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Succession and exit strategies

AUGUST 2008

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1 Introduction

This paper has been prepared for the Dealers Group tax conferences on 19 and 21 August 2008. The paper focuses on two elements that need to be considered when advising business owners about the tax implications of exiting their business:

- The use of earn-outs as part of a business sale; and
- The application of the small business concessions to reduce the incidence of CGT.

Earn-outs are relevant to sales of either businesses, or shares in a company, or units in a trust. As a result of the ATO's position as published in draft Taxation Ruling TR 2007/D10 there is a need to understand how the ATO consider they should be treated. In many cases the ATO's published views may deter a vendor and a purchaser from using an earn-out as part of a transaction.

The small business concessions are also relevant to the sale of a business or shares in a company or units in a trust, but, despite having been introduced in 1999 the recent "tweaking" that occurred from 1 July 2006 and 1 July 2007 means that there are still many issues to be aware of when accessing the concessions.

2 Earn-outs and reverse earn-outs

2.1 What is an earn-out?

An earn-out is an arrangement where something is to be delivered at a later time, if a certain contingency is met. In most cases the contingency is a profit target and the thing to be delivered is an amount of money.

For example, Tom sells his business for a promise by the purchaser to pay him 50% of the following year's profit. The promise to pay the 50% of next year's profit is an earn-out.

Earn-outs are used by a vendor to try to maximise the sales price of, typically, a business (whether they are selling the business or an interest in the business owning entity). If the events, such as profit levels, expected by a vendor are realised then they get rewarded based on an agreed formula.

For the purchaser an earn-out offers a level of protection. If a vendor is making promises, some of the consideration can be made contingent upon those promises, and purchase consideration only paid if those promises are fulfilled. In addition for a purchaser an earn-out offers a cash-flow advantage, with not all of the purchaser consideration being paid on settlement.

If the purchaser intends to employ the vendor in the business after acquisition, earn-outs are also sometimes used as de facto bonus mechanisms. For instance, if sales targets are met in the business in the three years following acquisition then the vendor can be expected to receive an amount under the earn-out. The reason for using an earn-out as a de facto bonus mechanism for the vendor is that an earn-out is usually capital in nature, meaning that the CGT general discount can often be used to reduce the incidence of taxation. This is in contrast to a bonus paid to an employee which will always be revenue in nature. For the purchaser the downside of using an earn-out over a bonus is that the outgoing is unlikely to be immediately deductible[1]. If earn-outs are used in this way there is the potential for the ATO to attempt to use the anti-avoidance provisions of Part IVA to disallow any tax benefits.

[1] Being part of the purchase price of business assets.

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Earn-outs typically only last for 1 – 3 years but there are many examples of longer periods. The reason that earn-outs do not last for longer periods is typically commercial – both the vendor and the purchaser want certainty about the amount to be paid under the earn-out arrangement. As well, the more time that passes the less control the vendor is likely to have over whether the targets set in the earn-out will be met.

2.2 Are earn-outs always cash?

While earn-outs are usually paid in cash they can consist of the delivery of other property. For instance, the purchaser may offer a mixture of cash and scrip for an acquisition with the scrip being used to fund the earn-out.

Care should be taken when non-cash consideration will be provided as part of an earn-out. Thought needs to be given as to whether the property can be converted to cash after receipt, and what the tax consequences of the conversion will be. The potential value of the property at the time of receipt is also important to consider.

For example, shares in a company are sold to a telecommunications company for a promise of $1 million in cash on settlement and 50% of the following two years' profit. The profit based payment will be shares in the telecommunications company equal in number to 50% of the profit dividend by the share price for the telecommunications company's shares at the date of settlement. Notice that if the share price of the telecommunications company's shares moves up to the time of the earn-out payment, the vendor will benefit – if it moves down they will lose.

Where the assets being sold are shares and the non-cash consideration is to be shares then scrip for scrip rollover relief will not be available to the extent that the sale price is made up of the earn-out. This is because to be eligible for scrip for scrip relief the vendor can only get a rollover to the extent they receive scrip in exchange for their scrip. The promise to pay an amount of scrip under an earn-out is not scrip.

