% interest in the shareholder.
    This is satisfied as Jacqui is the shareholder and is a CGT concession stakeholder.

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13. Case Study: Sale of shares

Facts

- Structure of group
  - Adam and Bob own interests in six dental practices through Queensland (Queensland Dental Group).
  - Each of these dental practices were established (rather than acquired).
  - Each is operated through a separate company.
  - Each dental practice is structured the same. The ownership is as follows (diagram 1):
    - Adam's family trust (AFT) which owns a 35% interest;
    - Bob's family trust (BFT) which owns a 35% interest;
    - an external party (being the dentist which practices in the dental practice) owns a 30% interest.
  - None of the dental companies are worth more than $6 million individually.
  - In total the dental companies would be worth $12 million (say $2 million each).
- AFT and BFT each satisfy the $6 million.
- AFT's and BFT's shares in total are worth $4.2 million each (35% of $12 million). They have a cost base of $1 for their shares.
- The shares in each of the dental companies would satisfy the active asset test.
- Adam and Bob are thinking about restructuring so that AFT and BFT will hold their shares in one company (diagram 2).
- Will the restructure impact on AFT's and BFT's ability to access the small business CGT concessions in the future?

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Diagram 1

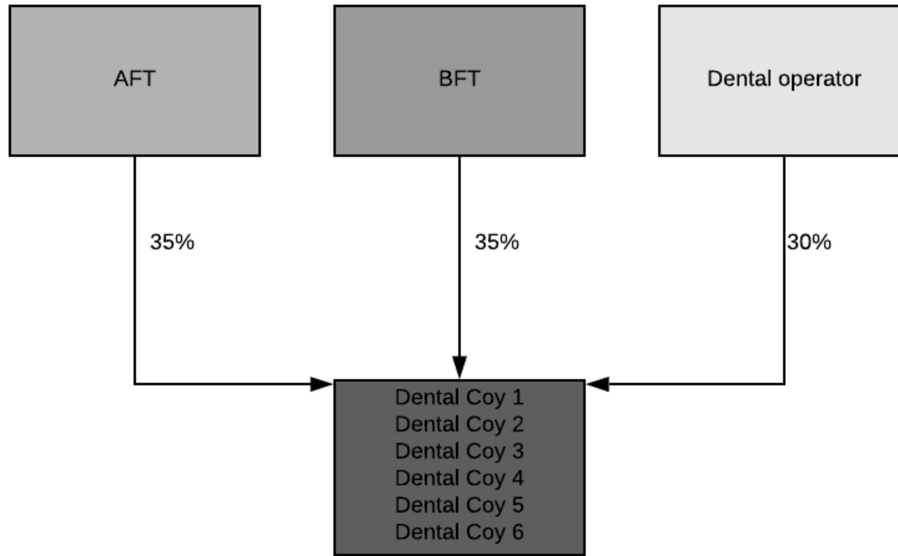
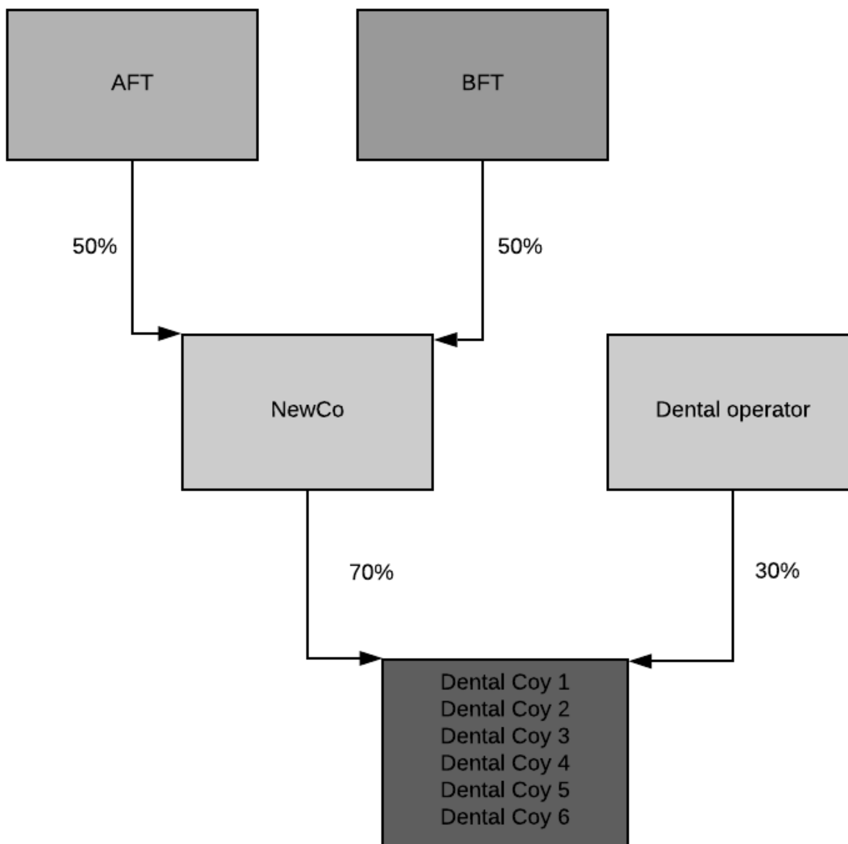


