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# Amendments to the Small Business Capital Gains Concessions

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*The small business capital gains concessions contained in Div 152 of the Income Tax Assessment Act 1997 (Cth), which are (1) the 15-year exemption, (2) the 50% active asset reduction, (3) the retirement exemption and (4) rollover relief, were designed to provide CGT relief for taxpayers who chose to dispose of an active asset in a small business. If a taxpayer wants to utilise the small business concessions, the taxpayer must satisfy certain conditions (the “access conditions”). The access conditions are complex and difficult to apply in practice. Under the most recent 2018 amendments introduced by the Treasury Laws Amendment (Tax Integrity and Other Measures) Act 2018 (Cth), the federal government has amended the third access condition, which applies when a taxpayer disposes of an interest in a company or trust. This article argues that the amendments are a missed opportunity to simplify access to the small business concessions, which has become more complex than ever before.*

## INTRODUCTION

On 24 August 2018, the *Treasury Laws Amendment (Tax Integrity and Other Measures) Act 2018* (Cth) received Royal Assent. The Act modified the accessibility rules for the small business capital gains tax (CGT) concessions in Div 152 of *Income Tax Assessment Act 1997* (Cth) (ITAA97) by amending the third access condition, which applies when a taxpayer disposes of an interest in a company or a trust.<sup>1</sup> The first and second access conditions were unaffected by the 2018 amendments.

This article argues that the amendments were a missed opportunity for the Government to simplify and facilitate access to the small business CGT concessions. The amendments have curtailed access and use of the small business CGT concessions, rendering access more complex and difficult to achieve than ever before.

It is appropriate to ask whether the policy objectives behind the small business CGT concessions, which were to provide relief from capital gains tax to retiring small business owners, remain current in light of these amendments.

First, this article considers the amendments to the small business CGT concessions as they are presented in the Explanatory Memorandum and the CGT Handbook. It then asks what consequences arise from the amendments for a taxpayer wishing to rely on the amended third access conditions. The article then discusses the problems in accessing high-level advice and considers whether the recent amendments will encourage aggressive tax planning measures.

Second, the article considers the context in which the amendments were made, the intention of the Government to curtail the use of the small business CGT concessions, the parliamentary debates in the House of Representatives and the Senate that suggest the amendments were not adequately debated in Parliament, the retrospective effect of the amendments and finally the role of industry groups in the public debate.

Finally, the article will make some concluding remarks.

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<sup>1</sup> The taxpayer must now satisfy one of two alternative tests in *Income Tax Assessment Act 1997* (Cth) s 152-40(2)(c).



## I. THE AMENDMENTS

### Explanatory Memorandum

The Explanatory Memorandum to the Bill provides clues on the intention of legislators to pass the amendments to the third access condition.<sup>2</sup> The purpose of the Bill is described as needing to ensure “[the] concessions in Division 152 of the *ITAA 1997* are only available for CGT assets that are either used or held ready for use in the course of a small business or are an interest in a small business.”<sup>3</sup>

The Explanatory Memorandum notes that the Bill does not amend the four small business CGT concessions, namely the 15-year exemption, the 50 per cent asset reduction exemption, the retirement exemption and the replacement asset rollover.<sup>4</sup>

The Explanatory Memorandum is drafted in language that is not precise, stating that the “basic conditions” remain the same, as do the additional conditions.<sup>5</sup> Reference to these “basic conditions” may be reference to the access conditions needed to access the small business CGT concessions.

Further, the Explanatory Memorandum states that an additional basic condition only applies to capital gains relating to CGT assets that are a share in a company or interest in a trust.<sup>6</sup> Adding to the confused terminology, the Explanatory Memorandum posits three additional basic conditions, which are the modified active asset test, the new requirements for a taxpayer and the new requirements for an object entity.<sup>7</sup>

The modified active asset test is presented in language that is convoluted and difficult to follow.<sup>8</sup> If the asset is held by a later entity, it will only be considered an active asset if the later entity is (1) at the relevant time, either (a) a CGT small business entity; or (b) satisfies that maximum net asset value test in relation to the capital gain.<sup>9</sup> There is a further requirement that the taxpayer has a small business participation percentage of at least 20 per cent or is a CGT concession stakeholder at the relevant time.<sup>10</sup>

The conditions relating to taxpayers are described more simply. These require all taxpayers to have carried on a business just prior to the CGT event occurring.<sup>11</sup> It appears that the intention of legislators was to exclude business activities that are too remote from the date of the CGT event.<sup>12</sup> There is a carve-out for this condition, which does not apply if taxpayers satisfy the maximum net asset value test in relation to the CGT event.<sup>13</sup>

Finally, the object entity requirements mandate that an entity to be either (1) a CGT small business entity or (2) to satisfy the maximum net asset value test in relation to the capital gain.<sup>14</sup> This requirement is to prevent the concessions being available to businesses “carrying on a business that is not a small business ... [having] both substantial aggregate turnover and net assets”.<sup>15</sup>

<sup>2</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth).

