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The small business CGT concessions and super – The practical aspects

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The publication has been written by Darren Wynen of Insyt Pty Ltd and is based on the law as stated 2 February 2020.

All references are to the ITAA 1997, unless otherwise stated.

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Publications

Insyt has now released an in-depth guide on the interaction of the small business CGT concessions and superannuation:

Comprehensive Guide to the Small Business CGT Concessions and Super, by Darren Wynen (160 pages) – available now from:

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The Small Business CGT concessions – the practical aspects

Introduction

The government introduced the small business CGT concessions (SBCs) to provide small business operators with options to fund their retirement or grow their businesses. These concessions include a 15-year exemption; retirement exemption; a 50% active asset reduction and small business rollover.

The SBCs allow eligible small businesses to reduce and/or defer a capital gain arising from the sale of a qualifying business asset (i.e., an active asset). The 15-year exemption also provides a further tax benefit in that an entity can distribute the disregarded capital gain (including gains on pre-CGT assets) to the stakeholders tax-free.
In addition to the tax concessions, an individual can choose for certain superannuation contributions made from the disposal of qualifying small business assets to count against a 'CGT cap' (i.e., instead of their non-concessional or concessional contributions cap). The cap is $1.48 million (2019 income year), increasing to $1.515 million (2020 income year).

The CGT cap recognises that many small businesses invest in their business, rather than regularly making superannuation contributions. That is, small businesses tend to use equity built up over time to provide for their retirement rather than save on an incremental basis.

Although the tax breaks and superannuation benefits provided by the concessions and the CGT cap are attractive, a range of conditions regulate access to the benefits. Also, the sale of a business asset by our clients is not an 'everyday' occurrence – adding a layer of complexity to determining whether the client can access the SBCs and CGT cap.

CGT Concessions under Review?

The Board of Taxation has released a report reviewing the small business CGT concessions. In its review, the Board noted that "Some of the capital gains being sheltered through the small business CGT concessions are considered to be excessive compared to what the concessions were originally meant to deliver and what the Board considers appropriate." Accordingly, the Board made the following recommendations:

- Integrating the eligibility criteria with the small business entity regime by raising the aggregated turnover threshold to $10 million per annum; and
- Repealing the maximum net asset value test; and
- Collapsing the 15-year exemption, active asset reduction and retirement exemption and replacing them with one CGT exemption subject to a cap.

The Government released the report on 12 December 2019, but has did provide any response to the review.

Terminology

The table below outlines common terminology applicable to the small business CGT concessions.

Term	Description
Affiliate	An affiliate is an individual or company that, in relation to their business affairs, acts or could reasonably be expected to act: • in accordance with the taxpayer's directions or wishes, or • in concert with the taxpayer. Trusts, partnerships and superannuation funds cannot be affiliates. Further, an affiliate must be carrying on business.
CGT concession stakeholder	An individual is a 'CGT concession stakeholder' of a company or trust if they are either: • A significant individual; or • The spouse of a significant individual and they have a small business participation percentage in the company or trust that is more than zero.
CGT small business entity	A CGT small business entity has an aggregated turnover of less than $2 million.
Connected entity	An entity is connected with another entity if: • Either entity controls the other entity, or • Both entities are controlled by the same third entity. This is discussed in more detail below.
Significant individual	An individual is a significant individual in a company or trust if they have a small business participation percentage in the company or trust of at least 20%. This 20% can be made up of direct and indirect percentages.
Small business participation percentage	An entity's small business participation percentage in another entity at a time is the sum of: • The entity's direct small business participation percentage in the other entity at that time; and • The entity's indirect small business participation percentage in the other entity at that time.

The SBCs and superannuation

Contributing to superannuation using the CGT cap is unique in that advisers must work through both of the following areas of law:

A. **Tax** – assess whether their client is eligible for the small business CGT concessions (SBCs) under Division 152; **and**

B. **Superannuation** – ensure that the receiving superannuation fund can accept the CGT cap contribution, and that the contributing individual meets the eligibility criteria for the CGT cap.

