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

EXPOSURE DRAFT EXPLANATORY MATERIALS

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Glossary

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

<i>Abbreviation</i>	<i>Definition</i>
Exposure Draft	Exposure Draft legislation for the Treasury Laws Amendment (2018 Measures No. #) Bill 2018
CGT	capital gains tax
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>

Chapter 1

Enhancing the integrity of the small business CGT concessions in relation to partnerships

Outline of chapter

1.1 Schedule # of the Exposure Draft amends the tax law to prevent the small business CGT concessions in Division 152 of the ITAA 1997 from being available for assignments of the income of a partner and other rights or interests in the income or capital of a partnership that are not a membership interest in the partnership.

1.2 All legislative references in this chapter are to the ITAA 1997 unless the contrary is specified.

Context of amendments

Small business CGT concessions

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

1.4 These four CGT concessions are:

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

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

1.6 Additional basic conditions apply if the asset is a share in a company or an interest in a trust (the object entity).

Interests in the income or capital of a partnership

1.7 Generally, partners in a partnership are entitled to a share of the income of the partnership. Under Division 5 of Part III of the ITAA 1936, each partner is generally taxed on the partner's share of the net income of the partnership.

1.8 However, a partner can make an assignment of some or all of their interest in the partnership. Such an assignment cannot make the assignee a partner, and usually does not entitle the assignee to influence the exercise of the partner's rights or entitlements. Instead, the effect of such an assignment means that the partner holds the partnership interest on trust for the assignee, and must deal with the interest consistent with the agreed terms. This may require the partner to transfer to the assignee the relevant share of any distributions of income or capital (or both) arising from the asset held on trust (ie. the partnership interest).

1.9 In its decision in *Federal Commissioner of Taxation v Everett* [1980] HCA 6 (FCT v Everett), the High Court found that such an assignment meant that the income received on trust did not form part of the income of the partner. Instead, the income was received on trust for the assignee and taxed in the hands of the assignee as a result of Division 6 of Part III of the ITAA 1936.

1.10 The use of such assignments and similar arrangements has subsequently become common for partners seeking to reduce income tax. Over time, many arrangements have moved away from the facts in FCT v Everett.

CGT interactions

1.11 Such arrangements result in a CGT event occurring and would usually result in a substantial capital gain for the partner.

1.12 This is because the entitlement to the future profits of the partnership is likely to be substantial and the costs of setting up the arrangement (which form the cost base) are likely to be minimal. Further, while in many cases the assignment or similar arrangement would be established on a non-arm's length basis (such as with family members) and the partner would receive minimal, if any, consideration, the market value substitution rule (see section 116-30) would apply. This rule broadly treats the capital proceeds of a non-arm's length transaction as being equal to the market value of the right or interest.

1.13 Prior to these amendments, individuals were able to substantially reduce or eliminate tax when undertaking such an assignment or similar arrangement by applying the small business CGT concessions in Division 152 to reduce or disregard any resulting capital gain.

Budget announcement

1.14 On 8 May 2018 in the 2018-19 Budget, the Government announced that partners that alienate their income by creating, assigning or otherwise dealing in rights to the income or capital of a partnership will no longer be able to access the small business CGT concessions in relation to these rights unless the right is a membership interest in the partnership.

Summary of new law

1.15 Schedule # of the Exposure Draft creates an additional basic condition that must be satisfied in relation to a capital gain in order to access the small business CGT concessions under Division 152 for that gain.

1.16 As a result of the new condition, the small business CGT concessions are only available in relation to a CGT event that relates to a right or interest that entitles an entity to the income or capital of a partnership (or amounts calculated by reference to a partner's entitlement to distributions from a partnership) if the right or interest is a membership interest of the entity that has the entitlement.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
The small business CGT concessions are only available for a capital gain arising from a CGT event that involves the creation, transfer, variation or cessation of an interest or right that entitles an entity to the income or capital of a partnership (or to an amount calculated by reference to a partner's entitlements) if the right or interest is a membership interest held by the entity with the entitlement.	The small business CGT concessions are available for a capital gain arising from a CGT event that involves an interest in or right to the income or capital of a partnership (or to an amount calculated by reference to distributions received by a partner) where the basic conditions are satisfied.

Detailed explanation of new law

1.17 Schedule # of the Exposure Draft amends Division 152 to introduce a new additional basic condition for the small business CGT concessions.

When the condition applies

1.18 The new condition applies to capital gains that arise from a CGT event that involves the creation, transfer, variation or cessation of a right or interest that entitles an entity to either:

- an amount of the income or capital of a partnership; or
- an amount calculated by reference to the partner's entitlement to an amount of income or capital of a partnership.