<sup>3</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 13 [2.1].

<sup>4</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 13 [2.4]; *Income Tax Assessment Act 1997* (Cth), Subdivs 152-B–152-E.

<sup>5</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 13 [2.5]–[2.6].

<sup>6</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 16 [2.13].

<sup>7</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 16 [2.15].

<sup>8</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 16 [2.16].

<sup>9</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 17 [2.17].

<sup>10</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 17 [2.17].

<sup>11</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 20 [2.25].

<sup>12</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 20 [2.25].

<sup>13</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 20 [2.26].

<sup>14</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 21 [2.27].

<sup>15</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 21 [2.27].

## CGT Handbook

The CGT Handbook provides a different interpretation of the amended rules.<sup>16</sup> The preconditions to the CGT concessions remain unaltered by the amendments.<sup>17</sup>

The first and second access conditions remain unaltered, namely (1) the small business entity test (or alternatively the \$6 million net asset value test)<sup>18</sup> and (2) the active asset test.<sup>19</sup>

The amendments concern the third access condition that applies only where the CGT asset is a share in a company or an interest in a trust.<sup>20</sup> It is with the third access test (and its alternative) that we are concerned with in this article.

Two scenarios arise from the amended third access condition.

For CGT events prior to 8 February 2018, if there is direct ownership in the shares of a company or interest in a trust, the amendments require that (1) there be a CGT concession stakeholder before disposal of the shares; and (2) that the individual claiming the concession must be a CGT concession stakeholder in the company or the trust.<sup>21</sup>

For CGT events on or after 8 February 2018, the amendments impose additional requirements to satisfy the third access condition. These are that (1) the CGT assets pass the modified active asset test; (2) if the taxpayer does not satisfy the maximum net asset value test, the taxpayer must have been carrying on a business before the CGT event; (3) the company or the trust would either be a small business entity or satisfy the maximum net asset value test; and (4) just before the CGT event, the taxpayer was a CGT concession stakeholder in the company or trust, having a business participation of at least 90 per cent.<sup>22</sup>

### What Consequences Arise from the Amendments?

Some observations may be made on the possible consequences of the amended access provisions. One observation is that a taxpayer is obliged to carry on a business prior to a CGT event occurring, unless the taxpayer satisfies the maximum net asset value test. By implication, only taxpayers that were operating a business would, in most cases, satisfy the third access conditions. This suggests that a business not carrying on a business will preclude the taxpayer from satisfying the third access condition and therefore render the taxpayer ineligible for the small business CGT concessions upon disposal of an interest in a company or a trust.

Moreover, if a taxpayer holds shares in a company that generates passive income (or income that is partly active and partly passive), the sale of those shares will preclude the taxpayer from accessing the CGT small business concessions.<sup>23</sup> Clearly, the third access condition skews access in favour of taxpayers with an interest in an active income-producing entity.

Another observation is that the size of the company will be restricted to those that qualify as small business entities with an aggregated turnover of less than \$2 million and those entities that have assets less than the maximum net asset value of \$6 million. This will exclude interests in companies and trusts that surpass one or both of these thresholds. If a taxpayer holds an interest in a company that is above these thresholds, the taxpayer will not be eligible to access the small business CGT concessions under the amended rules.<sup>24</sup>

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<sup>16</sup> C Evans, A Kayis-Kumar and T Russell, *Australian CGT Handbook 2018–19* (Thomson Reuters, 10<sup>th</sup> ed, 2018) Ch 2.

<sup>17</sup> *Income Tax Assessment Act 1997* (Cth) s 152-10(1)(a) and (b).

<sup>18</sup> *Income Tax Assessment Act 1997* (Cth) s 152-10(1)(c)(i).

<sup>19</sup> *Income Tax Assessment Act 1997* (Cth) s 152-40(1)(a).

<sup>20</sup> Evans, Kayis-Kumar and Russell, n 16, 12 [22 060].

<sup>21</sup> Evans, Kayis-Kumar and Russell, n 16, 15 [22 061].

<sup>22</sup> Evans, Kayis-Kumar and Russell, n 16, 17 [22 063].