2.3 Earn-outs prior to TR 2007/D10 – TR 93/15

Prior to the ATO issuing their draft Taxation Ruling TR 2007/D10 in October 2007 earn-outs were thought to work as follows. The ATO view of earn-out arrangements was previously set out in Taxation Ruling TR 93/15 which was withdrawn when the draft ruling was issued.

2.3.1 For the vendor

Where a vendor received part of their sales proceeds as an earn-out the sales proceeds are taken to include the market value of the earn-out at the time that the earn-out right was created.

When a capital asset is sold, the capital proceeds to be taken into account under a CGT event are:

- The amount of money received;
- The amount of money to be received;
- The market value of property received; and
- The market value of property to be received.

The earn-out right was considered to be property received.

For example, if the goodwill of a business was sold and the sales agreement set out that the purchaser would provide:

- ***$500,000 on settlement;***
- ***$250,000 two years after settlement;***
- ***A new BMW on settlement; and***
- ***A new BMW two years after settlement,***

then the capital proceeds would be taken to include the $750,000 to be received on settlement and in two years time as well as the market value at the date of exchange of contracts (this is usually the time the CGT event is taken to occur)of the two BMWs.

As the earn-out right is considered to be property it needs to be valued at the time of the CGT event, usually the time of exchange of contracts.

It is often difficult to value an earn-out right at the time of the CGT event but it is important when valuing the right to take into account only factors known at the time of the CGT event, as they would be the things that would influence the value of the earn-out right.

For example, the sale price of shares includes an earn-out payment of 25% of the following year's sales above $500,000 (the vendor expects this to be an additional $125,000 as they expect sales to be $1 million). At exchange it is considered highly likely that the $1 million will be achieved because of a large purchase order received. When the tax return is prepared for the year of the sale it is clear that the target will not be met as the purchase order was cancelled. The earn-out needs to be valued using the information available at the time of the CGT event.

While the market value of the earn-out right is taken into account in determining the proceeds received for the sale of any assets sold (whether they be CGT assets or other assets such as trading stock) the ATO view was also that the earn-out right is also a separate asset in itself.

As a separate asset there are CGT consequences when that asset comes to an end.

When a payment is made to a vendor to end their earn-out right the CGT event that occurs is CGT event C2. The proceeds for the CGT event will be the amount paid in consequence of the earn-out, and the cost base of the earn-out will be the market value of the earn-out included in the sales proceeds.[2]

This CGT event could result in a capital gain or loss that is separate and distinct from the gain or loss that occurred as a result of the original asset sale.

For example, to continue with the above case where the vendor expected to receive $125,000 they would include the $125,000 in their sales proceeds and this would become the cost base of their right. If they received nothing under the earn-out then they would make a capital loss. If they receive $125,000 they will make no gain and no loss. If they receive more than $125,000 they will make a capital gain.

Note that the timing of the CGT event when the earn-out right comes to an end often results in the gain or loss being made in a later year than the CGT event for the original sale. In the case of a capital gain, this can delay the timing of taxation, which is usually beneficial. In the case of a capital loss this means that the loss cannot be offset against the earlier gain, which is to the vendor's detriment.

[2] Effectively the earn-out right was acquired by giving up the asset under the sale contract.

It is important to note that the failure to receive the expected amount under the earn-out arrangement does not mean that the vendor is able to amend their original tax return to exclude the amount that they expected to receive, but did not receive.

Although a delayed capital gain is usually beneficial, as the earn-out right is treated as a separate asset, one needs to consider whether there are any concessions available to reduce the taxable capital gain that may arise when the asset comes to an end. On the sale of the original asset the capital gain made might have been reduced because:

- The original asset was acquired pre-CGT so that the capital gain was disregarded entirely;
- The CGT general discount might have been available; or
- The CGT small business concessions might have been available to reduce the taxable amount.

The earn-out right will be acquired at the time of contract, so that unless exchange occurred before 20 September 1985 it will not be a pre-CGT asset.

The earn-out right is not an active asset, so the small business CGT concessions are not available.

If the CGT event that results in the asset coming to an end occurs more than 12 months after the right comes into existence then the CGT general discount may be available to reduce the taxable gain if the entity making the gain is eligible for the CGT general discount[3].