[Item 2, subsection 152-10(2C)]

1.19 Broadly, the first type of right or interest includes equitable assignments of a partnership interest of the sort considered in *FCT v Everett*, as well as other assignments of rights and interests that entitle an entity to all or part of the income or capital of a partnership.

1.20 In this context, 'income or capital of a partnership' includes but is not limited to the profits of the partnership, the proceeds of the realisation of assets of the partnership and any surplus of partnership assets over liabilities on dissolution.

1.21 The second type of right or interest includes rights and interests that do not provide any entitlement to income or capital of the partnership, but entitle an entity to receive amounts from a partner if the amount is ascertained by reference to amounts the partner receives or is entitled to receive from the partnership.

1.22 An entitlement to a payment or asset is not an entitlement to income or capital of the partnership merely because the entity that is obliged to make the payment or provide the asset is a partner or a partnership. Thus, the new additional basic condition does not apply to such an entitlement.

1.23 For example, if an individual sells their business to a partnership and becomes entitled to a payment, the right to this payment is not a right to or interest in the income or capital of the partnership, merely a right to a payment from the partners.

1.24 The words 'creation, transfer, variation or cessation' encompass any dealing that may affect a right or interest. Any arrangement affecting the entitlement of a partner or giving another entity a related entitlement will result in a CGT event that involves the creation, transfer, variation or cessation of a right or interest of the sort described in paragraph 1.18.

1.25 A CGT event can involve the creation, transfer, variation or cessation of more than one right or interest. If a CGT event affects more than one right or interest, all of the rights and interests involved must satisfy the requirements of the new additional basic condition. That is, each of the rights and interests must be a membership interest in the

partnership of the entity that is entitled to an amount of the income or capital of the partnership as a result of that right or interest (or was entitled to an amount if the right or interest has ceased to exist).

What the condition requires

1.26 A capital gain resulting from a CGT event satisfies the new additional basic condition if all rights or interests involved in the CGT event are membership interests (see section 960-135) of the entity or entities that hold that right or interest immediately after the CGT event occurs.

1.27 If the right or interest ceases to exist as a result of the CGT event, the right or interest must have been a membership interest of the entity that held the right or interest immediately before it ceased to exist.

1.28 This means that the small business CGT concessions are only available for CGT events involving a right or interest in a partnership if the right or interest would be sufficient to make the entity holding the right or interest a partner (including for example, the transfer of all or part of a partner's share in a partnership to another entity, making that other entity a partner or increasing their existing share in the partnership). Other rights and interests are not membership interests within the meaning of the income tax law and cannot satisfy the new condition. This is the case even if the entity that holds the right or interest is a partner due to another right or interest.

1.29 The small business CGT concessions remain available for genuine disposals and transactions that affect the substance of the operation of the partnership. However, they are not available for assignments and other rights or interests that merely result in the transfer of income or capital that a partner receives from the partnership to other entities without making the other entity a partner.

1.30 The effect of the amendments is that the small business CGT concessions would not be available for any capital gain arising from the assignment of such a right or interest by a partner.

Example 1.1: Application of the new condition to a CGT event involving multiple interests

Laura, a partner in a partnership, makes an equitable assignment of half her partnership interest to Dominic, her spouse. This entitles Dominic to half of any amounts Laura receives as a partner, but does not make Dominic a partner.

The assignment results in Laura having a CGT event. The CGT event involves both the variation of Laura's partnership interest and the creation of a right in the hands of Dominic.

Both interests entitle the entity holding the interest – Laura for the partnership interest, and Dominic for the right to income – to an amount of the income and capital of the partnership. As a result, both interests must satisfy the additional basic condition for the small business CGT concessions to be available for the CGT event.

The partnership interest held by Laura is a membership interest of Laura's in the partnership and satisfies the condition. The equitable interest held by Dominic is not a membership interest of Dominic's and cannot satisfy the condition.

As Dominic's interest does not satisfy the new additional basic condition, the small business CGT concessions are not available to Laura in relation to the CGT event.

1.31 Schedule # of the Exposure Draft also makes minor amendments to the guide to Subdivision 152-A to take into account the additional basic condition that must be satisfied for a capital gain to access the small business CGT concessions in Division 152. *[Item 1, section 152-5]*

Application and transitional provisions

1.32 The amendments would commence from the start of the first quarter after Royal Assent.

1.33 These amendments would apply to CGT events that occur after 7.30pm legal time in the Australian Capital Territory on 8 May 2018. *[Item 3]*

1.34 The retrospective application of the amendments is consistent with the Budget announcement by the Government on 8 May 2018.