Diagram 2



Suggested Solution

Basic requirements to access the small business CGT concessions on the sale of shares:

- Just before the CGT event, the shareholder entity satisfies the $6 million net asset test or is a CGT small business entity for the year of the CGT event.

  As none of the shareholders own at least 40% of the shares in the dental companies they only need to take into account their respective shares in the companies.

- Just before the CGT event, the Object Entity satisfies the $6 million net asset test or is a CGT small business entity for the year of the CGT event.

  - Under the existing structure, AFT and BFT will sell their shares in each of the dental companies. This means that the object entities will be each of the dental companies, who do each satisfy the $6 million net asset test.
  - If the restructure occurs, AFT and BFT will sell their shares in NewCo. This means that the Object Entity is NewCo. NewCo owns interests in the dental companies (later companies). NewCo is currently worth $8.4 million (70% of $12 million).

14. Case Study Sale of shares versus asset sale

Facts

- ABC Pty Ltd operates a business which owns valuable copyright which it has developed.
- The shares in ABC Pty Ltd are owned by ABC Trust.
- ABC Trust has a nil cost base for its shares.
- ABC Trust is looking at selling the business.
- The sale can either be structured as:
    - a share sale whereby ABC Trust sells its shares in ABC Pty Ltd; or
    - an asset sale whereby ABC Pty Ltd sells its business assets.
- ABC's business assets have been valued as follows:

Inventory	$ 175,000	
Plant and Equipment	$ 125,000	(WDV nil)
Copyright	$2,000,000	(WDV nil)
Goodwill	$2,250,000	(cost base nil)
Total	$4,550,000	

- ABC Pty Ltd has other assets and liabilities as follows:

Other Assets	
Cash	150,000
Debtors	50,000
Loans to Shareholders	250,000
Total other assets	450,000
Other Liabilities	
Trade Creditors	100,000
Total other liabilities	100,000
Net other assets	350,000

- ABC Trust is looking at selling the business.
- The sale can either be structured as:
  - Option 1: a share sale whereby ABC Trust sells its shares in ABC Pty Ltd; or
  - Option 2: an asset sale whereby ABC Pty Ltd sells its business assets.
- Assumptions:
  - ABC Pty Ltd and ABC Trust satisfy the $6 million net asst test.
  - The shares satisfy the 'active asset' test.
  - The business assets and shares have been held less than 15 years.
  - The trustee of the ABC Trust will resolve to distribute 50% of any trust net income and capital each to Jack and Sandra for the year of the CGT event.
  - Jack and Sandra are over 55 years of age and have not used any of their $500,000 small business retirement exemption.