2.3.2 For the purchaser

The treatment of the purchaser was much simpler than the treatment for the vendor. The purchaser was simply treated as including in their cost base of the assets acquired the amount they paid under the earn-out arrangement, as it was paid.

For example, a purchaser agrees to acquire the goodwill of a business for a payment of $100,000 on settlement and 100% of the first year's profit. The payments made end up being $100,000 on settlement and $50,000 after the end of the first year. The cost base of the goodwill for the purchaser will be $150,000.

2.3.3 The "reverse" earn-out

The fact that a vendor might make a capital loss as a result of an earn-out arrangement, that could not be offset against the earlier capital gain on the sale of the underlying asset, meant that a solution was sought that could match the capital loss with the capital gain. The solution was the "reverse" earn-out.

Under this arrangement the vendor would nominate an amount to be received in the sale contract that was the maximum they thought they might receive. The vendor then agreed to an obligation to pay back some of this amount if certain targets were not met.

The repayment of the amount was considered to come within the operation of the repaid rule. The repaid rule provides that

> The *capital proceeds from a *CGT event are reduced by:
>
> (a) any part of them that you repay; or
>
> (b) any compensation you pay that can reasonably be regarded as a repayment of part of them.

[3] i.e. they are an individual, trustee of a unit trust or discretionary trust, or a complying superannuation fund

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However, the *capital proceeds are not reduced by any part of the payment that you can deduct.

Thus, if some of the sale price needed to be paid back because the targets were not met, then the repayment would reduce the amount of the original capital proceeds.

For example, the sale price of shares was to be $100,000 on settlement and an earn-out payment of 25% of the following year's sales above $500,000 (the vendor expects this to be an additional $125,000 as they expect sales to be $1 million). The vendor instead arranges for the contract to specify that they will received $225,000 with an amount to be repaid calculated as 25% of the difference between the following year's sales and $500,000 – but capped at $125,000.

The vendor will initially base their CGT calculations for the share sale on the receipt of $225,000.

If the sales come in at $750,000 the vendor will need to give back 25% of $250,000 ($1 million less $750,000) being $62,500.

When they give back the $62,500 they would amend their tax return to exclude the $62,500 from the original capital proceeds.

Under a reverse earn-out there is a practical problem that the purchaser is agreeing to make a payment before the earn-out target is known to be met. To overcome this difficulty, it is often the case that the purchaser's obligation to physically pay the amount, that might be repaid, is timed to correspond with the time that the amount is to be repaid.

In practice there is another issue to be faced in a reverse earn-out, which is that if the vendor becomes insolvent after the sale, the purchaser may not be able to claim back the full amount they are entitled to under the claw-back in the reverse earn-out.

2.4 Earn-outs as covered by TR 2007/D10

The ATO changed their views substantially on earn-out arrangements when they released their draft Taxation Ruling TR 2007/D10. Although the ruling is a draft ruling and therefore not binding on the Commissioner, the withdrawal of TR 93/15 means that failing to consider the ATO views set out in the draft ruling may lead to a later dispute with the ATO.

2.4.1 For the vendor

The ATO have not changed their view on the position of a vendor under an earn-out arrangement, but they took the opportunity to set out their views on what would occur if an earn-out arrangement spanned multiple payments.

If earn-out payments were separate rights then, as set out above, they would need to be valued and a capital gain or loss determined at the time that the right comes to an end.

Where an earn-out spans multiple periods but is one right the cost base of the part of the earn-out right that comes to an end when a payment is received is determined in a special way. At the time that a CGT event occurs you are required to value the remaining amount of the earn-out right, and apportion the original cost base of the earn-out right to determine what cost base can be used when proceeds are received using the formula:

cost base of original right X proceeds from CGT event/(proceeds from CGT event + market value of remaining payments to be received)

This formula requires a new valuation to be done each time a CGT event occurs in connection with the right to determine how to apportion the original cost base.

For example, Mark sells his shares for $100,000 at settlement and 50% of the next two year's profits, to be paid annually. The earn-out right is considered to be one asset.

At the time of the CGT event Mark is required to value the earn-out payment. He determines that the market value of the earn-out payment is $200,000.