An individual can only access the benefits of the CGT cap if they satisfy the SBCs first. Hence, the challenge for superannuation advisers is ensuring that small business clients satisfy the 'tax rules' in Division 152 before accessing the CGT cap. Advisers should not only check that the taxpayer qualifies for the SBCs and CGT cap on selling an asset (see roadmap A1), but check whether the current structure of existing small business clients is likely to meet the SBCs when they eventually sell (see roadmap A2).

The small business CGT concessions – what are they?

The small business CGT concessions outlined in Division 152 of the ITAA 1997 are outlined in the table below:

Concession	Description
The small business 15- year exemption	Any capital gain or loss is disregarded if the entity has continuously owned the asset for more than 15 years and the event happens in connection with the permanent incapacity or retirement of an individual aged at least 55.
Small business 50% active asset reduction	Provides for a 50% reduction of a capital gain where the basic conditions are satisfied (optional).
Small business retirement exemption	Exempts a capital gain up to a lifetime (unindexed) limit of $500,000 per eligible individual. However, the exempt amount must be paid into a complying superannuation fund if the relevant individual is under 55 at the time of making the choice.
Small business rollover	Defers a capital gain for a minimum of two years where no replacement asset is acquired. The capital gain can be deferred for a longer period of time if a replacement asset is acquired, or a capital improvement is made to an existing asset.

Understanding the CGT cap

The CGT cap is separate to the concessional and non-concessional contributions caps and recognises that many small business operators reinvest in their business and later use equity from their business to fund their retirement. Amounts from the 15-year or retirement exemption can be counted against the CGT cap (conditions apply).

The CGT cap is a lifetime, indexed cap ($1.48 million for the 2019 income year and $1.515 million for the 2020 income year) that is reduced by each qualifying contribution that counts against the cap. The CGT cap applies to contributions from 10 May 2006 and it only applies for contributions made where the amount is not included in the assessable income of the superannuation fund. That is, the contribution must be a personal superannuation contribution for which no deduction is claimed.

Note that a contribution is only counted against the CGT cap if a written election in an approved ATO form is provided to the superannuation fund on before the time that the contribution is made. The purpose of making this written election is to ensure that the superannuation fund correctly reports the contribution against the CGT cap instead of the non-concessional contributions cap.

The CGT cap provides an opportunity for small business operators to 'top-up' their superannuation using proceeds from either of these exemptions, provided that the eligibility criteria are met.

The benefits of the CGT cap for small business owners are as follows:

- **Total superannuation balance limit does not apply** – contributions counted against the CGT cap are not subject to the total superannuation balance restriction. In contrast, an individual's non-concessional contributions is zero if their total superannuation balance as at 30 June of the previous income year is at least $1.6 million.

- **Applies in conjunction with other contribution caps** – an individual can potentially contribute under their concessional and non-concessional contributions caps. As noted above, from 1 July 2017 the non-concessional cap will be nil for an income year if the individual has a total superannuation balance of at least $1.6 million at the end of 30 June of the previous financial year. In these circumstances, if non-concessional contributions are made in that year, excess non-concessional contributions will arise.

Although the CGT cap is only applicable for contributions relating to the 15-year and retirement exemptions, the CGT cap has its own set of rules in S.292-100 that must be satisfied before the contributions can counted towards the cap. That is, eligibility for the 15-year exemption or the retirement exemption does not guarantee that the individual automatically qualifies for the CGT cap.

General characteristics of the CGT cap

Set out in the table below are the general characteristics of the CGT cap:

Item	Description
Contribution counted in the year of being made	The contribution is counted towards the CGT cap in the income year in which the contribution is made (not the year in which the CGT event occurs).
CGT cap is a lifetime cap	The CGT cap is a lifetime limit, which is indexed annually. Currently, the cap is \$1.48 million (2019 income year) and \$1.515 million (2020 income year).
Contribution can be split between the CGT and other caps	An individual is permitted to part of an eligible contribution to count towards the CGT cap. This means that an individual can potentially divide the contribution between the CGT cap amounts, non-concessional contributions and/or concessional contributions.
Acceptance rules must be satisfied	A contribution made under the CGT cap is a 'member contribution' for the purposes of the acceptance rules in Reg 7.04 of the SIS Regs 1994. This means that: • Individuals aged between 65 and 74 when the contribution is made must meet the 'work test' unless the one-year work test exemption applies (from 1 July 2019) for individuals with low superannuation balances (discussed below); and • CGT cap amounts cannot be accepted for members over 75. Note that Reg 7.04(6A) provides an exception for 'look-through earnout rights'.
Preserved benefit	The CGT cap amount is generally treated as a preserved benefit for members under 65 (i.e., requiring a condition of release to be satisfied before the benefit can be accessed). Refer to Reg 6.10 of the SIS Regs 1994.
Total superannuation balance	Amounts counted towards the CGT cap are not subject to a total superannuation balance condition (i.e., as are non-concessional contributions).
Retirement exemption	Contributions of up to \$500,000 (unindexed) of capital gains that are disregarded under the retirement exemption can potentially count towards the cap.
15-year exemption (individual)	The capital proceeds from the disposal of assets that qualify for the 15-year exemption can potentially count against the cap.
15-year exemption (company or trust)	The capital proceeds from the disposal of assets from a company or trust can potentially count towards the CGT cap.
Written election to be made	The individual must make a choice in the approved form (see the Appendix for a sample) and give it to the superannuation fund on or before the time that the contribution is made. This form does not need to be lodged with the ATO.

Suggested approach to determining eligibility for the concessions and contributing to superannuation

Set out in the table below is a roadmap for approaching the SBCs and the CGT cap for a client that has sold their business:

Item	Description
Reviewing the tax aspects of the SBCs	
Step 1 – Determine if the basic conditions are met	Check whether the taxpayer satisfies the basic conditions in S.152-10 (i.e., because access to any SBC is subject to these conditions being met).
Step 2 – Review the CGT ordering rules	Know the order that the SBCs, capital losses and general 50% CGT discount apply (S.102-5) because this impacts on the capital gain amount that is disregarded under the 15-year and retirement exemption. In turn, this determines the level of any superannuation contributions that can be covered by the CGT cap instead of the non-concessional contributions cap.
Step 3 – Determine whether the taxpayer qualifies for the SBCs	Work out: • Which of the SBCs the taxpayer might qualify for; • Whether the taxpayer satisfies the conditions required to access the specific concession; and • Whether it serves the taxpayer to apply the particular concession/s. For example, the taxpayer may ignore the 50% active asset reduction to maximise the contributions to superannuation under the CGT cap.
Review the superannuation aspects of the SBCs	
Step 4 – Check the acceptance rules	Stakeholders seeking to make superannuation contributions using the CGT and/or other contribution caps must check that the fund can accept the contribution (e.g., that the acceptance rules in Reg 7.04 of the SIS Regs 1994 are met).
Step 5 – Review whether the 15-year or retirement exemption applies and obtain the individual's total superannuation balance (if making NCCs)	Check whether the taxpayer will contribute under the small business 15-year exemption or the small business retirement exemption, and whether the individual will make any additional superannuation contributions (e.g., using the non-concessional contributions cap). Obtain all stakeholder's total superannuation balances as at 30 June if they intend on making non-concessional contributions.
Step 6 – Determine the level of superannuation contributions	From Step 5, work out the level of superannuation contributions and type that the taxpayer and/or the individual/s are planning to make. Then, ensure that the superannuation fund receives the contributions, and any required CGT cap elections, within the applicable time limits.