Suggested Solution

Option 1 – ABC Trust disposes of its shares

- ABC Trust signed a Share Sale Agreement to sell its shares in ABC Pty Ltd for $4,900,000.

  This was based on the value of the shares as at completion calculated as follows:

  $4,550,000 (business assets) + 150,000 (cash) + 50,000 (debtors) + 250,000 (shareholder loans) – 100,000 (trade creditors).
- This means that ABC Trust will have a capital gain of $4,900,000 to which it will apply the general 50% discount under Division 115 to reduce the capital gain to $2,450,000.
- If ABC Trust cannot access the small business CGT concessions and Jack and Sandra are in the top marginal tax bracket, they will pay $1,151,500 in tax (in total). (47% x $2,450,000).
- If ABC Trust can access the small business CGT concessions, it may:
  - reduce the capital gain of $2,450,000 (after applying the general discount) by a further 50% to $1,225,000 under the small business 50% reduction;
  - further reduce the remaining capital gain to $225,000 by using the small business retirement exemption for the benefit of Jack and Sandra ($500,000 each).
  - further reduce the remaining capital gain to nil by applying the small business roll-over to the remaining gain of $225,000.
- If ABC Trust does not acquire replacement assets within 2 years, the deferred capital gain (small business roll-over) of $225,000 will be included in its assessable income in that year.

  Assuming Jack and Sandra include the $225,000 in their assessable income and are in the top marginal tax bracket, the further tax will be $105,750 (47% x $225,000).

Option 2 – ABC Pty Ltd sells its business assets

- ABC Pty Ltd signs a contract to sell its business assets as follows:
  - Inventory - $ 175,000
  - Plant and Equipment $ 125,000
  - Copyright $2,000,000
  - Goodwill $2,250,000.
- ABC Pty Ltd will have the following taxation implications:
- $2,300,000 will be included in its assessable income, being:
  - the sale of inventory of $175,000; and
  - the balancing adjustment event in relation to the plant and equipment and copyright resulting in $125,000 (for plant) and $2,000,000 (for copyright)
- Tax on $2,300,000 assuming that ABC Pty Ltd is a BRE will be $575,000. However the after tax profit still needs to be paid out of the company.
- There will be a capital gain on the sale of goodwill of $2,250,000.
- Will ABC Pty Ltd be able to apply the general discount under Division 115?
  - A company is not a type of entity that can apply the general discount.
  - This means that ABC Pty Ltd will not be able to reduce the capital gain of $2,250,000 by the general discount percentage.

Small Business Concessions

- Accessing the concessions
  - If ABC Pty Ltd can access the small business CGT concessions, the $2,250,000 will be:
    - reduced by 50% to $1,125,0000 applying the small business reduction; and
    - reduced by a further $1 million by applying the retirement exemption for Jack and Sandra; and
    - reduced to nil by applying the small business roll-over to the remaining $125,000.
  - ABC Pty Ltd will be taxed on the $125,000 in two years time if a replacement asset is not acquired. The after tax profit will still need to be paid out at some point.
  - Before ABC Pty Ltd can be wound up:
    - The retained profits need to be paid out
    - The 50% reduction (i.e. of $1,225,000) needs to be paid out
  - If the 50% reduction is paid out while the company is operating:
    - it will be a dividend to ABC Trust; and
    - ABC Pty Ltd may not have sufficient franking credits to fully frank the dividend

- If however, a liquidator distributes the 50% reduction as part of the winding up process the amount:
  - is not deemed to be a dividend;
  - will be consideration for the cancellation of the shares (CGT Event C2).
- This means that ABC Trust will have a capital gain in relation to its shares of $1,225,000.
  - ABC Trust will be able to reduce its capital gain by 50% under the general discount (Division 115) to $612,500.
  - If ABC Trust cannot apply the small business CGT concessions and Jack and Sandra are in the top marginal tax bracket, they will pay tax (in total) of $287,875 (47% of $612,500)
  - Assume that ABC Trust can access the small business CGT concessions:
    - It can reduce its capital gain by a further 50% under the small business reduction to $306,250.
    - It cannot choose to apply the small business retirement exemption for Jack and Sandra as they have used all of their lifetime $500,000 limit.
    - It can choose to apply the small business roll-over to the remaining $306,2500 (and defer the tax issues for 2 years). Deferred tax at 47% is $143,938.