As a result of the sale then, Mark calculates his capital proceeds as $300,000.

When the first earn-out amount of $50,000 is received Mark is required to value what he considers he will receive as a result of the second payment. He determines that he will receive $25,000. The cost base of the part of the right that came to an end is therefore determined to be $200,000 x $50,000 / ($50,000 + $25,000) = $133,333. He therefore makes a capital loss at the time of the first earn-out payment of $50,000 - $133,333 = $83,333. The cost base of the remaining earn-out right is $200,000 – 133,333 = $67,667.

If his second earn-out amount is $100,000, he will make a capital gain of $100,000 - $67,667 = $33,333.

Note that this apportionment formula can result in unusual outcomes. It can defer capital losses to a later time, especially if there is only a small amount of proceeds received as a result of an earn-out payment as compared to original expectations.

In practice the ATO have said that they would not seek to set aside a practice of treating the rights as independent assets which they recognise would be administratively simpler.

2.4.2 For the purchaser

The purchaser's position is where the ATO ruling has substantially changed their views. In the ATO view the purchaser has at the time of contract agreed to acquire assets, and has in return given property, being the earn-out right.

The purchaser must therefore value that property to determine the cost of the assets they have acquired.

For example, Tom acquires the goodwill of a business for 50% of next year's profits. At the time of contract he considers that the market value of the earn-out right is $225,000. This will be the cost base of the goodwill.

The ATO draft ruling is silent on what will occur if the amount actually paid under the earn-out is less than or more than the amount considered to be the market value of the earn-out, except to state that any difference will not be taken into account in the cost price of the asset acquired.

One wonders then what would occur if the purchaser paid less than expected under the earn-out – would this be a windfall gain on which they were taxable?

If the purchaser paid more than expected would this be a loss to them that is not deductible, and therefore potentially able to be written off under the black hole expenditure rules?

For the purchaser the lack of certainty over treatment of the earn-out is likely to mean that earn-outs will not be used unless a private binding ruling is obtained.

In the writer's view the main problem with the ATO draft ruling is their view that the purchaser "gives" property at the time of the creation of the earn-out right. The purchaser does create property in the vendor, but "gives" the vendor nothing as the purchaser did not own the right, the property, before creating it in the vendor.

2.5 Reverse earn-outs as covered by TR 2007/D10

The ATO position on reverse earn-outs is unusual. They do not agree that a reverse earn-out comes within the ambit of the repaid rule.

2.5.1 For the vendor

The ATO view is that at the time that a vendor agrees to a reverse earn-out arrangement they have in fact disposed of two assets to the purchaser, the assets that they intended to sell, and a right to a future payment (the reverse earn-out amount). Note that the amount allocated to the reverse earn-out does not trigger a capital gain as the ATO consider that no CGT event occurs (the relevant event is CGT event D1, but they ATO reason that that event does not apply).

They need to apportion their sales proceeds between these two assets.

The vendor arranges for a contract to specify that they will received $225,000 with an amount to be repaid calculated as 25% of the difference between the following year's sales and $500,000 – but capped at $125,000.

If the vendor expected to give back $25,000 under the reverse earn-out then they would allocate $25,000 of the sales consideration to that "asset".

The vendor would therefore calculate their capital proceeds on the sale of the original asset as being only $200,000 (being $225,000 less the $25,000 they expect to repay).

As for the purchaser in a standard earn-out arrangement the ATO do not set out what they consider occurs if the vendor gives back more or less than what is expected.

The ATO position on reverse earn-outs means that they are unlikely to be used by a vendor until the ATO view is settled.

2.5.2 For the purchaser

For the purchaser the position mirrors that of a vendor under a standard earn-out arrangement. The purchaser is taken to have acquired two assets from the vendor, the original assets and the reverse earn-out right. They need to value the reverse earn-out right, and allocate some of their cost base to this.

If they receive more or less under the earn-out arrangement than what is expected then they will make a capital gain or a capital loss.

For example, a purchaser arranges for a contract to specify that they will pay $225,000 with an amount to be repaid by the vendor calculated as 25% of the difference between the following year's sales and $500,000 – but capped at $125,000.