Case Study 1 – 15-year exemption

The facts of the case study are as follows:

- A unit trust (the Royal Unit Trust) is owned by two family discretionary trusts. Camilla (aged 62) and Charles (aged 67) control one discretionary trust, whilst William (aged 38) and Catherine (aged 38) control the other discretionary trust.
- The discretionary trusts generally distribute to bucket companies, which are owned by on a 50/50 basis by Camilla and Charles, and William and Catherine respectively.
- Assume that the unit trust is a 'fixed trust' and that the shares in the company as simply ordinary shares.
- The unit trust is a CGT small business entity, which has carried on business for the last 20 years.
- A contract was entered into on 3 March 2020 to sell the goodwill and land from which the business was conducted. Assume that settlement occurs on 5 May 2020.
- The sale is happening in connection with Charles' retirement.
- Kate and William do not wish to contribute to superannuation.
- Details of the capital gain made on each asset are set out below:

Asset	Date of purchase	Asset cost base	Consideration received	Capital gain
Land	1998	$150,000	$1,100,000	$950,000
Goodwill	1998	Nil	$1,000,000	$1,000,000
Total		**$150,000**	**$2,100,000**	**$1,950,000**

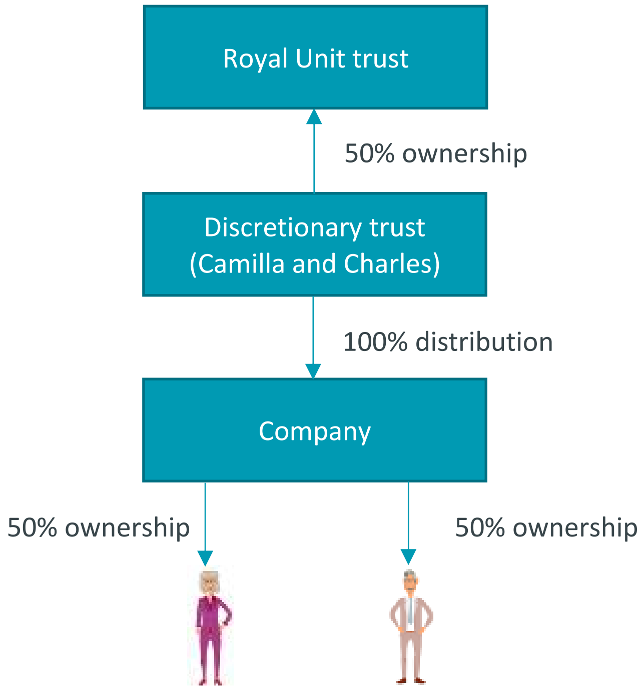
Question 1 – Is the unit trust eligible for the 15-year exemption?

Following the roadmap outlined above:

<table>
<tr><th>Item</th><th>Description</th></tr>
<tr><td colspan="2">Reviewing the <u>tax aspects</u> of the SBCs</td></tr>
<tr><td>Step 1 – Determine if the basic conditions are met</td><td>The Royal Unit Trust must satisfy the basic conditions:
• The Royal Unit Trust is a CGT small business entity.
• Assume the active asset test is met for the goodwill and the land.</td></tr>
<tr><td>Step 2 – Review the CGT ordering rules</td><td>The 15-year exemption applies before any capital losses. If the conditions are met, the capital gain can be disregarded in full.</td></tr>
<tr><td>Step 3 – Determine whether the taxpayer qualifies for the SBCs</td><td>• The Royal Unit Trust had a significant individual for a total of at least 15 years of the whole period of ownership (even if it was not the same significant individual during the whole period); and
• The individual who was a significant individual just before the CGT event was:
o At least 55 years old at that time and the event happened in connection with their retirement, or
o Was permanently incapacitated at that time.</td></tr>
</table>

Question 1(a) – How do we work out whether the unit trust had a significant individual for 15 years?

The example will now focus on Charles and Camilla's' 50% interest in the Royal Unit Trust. To determine whether the Royal Unit Trust satisfies the significant individual test, assume that the unit trust has always had net income to distribute and that the discretionary trust distributed the balance to the bucket company.



An individual is a significant individual of a company or trust if they have a small business participation percentage of at least 20% which is made up of the following:

- The direct small business participation percentage; and
- The indirect small business participation percentage.

