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The Treasury
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by email: sbcgtintegrity@treasury.gov.au

Dear Sir or Madam

Submission on Improving the Integrity of the Small Business CGT Concessions

MC Tax Advisors is a specialist tax advisory firm, servicing accounting practitioners and the SME market. We appreciate the opportunity to make a submission with respect to the Exposure Draft legislation('**ED'**) and Explanatory Material ('**EM**') on Improving the Small Business CGT Concessions ('**the Concessions**').

All legislative references below are to the Income Tax Assessment Act 1997.

<u>Modified Active Asset Test</u>

The test in the proposed section 152-10(2B) must be met just prior to the CGT Event in order for the assets of a 'later entity' to be counted as active assets of the 'object entity'. However, section 152-10(2B) requires the taxpayer to be a CGT concession stakeholder.

Only an individual taxpayer can be a CGT concession stakeholder[1]. This means that the modified active asset test cannot be satisfied by a non-individual taxpayer selling shares or interests, if more than 20% of the value of its active assets are held by a subsidiary entity. This may be a drafting error in the legislation. However, if this is intentional, this is a change of policy rather than merely an integrity provision. Historically, changes were made to the Concessions to ensure they could apply to interests disposed by non-individual entities, but this amendment appears to unwind this in many circumstances.

[1] Section 152-60

Submission point

The proposed section 152-10(2B) be extended to include either wording along the lines of section 152-10(2)(e)(ii) with respect to the later entity, or require the object entity to have a small business participation entity percentage in the later entity of 20%.

The modified active asset test is extremely complex, as well as needing to be applied across the ownership period of the object entity. In many instances, it may not be possible for a taxpayer to obtain information regarding the assets and turnover of later entities as they may only have a small, indirect, interest.

Submission point

We submit that the modified the active asset test would be simpler to follow if it was drafted as a standalone test rather than attempting to modify the operation of the existing active asset test in section 152-40(3)(b). Consideration should also be given to whether section 152-40(3)(b) has any residual application, in which case it could be removed altogether.

We further submit that the 'reasonable to conclude test' in section 152-40(3A) be broadened further to allow the modified active asset test to be satisfied where access to financial records in later entities is limited. This could be supported by the issue of a ruling or practical compliance guideline.

The policy reason for exclusion of cash and financial instruments as active assets unless they are trading stock is not clear. Most businesses require some financial assets for working capital and other genuine business purposes, and section 152-40 already includes a requirement that these assets must be inherently connected with the business.

Submission point

If there is concern that taxpayers are treating financial assets as business assets inappropriately, we would recommend the legislation provide additional guidelines on the 'inherently connected' requirement, rather than excluding all (non-trading stock) financial assets from the modified active asset test

Overall, we do not see an immediate policy need for requiring a modified active asset test in these amendments. In our view, the current active asset test provides adequate rules for ensuring the assets within the object entity are in relation to a business.

Requirement for object entity to carry on a business

The proposed section 152-10(2)(c) requires the object entity to be carrying on a business just before the CGT Event.

It is common for businesses to be established with valuable assets separated from the business function for asset protection purposes. This amendment will exclude a passive entity holding an asset which is used by a connected small business entity. This is inconsistent with the current drafting of the Concessions, which allows access for these passively held assets. It may also exclude the sale of interests in holding entity structures, where the only function of the holding entity is to hold interests in subsidiary entities.

It does not seem appropriate to require the object entity to be carrying on a business in the case where the taxpayer has satisfied the MNAV test.

In this regard we note that the ATO's interpretation of carrying on a business may provide disparity between entity structures in this context. We refer to draft Tax Ruling TR 2017/D7 that suggests that a company can be considered to be carrying on a business in a broader range of circumstances than a trust – for example, a holding company or a company that holds a rental property. This may allow an object entity that is a company to satisfy this requirement, but not a trust. It is therefore imperative that the Government provide clarity on this issue.

