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

By e-mail: SBCGTintegrity@treasury.gov.au

Attention: Mr Greg Derlacz

Dear Greg

Exposure draft – improving the small business CGT concessions

Chartered Accountants Australia and New Zealand (**Chartered Accountants ANZ**) appreciates the opportunity to comment upon the exposure draft of the Treasury Laws Amendment Bill 2018: improving the small business capital gains tax (**CGT**) concessions.

Executive summary

In the last Budget the government announced that it would amend the small business CGT concessions with effect from 1 July 2017 “to ensure that the concessions can only be accessed in relation to assets used in a small business or ownership interests in a small business.”¹ The proposed measure would deny “access to the concessions for assets which are unrelated to [a taxpayer’s] small business, for instance through arranging their affairs so that their ownership interests in larger businesses do not count towards the tests for determining eligibility for the concessions”. No further information was released until the publication of this exposure draft.

The measures contained in the exposure draft are extraordinarily complex. More importantly, in our view they go beyond what taxpayers could reasonably have expected from the Budget announcement designed to address “integrity” concerns. They reduce what many stakeholders would regard as the intended scope of the concessions. In these circumstances, if the measures proposed in the exposure draft proceed in substantially their current form, in our view:

- The government should explain the reason for the new policy settings.
- The proposed amendments should be simplified and more comprehensively explained in the explanatory memorandum.

¹ See Appendix B for the full extract of the budget announcement.

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- The amendments should apply prospectively to agreements to sell entered into after the release of the exposure draft.

In relation to the last point, the lack of clarity in the announcement, combined with the delay between the announcement and release of the exposure draft, means that taxpayers have in good faith sold, or entered into agreements to sell, interests in entities on the basis that they qualified for the concessions but will not now do so. If this had been known before the sale had concluded and/or terms of agreement had been reached, the structure of the transaction and/or price negotiations may have been different.

In some cases there will be adverse flow on consequences arising from a sale, e.g. where sale proceeds have been locked away in superannuation. Should the changes apply from 1 July 2017 any adverse flow on consequences should be identified and addressed.

Abusive arrangements which the announcement appears intended to address could apply from 1 July 2017, e.g. the selling down of an interest in a large company to below 40% to avoid aggregation in relation to the last sale.

More generally, in our view, the small business CGT concessions need to be reviewed holistically from a policy perspective to ensure that they are appropriate, fit for purpose and are meeting their objectives. To the extent that the exposure draft changes fundamental design principles of the concessions, it would have been preferable for this to have been done through a holistic, public and transparent consultation process rather than an exposure draft containing complex changes with a short consultation period.

Small business CGT concessions need fundamental reform

Chartered Accountants ANZ has been consistently calling for review of the small business CGT concessions.

They are extremely complex provisions for tax agents to navigate, let alone a segment of the taxpayer community for whom tax compliance burdens are already relatively high. As drafted, the proposed amendments add to that complexity.

While this complexity may have resulted in some relatively high wealth individuals accessing the small business concessions in circumstances that were not contemplated when the policy and legislation were formed, our members advise us that this complexity has meant that some genuine small businesses miss out on the concessions.

A fundamental review of the policy rationale for these provisions is needed. This is not a new issue. The Henry Review stated that”

“The concessions are a significant area of complexity within the capital gains tax rules. In a survey of tax practitioners on the drivers of capital gains tax compliance costs, Evans (2004) found that the small business concessions ranked prominently (6 out of 18) in the list of factors. Despite attempts to simplify the concessions, taxpayers are required to navigate a legislative maze of gateway and threshold conditions and then additional conditions that relate to each of the specific concessions.

Evans also found that the concessions have become more complex over time. They have frequently been amended to extend their reach and to ensure that the concessions do not provide opportunities for tax avoidance. The outcome is

*provisions so complex that specialist professional advice is typically required to access them.*²

Any review of the small business tax concessions should involve the issue of a considered consultation paper which outlines what the various policy objectives should be and how to achieve them. A substantial public consultation period is essential as small businesses are an incredibly diverse category of business taxpayer (they operate in a large variety of industries, adopt various types of business structures and can vary from sole traders to substantial employers) and time barriers are significant for this group.

The manner in which these changes has come about is unfortunate and, in our view, a missed opportunity.

Vague announcements and delayed legislation cause hardship

Life, and indeed business, does not stop still due to a government announcement.

As previously indicated, on 9 May 2017 the government announced that it would amend the small business CGT concessions “to ensure that the concessions can only be accessed in relation to assets used in a small business or ownership interests in a small business.”³ The description of the measure at pages 38-39 of Budget Paper 2 does not enlighten taxpayers or tax advisers of anything further and there is no media release about this Budget announcement.