- If ABC Pty Ltd cannot access the concessions
  - If ABC Pty Ltd cannot access the small business CGT concessions, the $2,250,000 will also be included in its assessable income.
  - Tax on $2,250,000 is $562,500 (if BRE), however the after tax profit will need to be paid out as a dividend at some point.

15. Case Study: Removing company capital profits

Facts

- Dobes Doggy Day Care Pty Ltd sold its business during the 2024 year and had a capital gain of $2 million to which it applied:
  - small business 50% reduction to reduce the capital gain to $1 million; and
  - small business retirement exemption for the benefit of its two shareholders (Bossie and Phoebe) to further reduce the capital gain to nil.

  Bossie and Phoebe are the only shareholders and each have six ordinary shares.

- The balance sheet of Dobes Doggy Day Care Pty Ltd is as follows:

Balance Sheet	
Assets	
Cash	$1,500,002
Equity	
Issued capital	$2
Reserve – Small business 50% reduction	$1,000,000
Reserve – cash flow boost	$ 100,000
Retained Profits	$ 400,000
Total Equity	$1,500,002

- Bossie and Phoebe want to take all of the cash out of the company.

Suggested Solution

- If the small business 50% reduction is distributed while the company is operating, it will be a taxable dividend to Bossie and Phoebie. As this was not assessable to the company there may not be sufficient franking credits to fully frank the dividend.
- If the cash is paid out on liquidation of the company, how much will be considered to be a capital payment rather than a dividend by the liquidator?

- Distributions by a liquidator will be deemed to be a dividend if it represents the 'income derived by the company' (section 47(1) of the 1936 Act).
- 'Income derived by a company' includes an amount which has been included in the company's assessable income (including a net capital gain which has been included in the assessable income of the company) (section 47(1A)).
- Distributions by the liquidator representing amounts which are not income or net capital gains will not be taken to be a dividend.
- It will be important that the liquidator can clearly identify that the amount distributed to the shareholders out of the capital profits reserve which represents a non assessable capital gain is in fact from this source to avoid any suggestion that this payment is a dividend.
- The principle in relation to liquidator's distributions is that, if a liquidator appropriates or sources a particular fund in making a distribution, then that appropriation will ordinarily determine the character of the distributed amount. This is known as the "Archer Brothers' Principle" (Archer Brothers Pty Ltd v FCT 90 CLR 140).
    - The Tax Office outlined its views on the application of the Archer Brothers Principle in Taxation Determination TD 95/10.
    - The Tax Office view in is that it is not essential that separate accounts are kept by the company or the liquidator "provided the liquidator is able to identify a fund or profit from which a distribution is made".
- On the winding up of the company, $1,000,002 representing the small business 50% reduction and share capital) will not be a deemed dividend to Bossie and Phoebe (section 47(1) of the 1936 Tax Act).
- The remaining $500,000 will be a dividend.

- What are the tax implications for Phoebe and Bossie?
    - $500,000 assessable to Phoebe and Bossie as a dividend.
    - $1,000,002 – consideration for the cancellation of their shares.
        - If company deregistered within 18 months – CGT event C2 will happen when Dobes Doggy Day Care Pty Ltd is deregistered (note – may not be year of the payment).
        - Assuming cost base of the shares is $1 each, capital gain of $500,000 each.
        - If shares are held 12 months – 50% general discount.
        - They may also obtain the small business CGT concessions (if tick all the boxes).

