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TIES: ISSUE FOR SUBMISSION

1. Please provide your contact details (full name, postal address, contact details during business hours, email address).

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2. Do you represent a professional body, company or firm? If so please provide details (optional).

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3. What is your role in that professional body, company or firm (optional)?

Tax Counsel

4. What area of the law are you concerned about (i.e. GST, superannuation, capital gains tax)?

Capital gains tax – small business CGT concessions

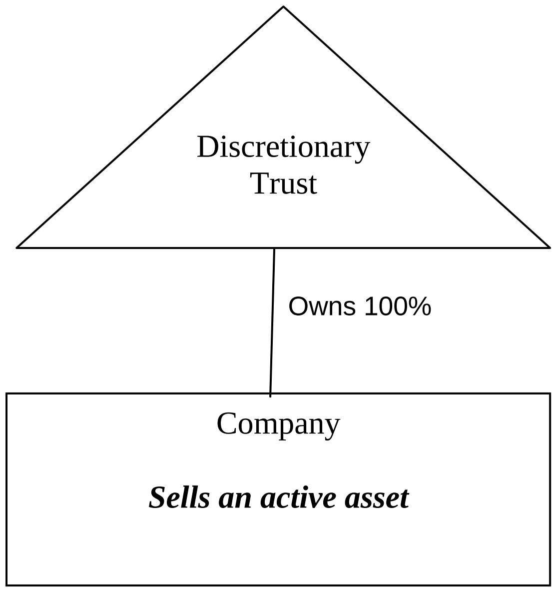
5. ***What Act (including the year of enactment) and section does this issue relate to?***

Income Tax Assessment Act 1997, Division 152

6. ***Please describe your issue in general terms as clearly as possible.***

The issue relates to a common structure where a company or unit trust is owned by one or more discretionary trusts. The sale of a business or active asset by the company or unit trust may not be eligible for the 15-year exemption simply because the discretionary trust has not had the capacity to make income or capital distributions in one or more years (despite having otherwise satisfied the relevant statutory requirements).

Simple Example



Technical Analysis

All references are to the *Income Tax Assessment Act 1997* unless otherwise stated.

The small business CGT concessions are set out in Division 152. The concession of concern in this submission is the 15-year exemption which is set out in Subdivision 152-B.

The pre-conditions for the 15-year exemption are outlined in section 152-110(1). The current issue involves the application of section 152-110(1)(c). The section and accompanying note provide as follows:

> *"(c) the entity had a *significant individual for a total of at least 15 years (even if the 15 years was not continuous and it was not always the same significant individual) during which the entity owned the CGT asset;*
>
> ***Note: There is an exception for discretionary trusts that have tax losses or no taxable income for an income year: see section 152-120****."*
> (Emphasis added.)

A significant individual is defined in section 152-55 as an individual with *"a small business participation percentage in the company or trust of at least 20%".*

The definition of small business participation percentage in section 152-65 comprises the sum of both direct and indirect interests.

The direct interests are outlined in section 152-70(1). Where the seller of the active asset is a company, we are first required to look to the direct legal and equitable interests in voting power, dividends and capital under item 1 of the table in s.152-70(1). Where discretionary trusts hold all the shares in the company it is apparent that no individual holds a direct interest in the company.

It is therefore necessary to look at the indirect interest or more precisely the "indirect small business participation percentage" as defined in section 152-75(1). Importantly, this provision relies extensively on section 152-70(1) for its operation. Section 152-75(1) specifically requires the calculation of direct interests (i.e section 152-70(1)) at different levels which are then multiplied to determine the indirect interest. Section 152-75(1) provides as follows:

> *"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 intermediate 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 or 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.*

Therefore, in the case of a company in which all the shares are held by discretionary trusts, an indirect interest in the company is determined by multiplying the following:

1. The direct interest of the discretionary trust in the company (i.e. 100%); and

2. The direct interest of an individual in the discretionary trust

Working out the direct interest of the individuals that benefit under the discretionary trust/s requires looking at the distributions of income or capital by the discretionary trust in accordance with item 3 of the table in subsection 152-70(1). However, where the discretionary trust did not have the capacity to make income or capital distributions, that brings us to the concession in section 152-120 which has specific application for the purposes of item 3 of the table in subsection 152-70(1):