We have reviewed the commentary that was issued by various accounting and information distribution organisations at the time of the Budget announcement and none of them contained analysis that was additional to that contained in pages 38-39 of Budget Paper 2. Some noted that they could not provide more information and suggested delaying transactions until legislation was released.

However, draft legislation was not released until 10 months later. Whilst some small businesses may have been able to delay their transactions, not all could. Numerous members have advised us that given the delay between the announcement and legislation many business transactions had to proceed. These transactions proceeded in good faith on the basis of the existing legislation and conservatively given the vagueness of the Budget announcement. Despite this, members have advised us that the draft legislation exceeds the expected scope of the Budget announcement and that many business transactions will now be adversely affected.

Scope of the draft legislation

As noted above, the scope of the announcement was vague. Our members have raised with us concerns regarding, in particular, the following proposed changes arguably not contemplated by the Budget announcement. This list is by no means complete as the brevity of the consultation period means that we, as well as our members (many of whom are also small businesses) have not had the opportunity to fully review the draft legislation and consider its application to small businesses.

The list can be broadly classified as concerns about the treatment of cash and financial instruments in determining whether an entity satisfies the 80% look through test, the requirement that the object entity be a small business entity (**SBE**) or satisfy the maximum

²

https://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/c_hapter_a1-3.htm

³ See Appendix A for the full extract of the budget announcement

net asset value (**MNAV**) test and issues surrounding the requirement that an entity carry on a business at particular times.

(a) Treatment of cash and financial instruments

Cash and financial instruments which are inherently connected with a business that an entity carries on will be excluded from the 80% look through test unless trading stock or, in the case of financial instruments, issued by particular types of businesses.

This will effectively make it harder for the vast majority of entities to satisfy the 80% test. It also means that at least some of the practical issues associated with the 80% test, which prompted a change in law to include these assets when inherently connected with a business, are once again “live”. Those issues are set out in the Board of Taxation’s 2005 Report on its post-implementation review of the small business CGT concessions – see paragraph 7.2. In particular:

- The nature of some business is such that they have to hold reasonable cash reserves which puts them at a disadvantage to other businesses.
- Even if this is not the case, member feedback is that the effect of the exposure draft is to “punish” small business owners who have managed their businesses well by retaining appropriate cash reserves for working capital purposes and/or it would encourage bad business management in future with business owners using debt to fund working capital (with corresponding interest and risk issues).
- Entities may receive large amounts of cash at particular times during the year so that interests in those entities may stop and start being active assets throughout the year because of the amount of cash at bank or financial instruments. As the active asset test in section 152-35 Income Tax Assessment Act 1997 (**ITAA 1997**) requires the assets to be active for at least half the ownership period (or for at least 7.5 years if held for more than 15 years), the holders of interests in these entities will need to measure the number of days the shares are active to see if the shares pass the active asset test. Despite subsections (3A) and (3B) of s152-40 of the ITAA 1997, this could be quite difficult.

The exclusion of cash and financial instruments from the 80% look through test in most situations is not evident from the Budget announcement.

(b) Requirement that the object entity be a SBE or satisfy the MNAV test

Our feedback is that the requirement that the object entity be a SBE or satisfy the MNAV test could also not have been anticipated from the Budget announcement and so should not apply retrospectively to, for example, the disposal of a 30% interest in a company with net assets of \$8m in circumstances where the shareholder would otherwise satisfy the MNAV test.

In a similar vein, some members say that the requirement that the object entity be a SBE or satisfy the MNAV test on the basis that you aggregate with affiliates and also entities you control based on a 20% (currently 40%) threshold could also not have been anticipated from the announcement.

In these circumstances, taxpayers who have in good faith sold, or entered into agreements to sell, interests in entities on the basis that they qualified for the concessions but will not now do so should not be adversely impacted.

The requirement that the object entity be a SBE or satisfy the MNAV test has broader impacts which we assume were taken into account in recalibrating the scope of the small business CGT concessions:

- Members have indicated to us that this adversely affects founders of businesses who sell large portions of their ownership in their successful business in order to expand their business further. Thus you may have the perverse result that someone who holds onto their shares at the expense of growth can access the small business concession but a person who sells some of their shares to further grow their business cannot claim the small business GST concessions for their remaining shares. This could be seen as a disincentive for growth.
- Other members have indicated that this also discourages collaborative business effort. A person who owns 100% of a business worth \$5.9m can claim the small business concession but two independent people who equally own a business worth \$8m (that is \$4m each) cannot.