<sup>23</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 20–22 (Examples 2.3 and 2.6).

<sup>24</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 21 (Example 2.4).

If a taxpayer holds an interest in a small business entity, which in turn holds an interest in a larger company (or trust) that does not qualify as a small business entity, the taxpayer will not be able to access the small business CGT concessions. It follows that if an object entity is not a small business CGT entity, the assets and income will be added to those of the intermediate entity in which the taxpayer holds an interest. This may preclude a taxpayer from accessing CGT concessions on the sale of his or her interests in that entity.<sup>25</sup>

It appears that holding an interest in a small business will not necessarily entitle a taxpayer to claim CGT relief, because an entitlement to relief will depend on satisfying the preconditions, the first and second access conditions, and the recently amended third access condition.

The third access condition in turn requires a taxpayer to satisfy the modified active asset test, carrying on a business before the CGT event occurs and holding an interest in an object entity, which is also a small business entity or satisfies the maximum net asset value test.<sup>26</sup>

Taken together, the access conditions present onerous requirements on anyone wanting to avail themselves of the small business CGT concessions.

### **The Problem with Accessing Advice**

There is a further issue associated with accessing the high-level advice needed to utilise the small business CGT concessions. This requires small business owners to obtain detailed taxation and legal advice, which in turn generates high compliance costs and expenditure for a taxpayer. There are also high compliance costs for the Australian Taxation Office, in the form of high audit costs needed to hold taxpayers to account.

In this part, we have reviewed the small business CGT concessions, as outlined in the Explanatory Memorandum and in the CGT Handbook. Both interpretations of the rules are very complex to digest and perhaps even more difficult to put into practice.

As a result of the amendments to the third access condition, there may be the unintended consequence of increasing compliance costs (for the taxpayer) and audit costs (for the ATO) in interpreting and applying the legislation. These costs will only be borne by a taxpayer with a high-level of resources, while necessarily excluding most small business owners who do not have the level of resources needed to access high-level professional advice. It is unfortunate that most middle-income small business owners, who may be eligible to access the small business concessions, may forgo the opportunity to do so.

### **The Amendments Encourage Aggressive Tax Planning**

Far from discouraging high-level aggressive structuring and planning, a corollary to the previous section is that the increased complexity of access conditions may encourage high-wealth taxpayers to adopt aggressive tax planning measures.

Such aggressive planning may include transferring shares to non-working spouses, who are coming close to retirement age. Another may be to diversify their business interests into active businesses, or active businesses held by object entities, in order to satisfy the requirements of the third access condition.

The 2018 amendments to the third access condition was designed to curb the use of the concessions that was perceived to be excessive. This may have the unintended effect of leading people to adopt more aggressive tax planning measures.

How then did we arrive at this point?

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<sup>25</sup> Explanatory Memoranda, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth) 22 (Example 2.5).

<sup>26</sup> Evans, Kayis-Kumar and Russell, n 16, 17 [22 063].

## II. THE POLITICAL DISCOURSE

### The Government Wants to Further Restrict Access

It is important to consider the background to the Bill,<sup>27</sup> that introduced the amendments to the third access condition.

In the 2017–2018 Budget, the Government announced that further integrity measures would be imposed on accessing the small business CGT concessions,<sup>28</sup> because some people were accessing the concessions for assets that were unrelated to small businesses.<sup>29</sup>

The integrity measures would have effect from 1 July 2017, meaning that all CGT transactions on or after this date would be caught.<sup>30</sup> Clearly, the amendments were designed to restrict access to the small business CGT concessions for small business owners, adding a further level of complexity that restricts access.

It is arguable that the policy intentions behind the original CGT small business concessions, which were to assist retirees by providing them with tax relief upon the sale of their businesses have been forgotten and put to one side.

### Parliamentary Debates Suggest a Lack of Understanding

There was a lack of significant political debate when the Bill was introduced into federal parliament.

The speeches by members of the House of Representatives did not highlight how the amendments would operate and how the proposed changes would affect the taxpayer.<sup>31</sup>

In the Senate, the HANSARD record suggests the political debate was vague. Senators would often repeat the suggestion that small business CGT concessions would be restricted, without any particular explanation on how far the restrictions would go.<sup>32</sup>

One example is the speech given by Senator Zed Seselja.<sup>33</sup> He begins this speech by outlining the Government's commitment growing the economy.<sup>34</sup> He moves on to deal with Sch 2 of the Bill that included the amendments to the third access condition. He claimed the amendments better targeted the small business GGT concessions by improving the integrity measures needed to access the concessions.<sup>35</sup> He then claimed the concessions were designed so only assets used in small business could qualify for concessional treatment. The remainder of Senator Seselja's speech outlined measures that had nothing to do with the small business CGT concessions, such as the venture capital reforms introduced in Sch 3 of the Bill,<sup>36</sup> and the expansion of the Defence Force Ombudsmen introduced in Sch 4 of the Bill.<sup>37</sup>

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<sup>27</sup> *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth).