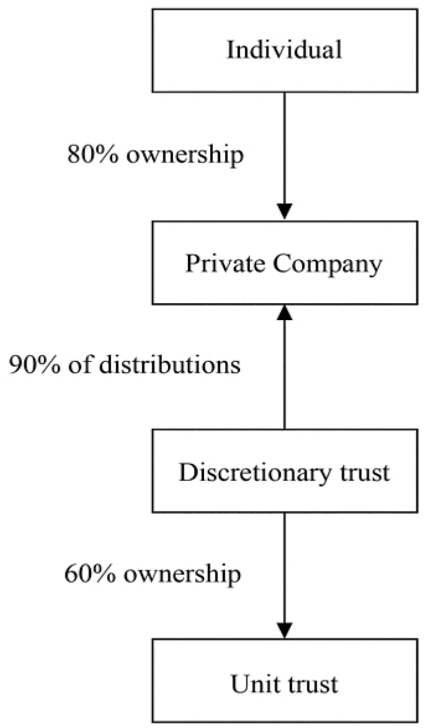
"152-120 Discretionary trusts need not have a significant individual in a loss year or nil income year

*Paragraphs 152-105(c) and 152-110(1)(c) apply for a trust referred to in item 3 of the table in subsection 152-70(1) as if the trust had a *significant individual during an income year for which the trustee did not make a distribution of income or capital, if the trust had a *tax loss, or no taxable income, for that income year.*

Note: This is because the trust might not have had the funds to make a distribution during that income year, which would prevent it from having a significant individual in that year."

While arguably the effect of section 152-120 is to deem the discretionary trust to have a significant individual for those years where there was no distribution of income or capital, this section does not specifically deem any individual to have a small business participation percentage which appears to be a pre-requisite for the operation of section 152-110.

Section 152-75(2) provides the following example which includes a discretionary trust as an intermediate entity in a control chain of entities:



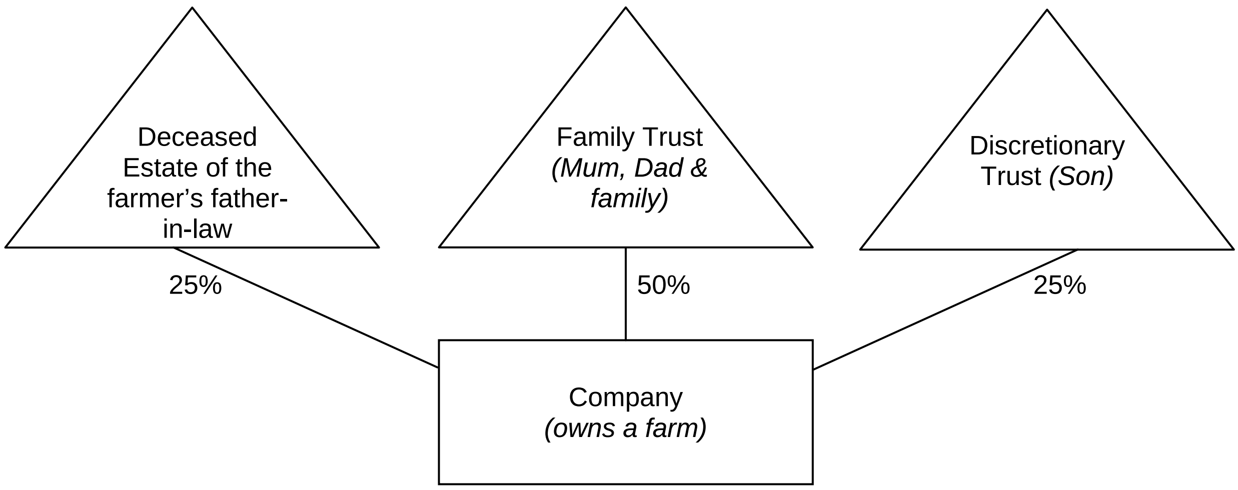
While the discretionary trust in this example has made distributions, it is evident from section 152-120 and the note to section 152-110(1)(c) that these provisions are not intended to penalise the beneficiaries of a trust merely because "the trustee did not make a distribution of income or capital or, if the trust had a tax loss or no taxable income" for the relevant year.