16. Case study: Informal liquidation to remove capital profits

Facts

- In the 2022 financial year the company sold a commercial property that it acquired pre-CGT.
- The commercial property has always been used to derive rent from unrelated parties.
- The Balance Sheet of the company as at 30 June 2022 shows:
    - a capital reserve of $250,000 (which represents the pre-CGT gain);
    - fully paid up share capital of $150,000; and
    - an unsecured loan to the shareholders of $400,000 which was made on 30 June 2022.
- There is no written loan agreement in relation to the loan.
- The shareholders acquired their shares pre-CGT.
    - The company is in the process of being wound up.

      It is expected that the winding up process will be completed within three years of the distribution being made (that is, 30 June 2025).
    - How do we deal with the capital profits reserve and the Division 7A issue?

Suggested solution

- Gain on Sale of commercial property

  As the commercial property was acquired pre-CGT, the company will not have included any portion of the capital gain in its assessable income (Pre-CGT Gain) in the year it was sold (2021 year).
- Distribution of Pre-CGT Gain
    - If the Pre-CGT Gain was paid out as a dividend it would be taxable in the hands of the shareholders.
    - However, the Pre-CGT Gain will not be assessable in the hands of the shareholders as a dividend if it is distributed in the course of winding up of the company.
        - Distributions made to shareholders by a liquidator in the course of winding up of the company will be deemed to be dividends only to the extent that they represent income derived by the company (section 47(1) 1936 Tax Act).

          Distributions of non-assessable income (such as the Pre-CGT Gain) will not represent income derived by the company (section 47(1A)).

          Any return of capital will also be excluded as a dividend under section 47.
        - Section 47 (2A) extends the application of section 47 to distributions made in the course of an informal winding up.

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Where the business of a company has discontinued, any cash or property of the company distributed otherwise then by the company to the shareholders is deemed to be a liquidator's distribution under section 47 (section 47(2A)).

- While the wording of section 47(2A) is a little ambiguous, it seems clear that it was intended to apply in circumstances such as these.

  The Commissioner has indicated that "section 47(2A) provides that distributions of cash or other property of a company appropriated to the shareholders, otherwise than by the company itself, in the course of an informal winding up or discontinuance of business are treated as though they are distributions by a liquidator in a formal winding up" (Private Ruling No. 57078).

- Section 47(2A) appears to require that 'a business of a company has been or is in the course of being, discontinued'.

  - The fact that the company conducted a commercial rental operation should not prevent section 47(2A) from applying.

  - The Explanatory Memorandum provides that distributions under section 47(2A) will taxed on the same basis as section 47 (which does not require a business to cease).

  - The Commissioner confirmed this in Private Ruling No. 78953, the circumstances of which are similar to these. The facts in that ruling were that the company sold commercial land and buildings which were acquired prior to September 1985. The Commissioner accepted that the distributions made in the course of an informal winding up of the company under section 47(2A) of the pre-CGT gain on the sale of the land and buildings were not considered to be income under section 47(1A).

    In any case, there are good arguments that the commercial exploitation of the company's assets for the benefit of its shareholders does amount to the carrying on of a business by the company (this is consistent with the Commissioner's current view in TR 2019/1).

- However, section 47(2A) will not apply to a distribution of cash or property if the company does not cease to exist within a period of three years after the distribution, in which case the distribution will be a deemed dividend.

  This means that provided the company is wound up prior to 30 June 2024, section 47(2A) should apply.

  Archer Brothers Principle

  The distribution of the Pre-CGT Gain may still be treated as a taxable dividend unless:

  - the company has maintained the accounts in a way which allows the revenue and capital components of the distribution to be separately identified; and

  - the liquidator actually identifies the different components of the distribution.

  This is known as the Archer Brother's Principal and the Commissioner view of what is required to satisfy this principal is set out in Taxation Determination TD 95/10 in which they state that:

"We consider that the Archer Brother's principal applies if:

- the company accounts have been kept so that a liquidator can clearly identify a specific profit or fund in making a distribution; and
- it is clear from either the accounts or statement of distribution that the liquidator has appropriated the specific profit or fund in making the distribution."