<sup>28</sup> Commonwealth, *Budget Measures: Budget Paper No. 2: 2017–18*, 38–39.

<sup>29</sup> J Ayoub and L Wakerly, *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* (Cth), Bills Digest No 123 of 2017–2018, 19 June 2018, 9–10.

<sup>30</sup> Ayoub and Wakerly, n 29.

<sup>31</sup> Commonwealth, *Parliamentary Debates*, House of Representatives, 10 May 2018, 3734–3737 (Matt Thistlethwaite); Commonwealth, *Parliamentary Debates*, House of Representatives, 10 May 2018, 3738–3740 (Jason Falinski); Commonwealth, *Parliamentary Debates*, House of Representatives, 10 May 2018, 3742–3744 (Matt Keogh); Commonwealth, *Parliamentary Debates*, House of Representatives, 10 May 2018, 3748–3749 (Michael Sukkar).

<sup>32</sup> Commonwealth, *Parliamentary Debates*, Senate, 20 September 2018, 6890–6892 (Amanda Stoker); Commonwealth, *Parliamentary Debates*, Senate, 20 September 2018, 6885–6887 (Slade Brockman); Commonwealth, *Parliamentary Debates*, Senate, 20 September 2018, 6882–6884 (Doug Cameron).

<sup>33</sup> Commonwealth, *Parliamentary Debates*, Senate, 20 September 2018, 6898–6900 (Zed Seselja).

<sup>34</sup> Commonwealth, *Parliamentary Debates*, Senate, 20 September 2018, 2 (Zed Seselja).

<sup>35</sup> Commonwealth, *Parliamentary Debates*, Senate, 20 September 2018, 2 (Zed Seselja).

<sup>36</sup> Commonwealth, *Parliamentary Debates*, Senate, 20 September 2018, 4 (Zed Seselja).

<sup>37</sup> Commonwealth, *Parliamentary Debates*, Senate, 20 September 2018, 5 (Zed Seselja).

It is unclear why Senator Seselja (and his colleagues) chose not to discuss the details of the proposed amendments. One can only speculate as to why the speeches were superficial. Ultimately all of the parliamentary speeches in both the House of Representatives and the Senate failed to properly consider the proposed amendments to the third access condition.

## A Retrospective Tax Law Undermines the Rule of Law

There was a significant problem with the Bill that was not debated in the Senate. The Bill was proposed to have a retrospective effect from 1 July 2017.

By the time the Bill was debated in Parliament more than a year had passed. The Senate Standing Committee for the Scrutiny of Bills argued against the retrospective application of the Bill, noting this would challenge the basic value of the Rule of Law and the principle that all laws should operate progressively, rather than retrospectively.<sup>38</sup>

The Standing Committee was critical of the Government's intention to backdate the operation of the Bill, noting that retrospective commencement could diminish respect for the law.<sup>39</sup> It was prepared to accept retrospective application for a period of six months, but noted it had been 11 months since the Budget, which was too long.<sup>40</sup>

Treasury wrote to the Standing Committee about the retrospective application of the Bill. Treasury did not fundamentally address the issue, noting there was no information available from the Australian Taxation Office to suggest the number of people that would be adversely affected by the retrospective operation of the Bill.<sup>41</sup>

Ultimately, the Standing Committee concluded that the amendments should come into force on the date of Royal Assent,<sup>42</sup> but left the final decision to the Senate.<sup>43</sup>

The retrospective effect of the legislation was not debated in the Senate, where the Bill passed without contest. It is suggested that a retrospective taxation law is most severe, by potentially penalising taxpayers who followed the law as it was enacted in 2017, but who were then caught by the amendments that were introduced more than a year later.

The retrospective operation of any law, especially a criminal law or a taxation law, has the potential to weaken a core value of our justice system, the Rule of Law.

## Industry Groups Are Largely Ignored

On 8 February 2018, the Government released the *Treasury Laws Amendment (Measures for a later sitting) Bill 2018: improving the small business CGT concessions* as an Exposure Draft for public consultation.<sup>44</sup>

The Government did not publish the submissions received by industry groups, but each group published their own submissions on their home website.