Example

An example is as follows.

Facts

This case relates to the sale of a farm which is the family's principal asset. The structure is broadly summarised as follows:



The family is proposing to sell the farm which has been owned by the company for over 15 years (per the structure diagram above);

4. The company satisfies the basic conditions for small business CGT relief under section 152-10 of the *Income Tax Assessment Act 1997*;

5. The family trust is a discretionary trust. This trust has directly owned 50% of the shares in the company for more than 15 years. The family trust has always been administered for the benefit of the same individuals (farmer, spouse and children);

6. The remaining shares are owned by:

   - The estate of the farmer's father-in-law which owns 25% of the company;

   - A discretionary trust established for the benefit of the farmer's son and his family. The son also works on the farm.

7. The primary individuals (i.e. farmer and spouse) are retiring and consequently wish to sell the farm;

8. The farm has suffered losses due to drought conditions for many years. Consequently, the company has not been able to declare dividends and the family trust has not made distributions of capital or income to the beneficiaries.

Tax outcome under current legislation

As per the analysis set out above, farmer and his spouse would arguably not be able to access the 15-year exemption on sale of the farm despite the fact that they are retiring and the company otherwise satisfies the basic conditions for relief under section 152-10.

While section 152-120 may arguably deem the family discretionary trust to have a significant individual, the provisions do not specifically attribute a “direct small business participation percentage” of at least 20% which is a prerequisite to access the 15-year exemption in multi-tier structures.

This outcome is clearly contrary to the legislative intention of these provisions. The required interpretation of the provisions clearly results in an anomalous outcome for discretionary trusts as the 2007 amendments were intended to allow the small business CGT concessions to apply to multi-tier structures and facilitate tracing of direct and indirect interests through one or more interposed entities.

7. How is this problem affecting you or your clients?

This problem will affect a large number of taxpayers who use the business structure (or one similar to) the example set out above. This is obviously a very common business structure. The difficulty arises where the relevant discretionary trust did not have the capacity to make income or capital distributions to beneficiaries in one or more years. Due to the current economic conditions, it is foreseeable that a significant percentage of trusts will be in this position. For example, this is a common occurrence for primary producers who have suffered prolonged drought conditions and also potentially for the broader small business community in light of the global financial crisis.

With the information publicly available, it is not possible to quantify the value of this issue. However data collected by the Australian Taxation Office (ATO) may be able to provide some insight into the quantum of this issue.

In this regard, it should be noted that this issue was raised for consideration by the ATO at the NTLG Losses and CGT sub-committee meeting held on 14 November 2007. Minutes of this meeting in relation to this agenda item are attached for your information.

The ATO expressed its view at this meeting (as recorded in the minutes of the NTLG losses and CGT sub-committee meeting attached) that the 15-year exemption is not available in these circumstances based on the current drafting of these provisions. At that meeting, the ATO referred the matter to Treasury for legislative amendment/clarification and has asked for further practical examples to assist in finding a solution.

We hope the example provided will assist you in developing a solution to this issue.

8. ***Do you have a possible solution to your issue?***

We submit that minor legislative amendments are required to clarify the operation of the 15-year exemption in the circumstances where one or more discretionary trusts hold significant equity in a private company or unit trust which owns an active asset.

We submit that the small business CGT concessions be amended to ensure that:

a. the 15-year exemption clearly applies in these circumstances; and

b. the provisions either attribute a small business participation percentage or remove the necessity for a small business participation percentage where the relevant discretionary trust has been administered for the benefit of the same family.

A corrective amendment would provide clarification and be entirely consistent with the objectives of the small business CGT concessions and, in particular, the 2007 amendments which were intended to extend the concessions to multi-tier structures.

We therefore submit that any legislative amendment have retrospective operation to avoid unfair outcomes for a potentially significant number of taxpayers who may have relied on the operation of section 152-120.

If you require any further information or assistance in respect of our submission, please contact me on 02 9958 3332 or the Taxation Institute's Tax Counsel, Deepti Paton, on (02) 8223 0044 .

Yours sincerely

David Williams
President