They calculate that they will receive back $25,000. They therefore apportion their cost base between the original assets and the reverse earn-out so that the original assets have a cost base of $200,000 and the reverse earn-out has a cost base of $25,000.

If the purchaser receives more under the reverse earn-out than $25,000 they will make a capital gain. If they receive less than $25,000 they will make a capital loss.

Again, until the ATO position is settled, the ATO's view of the treatment of a reverse earn-out, when combined with the practical difficulties for reverse earn-outs noted above, is likely to prevent their use by a purchaser.

2.6 Consultation/submissions made

On 30 April, the ATO held a meeting with the professional bodies who lodged a joint submission (NIA, TIA, ICAA and CPA) on the draft Taxation Ruling on earn-out arrangements.

The submission calls for a look-through approach when taxing earn-out arrangements, in particular for what are referred to as "standard" earn-out arrangements. These are characterised as ones where:

- The duration of the earn-out is no more than 5 years;
- At the time of entering into the contract the expected earn-out payments are likely to be no more than 50% of the total consideration for the arrangement;
- The earn-out payments are based on factors that are sufficiently connected with the relevant asset, business or entity (for example, an earn-out on the sale of shares in a company calculated by reverence to the performance of a share market index would not qualify); and
- The earn-out entitlement is to a pecuniary amount as compared with non-pecuniary assets such as shares (aligned to the discussion about deferred purchase arrangement warrants).

The look though approach would allow any gain or loss on the earn-out arrangement to be taken into account in the CGT calculations for the sale of the underlying assets. Thus, if the underlying assets were pre-CGT then the gain or loss on the earn-out arrangement would also be taken to be as a result of the disposal of a pre-CGT asset.

3 Passing the maximum net asset value test or the small business entity test

The small business CGT concessions are the best way to maximise the after tax funds available to the owners or controllers of a "small business". As a result of the introduction of the concept of a small business entity from 1 July 2007 being an entity whose aggregated turnover is less than $2 million, the concept of small business has also extended to asset rich, but low turnover businesses.

There are four small business CGT concessions:

- The 15-year retirement exemption;
- The small business 50% reduction;
- The retirement exemption; and
- The active asset rollover.

Each of these concessions has its own unique features that you need to be aware of in applying the concession.

In order to apply any of the concessions there are certain threshold criteria that must be met:

- The asset must be pass the active asset test[4]; and
- You must satisfy one of the following criteria:
    - You pass the $6 million net asset threshold test;
    - You are a small business entity; or
    - You are a partner in the partnership, the partnership is a small business entity and the CGT asset is an asset of the partnership.

3.1 The active asset test

In general, an asset will pass the active asset test if it has been used or held ready for use in a business being carried on by you, an entity connected with you, or your affiliate for the lesser of 7.5 years and half the time you have owned it. It also cannot be an asset whose main use in the business was to derive passive income such as rents, royalties, dividends, etc or a financial instrument (such as a loan, note or debenture).

A share in a company or a unit in a trust can pass the active asset test if for the lesser of 7.5 years or half the time you have owned the share or unit at least 80% of the assets of the company or trust were active assets (the “80% test”).

Where an individual owns an asset and it is used in a business being carried on by their spouse or child under 18 years old, it will be taken to be used in the business of their affiliate.

There are many special rules and unusual outcomes that can arise as a result of the active asset requirement that an advisor needs to be aware of such as:

- When applying the 80% test cash will not count towards the 80% requirement unless it is inherently connected with the business – but what it means to be inherently connected is not defined;
- An asset cannot be used to derive rent in the business being carried on, but that does not mean that it cannot be used to derive rent by its owner if it is used in a business of an affiliate or connected entity other than to derive rent; and
- The family home can be an active asset if a business is carried on from part of the property.

In this paper however, the focus will be on the $6 million net asset threshold test and the $2 million small business entity test.

3.2 The $6 million net asset threshold test

To pass the $6 million net asset threshold test it must be the case that the net value of the CGT assets of yours, of entities connected with you, of your affiliates and entities connected with your affiliates does not exceed $6 million.

In working out the net value of assets you subtract from the market value of the assets the liabilities that are related to the assets. From 1 July 2006 it is also the case that you can take into account provisions for annual leave, long service leave, unearned income and provisions for tax liabilities.

