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Senior Adviser
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The Treasury
Langton Crescent
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By email: sbcgtintegrity@treasury.gov.au

Dear Sir or Madam

Submission to Government on Improving the Integrity of the Small Business CGT Concessions

PVW Partners welcomes the opportunity to make a submission on the proposed amendments to the Small Business CGT concessions contained in the *Income Tax Assessment Act 1997* (**ITAA97**).

Introduction

PVW Partners is a locally owned Townsville based firm providing taxation and business advisory solutions for every stage of business growth and development. We believe in the potential of regionally based Australian business to make a strong contribution to the national economy and are proud of the role we play in the growth journey for many North Queensland family owned businesses.

Regional economies have a far greater dependence on small business than do our capital cities (where larger corporate enterprises employ proportionately more people than do smaller businesses). Hence, any changes to the taxation provisions targeted at small businesses, or the families that own those small businesses, have the potential for more adverse and unintended consequences in regional economies than they might in our capital cities.

We are concerned that both the scope of the proposed amendments and, in some aspects, their retrospective effect, will have an inequitably adverse impact on regional Australian economies, like ours in North Queensland.

Our concerns with the proposed amendments

PVW Partners is particularly concerned that proposed amendments extend far beyond the Treasurer's announcement in the 2017-18 Budget on 9 May 2017. Although there are some integrity provisions which could reasonably be anticipated from the budget announcement, there are numerous unexpected substantive law changes which do not fall within the scope of the improvements as announced in the Treasurer's Media Release on 8 February 2018:

> *This is an integrity rule designed to prevent taxpayers from accessing these concessions for assets which are unrelated to their small business, such as by arranging their affairs so that their ownership interests in larger businesses do not count towards the tests for determining eligibility for the concessions.*

We have specific concerns in relation to the following aspects of the Exposure Draft:

1. The requirement for the object entity to be carrying on a business just before the CGT event;
2. Cash at bank used in the business is excluded from being an active asset; and
3. The object entity must be a CGT small business entity or would satisfy the maximum net asset value test under a certain set of assumptions

The resulting retrospective operation of the legislation is also unfair on taxpayers who have entered transactions between 1 July 2017 and release of the exposure draft in reliance of the current law without knowing the details of the proposed changes.

The 2004 Treasury Department review of aspects of income tax self-assessment concluded that tax measures imposing new obligations should apply prospectively but retrospective commencement dates may be appropriate where a provision:

- corrects an 'unintended consequence' of a provision and the ATO or taxpayers have applied the law as intended;
- addresses a tax avoidance issue; or
- might otherwise lead to a significant behavioural change that would create undesirable consequences, for example bringing forward or delaying the acquisition or disposal of assets.

We submit that the majority of the substantive law changes introduced by the proposed amendments exhibit none of these characteristics and it is therefore appropriate that they operate on a prospective basis.

We also note that Senate Procedural Order 44 deals with retrospectivity of taxation bills and states:

> *Where the government has announced, by press release, its intention to introduce a bill to amend taxation law, and that bill has not been introduced into the Parliament or made available by way of publication of a draft bill within 6 calendar months after the date of that announcement, the Senate shall, subject to any further resolution, amend the bill to provide that the commencement date of the bill shall be a date that is no earlier than either the date of introduction of the bill into the Parliament or the date of publication of the draft bill.*

As the exposure draft was released 9 calendar months after the Budget announcement, and contained many substantive law changes that could not have been reasonably expected from the original Budget announcement, we recommend that the commencement date of the legislation be postponed at least until the date of the exposure draft, or preferably 1 July 2018, to remove the retrospective nature of the legislation and also to enable taxpayers currently negotiating business sale agreements in reliance of the current CGT concessions to conclude those transactions under the current law.

1. Object entity required to be carrying on a business just before the CGT event

The proposed amendments introduce additional basic conditions in s152-10(2) to be satisfied if the CGT asset is a share in a company or an interest in a trust. The proposed additional conditions include the requirement that the object entity is carrying on a business just before the CGT event. This proposed requirement effectively prevents taxpayers from accessing the small business CGT concessions on a winding-up of a company or trust following the sale of an active business, as the object entity will not be carrying on a business just before the CGT event.

Under the current law, taxpayers operating their small businesses in a company or fixed trust can elect to apply the small business 50% reduction in s152-205 ITAA97 to reduce the capital gain by 50%. Although this may leave the company or trust with untaxed retained earnings, they could be distributed to the shareholders or unit holders as a capital payment upon liquidation of the company or trust. The current small business CGT concessions could apply to the capital gain arising on the CGT Event on distribution of those proceeds provided the basic conditions in s152-10 were satisfied. However, the proposed amendment denies the application of the small business CGT concessions to the capital payment on liquidation and effectively claws back the small business 50% reduction that was previously applied by the company or trust. There will be now be an even greater disparity in the generosity of the concessions between companies and discretionary trusts, and as between an asset sale or entity sale.

This additional condition was not contained in the Budget announcement and goes beyond a mere integrity provision. Taxpayers who have structured the sale of their active small businesses as an asset sale rather than an entity sale during the intervening period with the expectation that the small business concessions would apply to the extraction of those proceeds under the existing law will be unfairly impacted by the proposed change.