Submission point

We recommend that either:

Section 152-10(2)(c) be removed on the basis that sufficient integrity is provided by section 152-10(2)(d), in conjunction with the active asset test (subject to our concerns with this subsection below).

Alternatively, a provision could be added similar to section 152-10(1A) to cover an entity that does not carry on a business but holds assets used by a connected entity. However, this would still not deal with the issue of holding entities.

Section 152-49 currently operates to ensure that a taxpayer that is winding down its business can be treated as a small business, even though it may no longer be considered as carrying on a business. As currently drafted, it will not apply to the new requirements to carry on a business in the proposed amendments.

Submission point

We recommend amendments be made to ensure that the operation of section 152-49 extends to section 152-10(2)(b) and (c).

Requirement for object entity to meet MNAV Test or SBE Test

We are concerned with the removal of the Concessions on disposal of interests in entities that would not be eligible for the Concessions directly (as a result of the proposed section 152-10(2)(d)).

If the taxpayer meets the MNAV test, which already considers the value of its interest in the object entity, the requirement for the object entity to also meet the MNAV or SBE test is a change in policy. This is not an integrity amendment, as it has always been the clear intention of the legislation to allow

a taxpayer with a non-controlling interest in an entity to potentially access the provisions, regardless of whether that entity would satisfy the provisions on a standalone basis.

When the Tax Board issued its report to the Treasurer on the SBCGT concessions in October 2005[2] it considered this issue with respect to the application of the MNAV test to partnerships. The Board recommended removal of the requirement that a partnership satisfy the MNAV test in order for any (non-controlling) Partner to access the Concessions on selling an interest in a partnership asset. This was stated as being to align the treatment of partnerships with other entities[3].

These may be appropriate outcomes if the taxpayer itself is relying on the SBE test to access the Concessions, as the policy of the SBE test is that it only applies to the direct sale of business assets. However, it does not seem appropriate to require the object entity to meet these conditions if the taxpayer itself satisfies the MNAV test.

Submission point

We recommend that section 152-10(2)(d) is amended so that it is only applicable where the taxpayer itself is relying on the SBE test.

Application date

The proposed amendments are to apply to CGT Events happening on or after 1 July 2017.

The amendments were announced on Budget night on 9 May 2017 as being 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*".[4] No further details were provided until the release of the ED and EM on 8 February 2018.

The extent of the proposed amendments goes far beyond what could be anticipated from the Budget announcements and were not foreseen by tax practitioners. In the interim period, many taxpayers may have disposed of interests, anticipating access to the Concessions. These taxpayers may not have entered into these transactions (for example, agreeing to sell shares rather than direct business assets, or undertaking an internal transfer) if they had knowledge of the legislation.

Further, taxpayers may have already elected to apply the retirement exemption and made payments to superannuation funds or direct to significant individuals.

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[2] A Post-Implementation Review of the Quality and Effectiveness
of the Small Business Capital Gains Tax Concessions in Division 152 of the Income Tax Assessment Act 1997
[3] Refer paragraph 6.83
[4] Budget 2017-18 Budget Measures Budget Paper No.2 Tax Integrity Package – Improving the small business capital gains tax concessions

Submission point

We recommend that the application date of the amendments be for CGT Events occurring from 8 February 2018 when the draft legislation was released.

In the absence of this, transitional provisions should be included to allow retirement payments to be clawed back without any implications arising under the Income Tax Assessment Acts or Superannuation Industry (Supervision) Act 1993.

Other submission points

In addition to the points made above with respect to the draft provisions, we would also like to make a general recommendation with regards to the approach taken to address the integrity concerns. In our view, a number of these concerns could be more simply addressed by requiring the interest that is being disposed to be related to the business that is being carried on by the SBE. This would prevent the provisions from having broader, unintended, consequences.

If you would like to discuss any of these submission points in further detail, please contact Natalie Claughton on 0403 251373 or Jacci Mandersloot on 0414 987485.

Yours sincerely,

MC Tax Advisors

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