[4] Unless the CGT event is CGT event D1 in which case it must only be the case that the right that you create is inherently connected with a CGT asset that satisfies the active asset test

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3.3 What assets are excluded for the purposes of the $6 million net asset value test?

Certain assets are not taken into account in determining whether the $6 million net asset value test is passed:

- Shares, units or other interests in entities that are taken to be connected with you (to prevent double counting).
- For individuals:
    - Assets held solely for their personal use or enjoyment (except a main residence);
    - The main residence (unless it is used in such a way that mortgage interest would be deductible in which case it may be included);
    - Superannuation or ADF benefits; and
    - Life insurance policies.
- For your affiliates:
    - You disregard assets held by your affiliate unless they are being used in a business being carried on by you or an entity connected with you unless that connection is solely by virtue of your affiliate.
- For entities connected with your affiliates:
    - You disregard assets held by entities connected with your affiliates unless they are being used in a business being carried on by you or an entity connected with you unless that connection is solely by virtue of your affiliate.

3.4 The $2 million turnover test

If you pass the $2 million turnover test you are considered to be a small business entity.

You must be in business in the year in which you want to be treated as a small business entity to pass this test.

To pass the $2 million turnover test you need to calculate your aggregate turnover.

Your aggregate turnover is calculated as the sum of the annual turnovers of:

- You;
- Entities connected with you; and
- Your affiliates.

Annual turnover is the defined to be the ordinary income received for the year, excluding amounts collected for GST. If an entity has carried on business for only part of an income year then the turnover needs to be grossed up to represent a full income year.

You do not include retail fuel sales in annual turnover.

In addition, if an entity derives income through dealings with associates, the turnover needs to be adjusted to include the amount that would be paid if the dealing between the parties were to be conducted at arm's length.

As with the $6 million net asset value test you do not include certain amounts so as to prevent double counting:

- You do not include turnover derived by you from dealings with an entity connected with you or your affiliate; and

- You do not include turnover derived by an entity connected with you or your affiliate from you.

There are then three ways in which you can pass the $2 million turnover test:

- Your actual aggregate turnover (measured at year end) can be less than $2 million;
- You carried on a business in the previous year and last year's aggregate turnover was less than $2 million; or
- Your aggregate turnover for the current year is likely to be less than $2 million.

Note that the third method of passing the test is not available to you if you were in business in each of the previous two income years and your aggregate turnover in each of those years exceeded $2 million. In this case you would need to rely on the third method, i.e. you would need your actual aggregate turnover to be less than $2 million

3.5 Who is connected with you?

In both the $6 million net asset value test and the $2 million turnover test you need to include the turnover or assets of entities connected with you.

To determine whether or not you are connected for the purposes of both tests the rules are set out in Division 328 of ITAA1997.

You will be connected with an entity if:

- You control it;
- It controls you; or
- You are under common control.

Whether or not you control an entity is dependent upon what type of entity is involved:

- A company;
- A partnership;
- A unit trust; or
- A discretionary trust.

3.5.1 A company

You will be taken to control a company if you own shares that carry the rights to at least 40% of the dividend, capital or voting entitlements. Note that if you own less than 50% of the rights then the Commissioner has the discretion to treat you as not controlling the company.

3.5.2 A partnership

You will be taken to control a partnership if you own interests that carry the rights to at least 40% of the income or capital entitlements. Note that if you own less than 50% of the rights then the Commissioner has the discretion to treat you as not controlling the partnership.

3.5.3 A unit trust

You will be taken to control a unit trust if you own interests that carry the rights to at least 40% of the income or capital entitlements. Note that if you own less than 50% of the rights then the Commissioner has the discretion to treat you as not controlling the unit trust.

3.5.4 A discretionary trust

There are two ways to be taken to control a discretionary trust:

- Through control of the trustee; and
- Through distributions.

If the trustee of the discretionary trust acts or could be reasonably expected to act, in accordance with your directions or wishes then you will be taken to control the trust. Note that the ATO view is that the appointor of a trust controls the trustee in this way.