Therefore, it is reasonably arguable that section 47(2A) will treat the distributions of the Pre-CGT Gain and paid up capital to the shareholders as if they were made by a liquidator in the course of winding up the company because:

- there was a discontinuance of the company's business;
- the shareholders distributed the company's assets to themselves;
- the Pre-CGT Gain was clearly identified in the company's accounts; and
- the shareholders will then set about having the company deregistered within three years of paying out the distribution.

This means that the distributions will not be taken to be a dividend to the shareholders.

- Treatment of the distributions of the Pre-CGT Gain in the hands of the shareholders

  The distribution of the Pre-CGT Gain and return of capital will represent capital proceeds for the cancellation of the relevant shares for the purpose of determining whether the shareholder makes a capital gain or loss.

  However, because the shares were acquired pre-CGT any capital gain or capital loss is disregarded.

- Division 7A
  - Division 7A loans
    - Division 7A may deem a private company to have paid a dividend where the company makes a loan to a shareholder, and the loan is not fully repaid prior to the lodgement date of the company's tax return (section 109D).
    - Although the amounts distributed to the shareholders are recorded in the Balance Sheet for the 2021 income year as a 'loan', if these amounts do not have the characteristics of a loan, the Company will not be taken to have made a loan to the shareholders and therefore Division 7A will not apply.
    - This is similar to the facts in Private Binding Ruling Number 64984 where the shareholders made a distribution to themselves representing the proceeds from the sale of a pre-CGT asset.

      The shareholders incorrectly recorded the amounts in the financial statements as being an 'unsecured loan'.

      The shareholders believed that the financial statements were incorrect because there was no debtor/creditor relationship between the Company and the shareholder and the amounts received were because of a distribution in the course of the winding-up of a company.

- The Commissioner accepted that the distributions did not have the characteristics of a loan as:
  - the loan was never intended to be repaid; and
  - a debtor/creditor relationship was not created.
- Division 7A payments
  - Division 7A may deem a private company to have paid a dividend where the company makes a payment to a shareholder (section 109C).
  - In Private Binding Ruling Number 94932 the Commissioner's view was that where section 47(2A) applied and the distribution was treated as being a distribution by a liquidator in the course of winding up the company, then provided that the payment was excluded from being treated as a dividend under section 47(1A), Division 7A would not apply because of the exclusion in section 109L.
  - Section 109Lof the 1936 Tax Act provides that a payment or loan to a shareholder is not taken to be a dividend under sections 109C or 109D to the extent that the amount would be either:
    - included in the shareholders assessable income because of a provision other than Division 7A of the 1936 Tax Act operating in conjunction with section 44 of the 1936 Tax Act; or
    - excluded from the shareholders assessable income due to the effect of a provision of the Act other than Division 7A of the 1936 Tax Act.

17. Case study: 15-year exemption payments

Facts

- XYZ Pty Ltd has a capital gain of $1 million in the 2024 year on the sale of its goodwill.

  The goodwill was internally generated from the business which XYZ Pty Ltd commenced in 1995.

  The capital proceeds were $1 million.

- XYZ Pty Ltd was established in 1995 and its shares have always been held by:
  - Matt – 45%;
  - Sue (Matt's wife) – 45%; and
  - Tom (Matt and Sue's son) – 10%.
- Assumptions:
  - XYZ Pty Ltd satisfies the basic conditions to access the small business CGT concessions.
  - XYZ Pty Ltd has had a CGT concession stakeholder for at least 15 years.
  - Matt is 66 years of age, Sue (Matt's wife) is 40 years of age.
  - The sale of the business by XYZ Pty Ltd is in connection with Matt's retirement.
- Questions:
  - Can XYZ Pty Ltd access the 15-year exemption?
  - If so, how do the shareholders get the 15-year exemption amount out tax effectively?
  - Assume that the business commenced in 1984, how can we get the funds out of the company?