(c) Carrying on of a business

Where the CGT asset is an interest in an entity, additional requirements which must be satisfied in order to qualify for the concessions are that:

- Unless you satisfy the MNAV test, you are carrying on a business just before the CGT event; and
- The object entity is carrying on a business just before the CGT event.

These requirements will perpetuate the confusion over the meaning of “carrying on a business”. This issue has already gained significant attention in relation to access to the reduced corporate tax rate for small businesses. While the Australian Taxation Office (ATO) has issued some guidance in relation to companies, it does not extend to individuals or trusts where different considerations may apply.

The requirement that the object entity be carrying on business immediately before the CGT event has other potential impacts:

- Under the existing rules, where for asset protection purposes an entity (e.g. a unit trust) holds valuable assets which are leased to a commonly owned entity which carries on a trading business, a sale of interests in both entities may qualify for the small business CGT concessions. Based on the exposure draft, the sale of interests in the unit trust will not qualify unless the trust is considered to be carrying on a business which may not be the case. We would hope that this is unintended.
- It would seem this requirement will prevent any shareholder from accessing the small business CGT concessions in relation to a gain arising on shares upon the liquidation of a company where the CGT event is triggered upon deregistration date (generally three months after advising the ASIC of the final meeting of members having been held) at which time the company has not conducted any activity for three months. Such a result would not seem within the intended scope of improving the integrity of these provisions.

Flow on consequences

Small businesses which have utilised the small business CGT concessions since 1 July 2017 may have transferred amounts that they thought were non-taxable into superannuation. If the small business is not entitled to the CGT concessions, then these amounts will be reclassified as non-concessional contributions. Non-concessional

contributions are subject to caps⁴. Breaches of these caps result in 47% tax on the excess contribution.

A superannuation fund can refund these excess amounts, however, the small business taxpayer will be required to return and pay tax at their marginal tax rate on notional earnings made in relation to the excess funds which had been deposited into the superannuation fund. These notional earnings are calculated at 9.2%, which is much higher than actual earnings and may be for a period in excess of which the superannuation fund actually held the excess funds.

If the amount is not in excess of the cap but is subject to income tax in the hands of the small business taxpayer, then the small business taxpayer may have difficulty finding the cash to pay the tax debt as the cash has been deposited into superannuation. Taxpayers in this situation would need to rely on the ATO exercising its discretion to allow a refund of the excess contributions tax. Traditionally this has only been exercised in very unusual and extraordinary circumstances.

Given that taxpayers have acted in good faith, this result seems unduly harsh.

We have not considered whether there are adverse flow-on consequences for taxpayers seeking to utilise other small business CGT concessions.

Implementation date needs to be postponed

In the event that the proposed amendments are legislated substantially in their current form Chartered Accountants ANZ calls upon the Government to reconsider the proposed commencement date. In our view, the proposed provisions should only apply prospectively given the vagueness of the Budget announcement, the substantial delay between Budget announcement and exposure draft, and the significant hardships a 1 July 2017 start date can impose on taxpayers.

Should the government wishes to discuss further with stakeholders the policy underpinning the proposed amendments we would be pleased to be involved.

I would be happy to discuss any aspects of our submission with you. I can be contacted on 02) 9290 5609 or by email at michael.croker@charteredaccountantsanz.com.

Yours faithfully,



Michael Croker
Australian Tax Leader
 Chartered Accountants Australia and New Zealand

⁴ Up to \$300,000 p.a. and a lifetime limit of \$1.6 million.

Appendix A – extract from pages 38-39 of Budget Paper 2 of 2017

Tax Integrity Package — Improving the small business capital gains tax concessions

Revenue (\$m)	2016-17	2017-18	2018-19	2019-20	2020-21
Australian Taxation Office	-	-	*	*	*

The Government will amend the small business capital gains tax (CGT) concessions to ensure that the concessions can only be accessed in relation to assets used in a small business or ownership interests in a small business. This measure will take effect from 1 July 2017. This measure is estimated to have an unquantifiable gain to revenue over the forward estimates period.

The concessions assist owners of small businesses by providing relief from CGT on assets related to their business which helps them to re-invest and grow, as well as contribute to their retirement savings through the sale of the business. However, some taxpayers are able to access these concessions for assets which are unrelated to their small business, for instance through arranging their affairs so that their ownership interests in larger businesses do not count towards the tests for determining eligibility for the concessions.

The small business CGT concessions will continue to be available to small business taxpayers with aggregated turnover of less than \$2 million or business assets less than \$6 million.

This measure will improve the integrity of the tax system and ensure that these concessions are appropriately targeted.