If you receive distributions of at least 40% of the income or capital distributions made in the four income years prior to the year in which you are applying the test then you will be taken to control the trust. Note that if you own less than 50% of the rights then the Commissioner has the discretion to treat you as not controlling the trust.

Note that an exempt entity or deductible gift recipient cannot be taken to be in control of a discretionary trust as a result of distributions received.

3.5.5 Control is measured together with your affiliates

When you are measuring whether control exists for the purposes of the rules in Division 328 you consider control entitlements held or received between you and your affiliates (see further below).

3.5.6 Indirect control

In addition, if you control an entity (the first entity) that in turn controls another entity (the second entity) then you will be taken to control that second entity. Importantly this only applies if the first entity controls the second entity. It does not allow aggregation of indirect holdings.

For example, Tom owns all of the shares in company one, company two and company three. These three companies in turn own equal shares in company four. Although company one, company two and company three will be connected with Tom (because he owns at least 40% of the shares) company four will not be connected with him as he does not control it directly or indirectly (as you do not aggregate the interests of his controlled entities). It may still be Tom's affiliate.

Note that an application of the indirect control provision cannot result in you being taken to indirectly control entities including:

- A listed company;
- A publicly traded unit trust; or
- A mutual insurance company.

3.6 Who is your affiliate under Division 328?

The definition of affiliate found in Division 328 is:

> An individual or a company is an affiliate of yours if the individual or company acts, or could reasonably be expected to act, in accordance with your directions or wishes, or in concert with you, in relation to the affairs of the *business of the individual or company.

Under the old definition of small business affiliate found in Division 152 your spouse or child aged under 18 were automatically included as your affiliates. That is no longer the case.

As can be seen in order to be your affiliate the other entity must be a company or an individual, and not a partnership or a trust.

In addition the company or individual must carry on a business. Someone cannot be affiliated with you if they do not carry on a business.

3.7 How do you avoid being connected?

There are a number of ways to avoid being connected with another entity that may hold assets or have a business turnover.

3.7.1 Idea 1 – 40%

If you own less than 40% of an entity then you are not connected with the entity. You need to take care for two reasons when reducing your interests (held between you and your affiliates) to less than 40%:

- Holding less than 40% can result in you losing real control of an entity, this needs to be weighed up against potential tax savings; and
- A reduction in interest solely to allow access the small business CGT concessions may be a scheme to which Part IVA can be applied.

3.7.2 Idea 2 – Affiliates

If assets are held in the name of your affiliate then they will not be included in with your assets for the purposes of the $6 million net asset value test unless they are used in a business being carried on by you or an entity connected with you (unless the connection is only by virtue of your affiliate).

In this case it is worth considering holding investments in a spouse's name rather than in the name of an entity such as a discretionary trust.

For example, if you hold assets in a discretionary trust and are the trustee or the appointor then the trust's assets will count towards your total assets for the purposes of the $6 million net asset threshold test. If however those assets were held in your spouse's name then they would not be counted.

Further to the 40% requirement listed above, in many instances, if husband and wife as shareholders or unitholders held each less than 40% of the interests in an entity, these would now no longer be aggregated to be an interest of 40% for the purposes of the connected with tests. This is because as shareholders or unitholders the husband and wife are unlikely to be carrying on businesses and so would not be affiliates.

3.7.3 Idea 3 – Indirect ownership

As mentioned above, if you were to hold your controlling interests in a company, unit trust or partnership (the "final entity") through interposed entities, you may not be connected with the final entity for the purposes of the rules in Division 328. Care would need to be taken that such a structure was not put in place artificially as the ATO may then carefully consider whether Part IVA may be used to defeat the structuring in place.

3.8 Partnerships as a structure

As a structure partnerships can offer advantages.

One advantage is that if you own less than 20% of a partnership and a partnership asset is disposed of you may be able to as a partner access the small business CGT concessions.

For example, Simon is a 10% partner in a partnership and disposes of his interests in the partnership assets. If he satisfies the $2 million test (as it applies to partners) or the $6 million test then he would be eligible to access the small business concessions.

Contrast this with a shareholder in a company, where, to benefit from the small business CGT concessions, it must be the case that they hold at least 20% of the shares to access the small business CGT concessions (or their spouse must – see the section on significant individuals below).