Suggested Solution

- Requirements for the 15-year exemption:
  - Requirement 1: Basic Tests for Eligibility for small business concessions satisfied – which they are, that is:
    - XYZ satisfies the $6 million net asset test or is a CGT small business entity; and
    - the goodwill must satisfy the active asset test (be inherently connected with the business XYZ carried on for at least half the time XYZ owned the goodwill).
  - Requirement 2: The goodwill has been owned by XYZ for at least 15 years – which it has been.
  - Requirement 3: XYZ has had a CGT concession stakeholder (that is, an individual with an interest of at least 20%) for 15 years – which it has.
  - Requirement 4: The sale of the goodwill occurs in connection with the retirement of a CGT concession stakeholder – which it did.

This means that XYZ will disregard the capital gain of $1 million on the sale of the goodwill.

- Payment of $1 million to shareholders.
  - If the $1 million is paid out as a dividend, it will be a taxable in the hands of the shareholders.
  - However, the $1 million can be paid out to shareholders tax-free (section 152-125):
    - provided that XYZ makes the payment within two years of signing the contract to sell the goodwill;
    - to the extent that it is paid to a CGT concession stakeholder (an individual who has a fixed interest in the voting, dividend and capital rights of at least 20%); and
    - to the extent of the CGT concession stakeholder's SBPP (interest) in the company just before the CGT event.
  - Therefore, if the $1 million is paid out to the shareholders in proportion with their shareholding:
    - Matt will receive $450,000;
    - Sue will receive $450,000; and
    - Tom will receive $100,000.

    Matt and Sue are both CGT concession stakeholders, therefore their payment will not be taxable to them.

    Tom is not a CGT concession stakeholder (as his interest is only 10%), therefore his payment will be assessable to him.
  - If the $1 million is paid out to the shareholders as follows:
    - Matt - $500,000; and
    - Sue - $500,000.

    Matt and Sue are both CGT concession stakeholders, however the non assessable amount is calculated as:

    Their SBPP (just before the CGT event) x Exempt Amount ($1 million).

    Therefore, Matt and Sue will not include $450,000 (being 45% x $1 million) in their assessable income.
- If the goodwill is pre-CGT, XYZ can still apply section 152-125 provided that it would have been able to access the 15-year exemption had the goodwill been post-CGT.

  As it does satisfy these requirements, then provided XYZ pays the $1 million to the shareholders within two years (or a longer period that the Commissioner allows), Matt and Sue will not have to include the amount in their assessable income.

- Issues to note:
  - If the payment is not made within two years, XYZ can be liquidated and the $1 million can be paid out as a liquidator's distribution (CGT event C2).
  - If all of the shares were acquired pre-CGT but not all of the shareholders are CGT concession stakeholders, it may be more beneficial to do the liquidation as all of the shareholders will have a capital gain on the cancellation of their shares (which will be disregarded if pre-CGT).

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18. Case Study: CGT event E4

Facts

- Dobes Unit Trust has a capital gain in the 2024 year of $4 million on the sale of the real estate used by Dobes Doggy Day Care Pty Ltd.
- It applies the general discount under Division 115 to reduce the capital gain to $2 million.
- It further reduces the capital gain to $1 million under the small business reduction.

Balance Sheet

Asset – Cash	$3,000,002
Equity	
Issued units	$2
Reserve – 50% general discount	$2,000,000
Reserve – small business 50% reduction	$1,000,000
Total Equity	$3,000,002

Solution

- If the trustee winds up the trust and makes a final winding up payment of $3 million, then CGT event C2 will happen and the capital gain will be calculated on $3 million less the cos bae of the shares.
- If the trustee makes an interim capital distribution of $3 million, then CGT event E4 only happens in relation to the $1 million (being the small business reduction). This is because the 50% general discount is ignored for the purpose of CGT event E4.