The proposed change may also prevent taxpayers accessing the concessions in the following scenarios:

- sale of interests in an object entity that holds passive assets, even though the assets pass the active asset test by being used in a business carried on by a connected entity or an affiliate; and
- sale of interests in an object entity that is a holding company in a corporate group, where the subsidiaries carry on the active trading business or businesses

There is currently significant uncertainty as to when a company is carrying on a business and there appears to be conflict between Treasury and the Commissioner of Taxation **(the Commissioner**) on this issue.

On 18 October 2017 the Commissioner published *TR 2017/D7* Income tax: when does a company carry on a business within the meaning of *section 23AA of the Income Tax Rates Act 1986*? This draft ruling provides guidance on when a company is carrying on a business and confirms that, in the Commissioner's view, companies are likely to be carrying on a business where they are established and maintained to make a profit for their shareholders and invest their assets in gainful activities which have both a purpose and prospect of profit. Although the Ruling is framed in relation to section 23AA, the Commissioner considers that it is equally applicable to the small business entity provisions and intends to finalize the draft ruling in relation to *section 23 of the ITRA 1986* and *328-110 of the ITAA 1997*, rather than section *23AA of the ITRA 1986* as it is presently drafted.

If Treasury shares the Commissioner's view and considers that passive investment activities of a company will be sufficient for it to be carrying on a business, the introduction of a new requirement that the object entity carries on a business just before the CGT event appears to be superfluous, as almost all companies will be carrying on a business in the Commissioner's view (except where they are in liquidation). Therefore, it appears that the policy intent has changed with the result that the object entity must be carrying on an active trading business just prior to the CGT event.

We do not agree with this policy change, as it will make the small business CGT concessions inaccessible to many common business structures which were designed to protect valuable business assets, such as intellectual property or business premises, from the risks associated with the trading operations.

If the policy intent has actually changed, and it is intended that the small business CGT concessions should not apply to holding companies or passive asset holding entities even though the assets are used in business of a related entity, we recommend that this is expressly clarified in the Explanatory Memorandum to provide certainty to taxpayers.

2. Cash at bank not an active asset

Currently, to determine whether a share in a company or an interest in a trust is an active asset, it is necessary to look through the company or trust and establish whether 80% of the company or trust's assets are active (**80% look through test**). Cash and financial instruments counts towards the satisfaction of the 80% look through test provided that they are inherently connected with the business.

The proposed modified active asset test in section 152-10(2) imposes a new requirement that, for the purposes of the 80% look through test, financial instruments that are inherently connected with a business must be held either:

- as trading stock, or
- issued by the object entity in the course of conducting a financial services business.

The Commissioner is of the view that a bank account is a financial instrument and therefore bank accounts held by taxpayers that are not conducting a financial services business will not be active assets for the purpose of the 80% look through test.

There does not appear to be any integrity reason for the introduction of this additional requirement and it is submitted that it will lead to inappropriate and perhaps unintended outcomes in genuine business situations. There are many small businesses that may have significant cash deposits from

time to time due to inconsistent cash flows or as a requirement imposed by business contracts designed to ensure financial viability of the contractor.

For example, a primary producer growing seasonal crops may receive all of its income in a three-month period and bank the proceeds to fund the business expenses incurred over the remaining nine months of the year. Or a business performing civil construction services may be required to maintain a term deposit to obtain the bank guarantee required to be provided under the terms of the civil construction contract.

The proposed amendment effectively repeals the legislation that was introduced in response to the Recommendation 7.5 of the Board of Taxation's Recommendation Report to the Treasurer: 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:

> *To provide a more practical test which takes into account actual taxpayer circumstances and commercial practices, subsection 152-40(3) should be amended so that financial instruments of the company or trust which are inherently connected with a business are included as active assets for the purposes of the 80 per cent look through test.*

The proposed change to the 80% look through test not only applies to CGT Events from the date of the Budget announcement, it has retrospective application to periods prior to 1 July 2017 as the modified active asset test looks back at the history of the ownership of the relevant interests in the object entity.

3. Object entity is either a CGT small business entity or passes modified $6m net asset value test

The proposed additional conditions in section 152-10(2) also includes the requirement that the object entity is either a CGT small business entity for the income year or would satisfy the maximum net asset value test ($6m net asset test) under a certain set of assumptions.

This is another substantive change in the law and should not operate on a retrospective basis. In our view, this additional requirement is too restrictive in relation to the $6m net asset test. The requirement for the object entity itself to pass the $6m test, where its turnover is greater than $2m, can result in inequitable treatment as between taxpayers.

For example, a taxpayer with net assets of $1.5m from a 25% interest in a company with net assets of $6m will now not be eligible for the small business CGT concessions, but a taxpayer with net assets of $5.5m from a 100% interest in a company with $5.5m of net assets remains eligible for the concessions.

The Treasurer's Media Release on 8 February 2018 stated that these concessions will continue to be available to genuine small business taxpayers with an aggregated turnover of less than $2 million or business assets less than $6 million.

If the policy intent has changed so that it is the turnover or business assets of the object entity that is being tested, rather than the turnover or net assets of the taxpayer and connected entities, we recommend that legislation be amended to:

a) exclude non-business assets of the taxpayer from the maximum net asset test, rather than the limited exclusions currently in s152-20(2); and

b) remove the requirement for the taxpayer to be carrying on a business just before the CGT event where the object entity is a CGT small business entity.

Should you have any queries, or wish to discuss any aspect of the submission, please contact Carl Valentine on (07) 4721 8543 or Scott Vollmerhause on (07) 4721 8681.

Yours sincerely,

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