There were several industry groups that drafted submissions. The submissions were largely consistent, in that all noted the proposed amendments had the effect of increasing the complexity of an already

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<sup>38</sup> Commonwealth, *Standing Committee for the Scrutiny of Bills – Scrutiny Digest 6 of 2018* (20 June 2018) 152, [2.284].

<sup>39</sup> Commonwealth, *Standing Committee for the Scrutiny of Bills – Scrutiny Digest 6 of 2018* (20 June 2018) 152, [2.285].

<sup>40</sup> Commonwealth, *Standing Committee for the Scrutiny of Bills – Scrutiny Digest 6 of 2018* (20 June 2018) 152, [2.282–2.286].

<sup>41</sup> Commonwealth, *Standing Committee for the Scrutiny of Bills – Scrutiny Digest 6 of 2018* (20 June 2018) 153, [2.288].

<sup>42</sup> Commonwealth, *Standing Committee for the Scrutiny of Bills – Scrutiny Digest 6 of 2018* (20 June 2018) 153, [2.292].

<sup>43</sup> Commonwealth, *Standing Committee for the Scrutiny of Bills – Scrutiny Digest 6 of 2018* (20 June 2018) 153, [2.293].

<sup>44</sup> The Treasury, "Improving the Integrity of the Small Business CGT Concessions", *The Treasury*, 8 February 2018; S Morrison (Treasurer), "Improving the Integrity of the Small Business CGT Concessions: Exposure Draft Released" (Media Release, 8 February 2018), cited in Ayoub and Wakerly, n 29, 10.

<sup>45</sup> Chartered Accountants Australia and New Zealand (CAANZ), Submission to Treasury, *Improving the Small Business CGT Concessions*, 28 February 2018, 5; Institute of Public Accountants, Submission to Treasury, *Improving the Integrity of the Small*

complex regime.<sup>45</sup> One of the most authoritative submissions was The Tax Institute's submission to the Board of Taxation Secretariat.<sup>46</sup> It noted that the small business CGT concessions were very complex for small business to follow.<sup>47</sup> The Tax Institute submissions also noted that the original purpose of the concessions was to encourage retirement planning for small business owners, that the high cost of compliance would discourage business owners from utilising the small business CGT concessions, and that the policy intent of providing the concessions should be reviewed.<sup>48</sup>

The Tax Institute's submission suggested that the small business CGT concessions lacked simplicity and efficiency and urged reform to focus on both of these issues.<sup>49</sup>

It is surprising that the Government ignored the advice of industry groups. In hindsight, the 2018 amendments not only failed to simplify and streamline access to the small business CGT concessions, but further increased their level of complexity.

## CONCLUSION

The policy behind the small business CGT concessions was to relieve small business owners from capital gains tax upon the sale of their small businesses. The proviso was that small business owners needed to meet general access conditions.

With the introduction of the *Treasury Laws Amendment (Tax Integrity and Other Measures) Act 2018* (Cth) and the consequential amendments in Subdiv 152 of *ITAA97*, the Government introduced more stringent requirements to satisfy the third access condition. This was done under the guise of limiting use of the concessions to assets held by a small business.

It has been argued that the 2018 amendments have curtailed access to the detriment of small business owners, and that in fact the amendments are a missed opportunity for the Government to simplify these measures.

There is a lacuna in the federal government debates, wherein no Senator or Member of the House of Representative adequately debated the effects of these amendments in either the Senate or the House. The Government has ignored the advice of industry groups and instead introduced retrospective taxation measures that undermine one of our core values, the rule of law.

The level of complexity of the access conditions will lead to high compliance costs for taxpayers, such that only the wealthiest individuals will be able to avail themselves of concessions.

Overall, the 2018 amendments are a missed opportunity to simplify and streamline the access provision to the small business CGT concessions. It is reasonable to question whether the original policy objectives of the concessions, which was to assist small business owners, remains current to this day.

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*Business CGT Concessions*, February 2018, 3–4; BDO, n 45, 4; The Tax Institute, Submission to Treasury, *Improving the Integrity of the Small Business CGT Concessions*, 1 March 2018, 2, cited in Ayoub and Wakerly, n 29, 10.

<sup>46</sup> T Rens, Submission to the Board of Taxation Secretariat, *Review of Small Business Tax Concessions*, 6 August 2018.

<sup>47</sup> Rens, n 46, 2.

<sup>48</sup> Rens, n 46.

<sup>49</sup> Rens, n 46, 1.