Charles and Camilla do not have any direct ownership interest in the Royal Unit Trust. Therefore, we need to work out their indirect small business participation percentages. We do this as follows:

- **Work out Charles and Camilla's direct participation percentage in the company** – this is 50% each, being the smallest percentage of:
    - The percentage of the voting power in the company that the entity is entitled to exercise (except for jointly owned shares)
    - The percentage of any dividend payment that the entity is entitled to receive
    - The percentage of any capital distribution that the entity is entitled to receive.

- **Work out the company's direct participation percentage in the discretionary trust** – this is 100%, being the lower percentage of either:

    (a) if the trustee makes distributions of income during the income year (the relevant year) in which that time occurs--the percentage of the distributions to which the entity was beneficially entitled; or
    (b) if the trustee makes distributions of capital during the relevant year--the percentage of the distributions to which the entity was beneficially entitled. Note that the references to distributions of 'income' in the context of determining an entity's direct small business participation percentage in a trust mean the income of the trust, determined according to the general law of trusts, to which a beneficiary could be entitled – refer to ATO ID 2012/99.

- **Work out the discretionary trust's direct participation percentage in the Royal Unit Trust** – this is 50%, being the lower percentage of either:
  - The percentage of any distribution of income that the trustee may make to which the entity would be beneficially entitled; or
  - The percentage of any distribution of capital that the trustee may make to which the entity would be beneficially entitled;

Therefore, the indirect stakeholder percentages that Charles and Camilla each hold is calculated as follows:

- Charles and Camilla's direct interest in company (50%) x Company direct interest in discretionary trust (100%) x discretionary trust direct interest in the Royal Unit Trust (50%)
- = 50% x 100% x 50% = 25% each

In conclusion, the Royal Unit Trust satisfies the significant individual test for the last 15 years on the assumption that the above distributions are consistent for a 15-year period (not necessarily continuous).

It should also be noted that special rules apply to work out the small business participation percentage if the discretionary trust had tax losses or had no net income.

Question 1(b) – How do we work out whether the Royal Unit Trust had a significant individual just before the CGT event?

The confusion arises here in that the significant individual must be determined just before the CGT event (which is 3 March 2020). The following points should be noted in determining whether this requirement is satisfied:

- Per above, Charles and Camilla each have an ownership interest of 50% in the company just before the CGT event.

- In relation to the company's direct participation interest in the discretionary trust, this is:
  (a) if the trust makes distributions of income during the 2020 income year – the percentage of the distributions to which the entity was beneficially entitled; and
  (b) if the trustee makes distributions of capital during the 2020 income year--the percentage of the distributions to which the entity was beneficially entitled.

  Assuming that no distributions of capital are made, and the trust makes the company presently entitled to all of its net income, the company's direct participation interest in the discretionary trust is 100%.

- Assuming that the unit trust is a 'fixed trust', and that the discretionary trust has equal entitlements to income and capital – the discretionary trust has an ownership interest of 50% in the Royal Unit Trust just before the CGT event.

On the basis of the reasoning above, the Royal Unit Trust had a significant individual just before the CGT event.

Question 1(c) – Did the event happen in connection with the retirement of a significant individual?

Yes, as stated above – the CGT event happened in connection with the retirement of Charles.

Question 2 – How do we ascertain whether the Trust has a significant individual 'just before' the CGT event?

Item	Description
Review the superannuation aspects of the SBCs	
Step 4 – Check the acceptance rules	Stakeholders seeking to make superannuation contributions using the CGT and/or other contribution caps must check that the fund can accept the contribution (e.g., that the acceptance rules in Reg 7.04 of the SIS Regs 1994 are met).
Step 5 – Review whether the 15-year or retirement exemption applies and obtain the individual's total superannuation balance (if making NCCs)	In this case, the 15-year exemption applies, and the individuals will not be making any additional superannuation contributions (e.g., using the non-concessional contributions cap).
Step 6 – Determine the level of superannuation contributions	From Step 5, work out the level of superannuation contributions and type that the taxpayer and/or the individual/s are planning to make. Then, ensure that the superannuation fund receives the contributions, and any required CGT cap elections, within the applicable time limits.

Assume that both Charles and Camilla wish to contribute into superannuation.

In relation to the 15-year exemption, the amount that can be contributed to superannuation is capped to the exempt amount paid out of the Royal Unit Trust within two years of the CGT event. In turn, being a unit trust, the CGT exempt amount is capped to the actual small business participation percentage of the CGT concession stakeholder just before the CGT event. For the Royal Unit Trust, this can be summarised as follows:

- The exempt amount must be paid out by the Royal Unit Trust directly or indirectly to Charles and Camilla, in proportion to their stakeholder percentages just before the CGT event. As determined above, this is 25%.
- Therefore, the exempt payment to Charles and Camilla respectively is $487,500 (i.e., 25% x $1.95 million capital gain).
- This amount must be paid out by Royal Unit Trust to Charles and Camilla by 2 March 2022 (multiple payments are permitted).
- Charles and Camilla must each contribute the payment to their fund within 30 days of receiving the exempt amount.
- Further, Charles must satisfy the 'work test' in respect of the contribution.
- The maximum amount that they can benefit from under the CGT cap is $487,500 – this cannot be altered (e.g., for Camilla to reduce her entitlement to allow Charles to increase his CGT cap amount).
- They both must provide a CGT cap election form to their fund prior to the contribution being accepted.

In relation to Kate and William, note the following:

- Assume their structure mirrors that of Charles and Camilla – meaning that they are both CGT concession stakeholders with a small business participation percentage of 25% each.
- This means that they can benefit from the tax-free payment from the Royal Unit Trust.
- However, in contrast to the retirement exemption, there is no requirement under the 15-year exemption for this amount to be contributed to superannuation.

Case Study 2 – retirement exemption

Assume the same facts as above, except that the Royal Unit Trust is seeking to apply the retirement exemption. The outcomes can be summarised as follows:

- A unit trust (the Royal Unit Trust) is owned by two family discretionary trusts. Camilla (aged 62) and Charles (aged 67) control one discretionary trust, whilst William (aged 38) and Catherine (aged 38) control the other discretionary trust.
- The discretionary trusts generally distribute to bucket companies, which are owned by on a 50/50 basis by mum and dad.
- Assume that the unit trust is a 'fixed trust' and that the shares in the company as simply ordinary shares.
- The unit trust is a CGT small business entity, which has carried on business for the last 20 years.
- A contract was entered into on 3 March 2020 to sell the goodwill and land from which the business was conducted. Assume that settlement occurs on 5 May 2020.
- Assume that Kate and William do not wish to contribute any money to superannuation.
- Details of the capital gain made on each asset are set out below:

Asset	Date of purchase	Asset cost base	Consideration received	Capital gain
Land	2000	$150,000	$1,100,000	$950,000
Goodwill	2000	Nil	$1,000,000	$1,000,000
Total		**$150,000**	**$2,100,000**	**$1,950,000**

Key points to note about applying the retirement exemption are as follows:

- Based on the reasoning for Case Study 1, Charles and Camilla are CGT concession stakeholders of the Royal Unit Trust.
- Assume that the structure is identical for Kate and William, and therefore they qualify to be CGT concession stakeholders of the Royal Unit Trust.
- However, as stated above, Kate and William do not wish to contribute to superannuation. Therefore, the Royal Unit Trust could make the following choices:
  - Although the 50% CGT discount applies (this is compulsory), the Royal Unit Trust could choose not to apply the small business 50% active asset reduction. Note that payment of the 50% CGT discount amount out of the trust will not trigger CGT event E4.
  - Charles and Camilla are free to choose to allocate the remaining capital gain of $975,000 in whichever proportion they choose. A written record should be made by the unit trust allocating the proportions between Charles and Camilla.
- Should Camilla and Charles wish to contribute to superannuation, the following time frames would need to be adhered to:
  - The Royal Unit Trust needs to make the payment out to the CGT concession stakeholders by seven days after the company or trust makes the choice (generally, the actual date of lodgement of return).
  - Charles and Camilla then have 30 days from when they receive the payment from the Royal Unit Trust.