For example, if Simon instead owned only 10% of a company (when his spouse owned less than 20%) and sold his shares, he would not be a significant individual or CGT concession stakeholder and could not access the concessions.

In addition, because of the ability of a partner to independently determine their CGT position and to access concessions as partners, partnerships can be used to maximise the availability of the small business CGT concessions.

3.8.1 Changes to NAV test from 1 July 2006

It should be noted that prior to 1 July 2006 in order for a partner to access the small business CGT concessions when a partnership asset is sold that both the partner and the partnership would need to pass the net asset value test (then a $5 million test). Now it need only be the case that the partner satisfied the net asset value test.

3.8.2 Partners and partnerships for SBE purposes

As noted above in the eligibility criteria, it is not necessary for a partner in a partnership to carry on a business in order for them to determine their eligibility under the small business entity rules.

This should be contrasted with a shareholder in a company where if they wanted to be treated as a small business entity they would need to carry on a business.

3.8.3 Active asset problem

There is an issue that has not yet received legislative attention with respect to partnerships where the partner’s interest in the partnership is such that they do not control the partnership (i.e. less than 40%). In this case while the partner may pass the $6 million test or the $2 million test, it is not clear how the asset that they are disposing of is an active asset.

To be an active asset the asset must be used or held ready for use by you or an entity connected with you (or your affiliate) in the carrying on of a business. In the case of a partner who does not control the partnership they would need to be in a position to say that they are using the asset in a business that they carry on. Presumably they would rely upon the fact that at law the partners carry on the business “in common”.

4 Meeting the significant individual test

The concept of significant individual was introduced with effect from 1 July 2006 and is central to the eligibility for:

- The 15-year retirement exemption;
- The retirement exemption;
- The active asset rollover; and
- Access to the concessions as a shareholder or a unit holder.

In the 15-year retirement exemption, in order for a company or a trust to be eligible for the concession there must have been a significant individual in the company or trust for at least 15 years over the time in which the asset (that has been disposed of for a gain) was owned.

For the purposes of the retirement exemption for a company or a trust there must be a significant individual in the year that the capital gain is made.

For the active asset rollover if the replacement asset is a share or a unit it is a requirement that you or an entity connected with you must be a significant individual or a spouse of a significant individual to prevent CGT event J5 occurring[5].

To access the concessions as a shareholder or a unit holder you must be a significant individual or the spouse of a significant individual (and have a "participation percentage" of more than 0%).

A significant individual is someone who:

- In a company:
    - Has the right, directly or indirectly, to at least 20% of the voting AND capital AND dividend entitlements;
- In a unit trust:
    - Has the right, directly or indirectly, to at least 20% of the income AND capital entitlements;
- In a discretionary trust:
    - Has received distributions, directly or indirectly, of at least 20% of income AND capital distributions made.

4.1 Some anomalies with regard to the significant individual test

There are three points to note in respect of the significant individual requirement:

- Class shares;
- Spouses having a participation percentage; and
- Different significant individuals than controllers in discretionary trusts.

[5] Note that in the case of an active asset rollover where an interposed entity is acquiring the share or interest it is a requirement that CGT concession stakeholders have a participation percentage in you of at least 90%

4.1.1 Class shares

As it is a requirement that an individual hold an entitlement directly or indirectly to at least 20% of the voting and capital and dividend entitlements in a company, class shares that give a company the ability to determine to whom a dividend should be paid at the discretion of the directors can prevent there being someone with the right to at least 20% of the dividend entitlements.

Note however that if such class shares are redeemable that their entitlements are disregarded for the purposes of testing whether there is a significant individual from 1 July 2006.

4.1.2 Ensuring that a spouse can be treated as a CGT concession stakeholder

A significant individual is someone with a participation percentage of at least 20% in the entity concerned. The participation percentage is then in turn the sum of your direct and indirect small business participation percentages in the entity.

Your percentage interests are measured with regard to your rights in a company to votes, capital and dividends, and in a trust to income and capital. Your lowest percentage interest across these rights is taken to be your small business participation percentage.

If you are the spouse of a significant individual and you have an interest in the company or trust then the company or trust is entitled to disregard up to $500,000 of a capital gain in connection you're your interest (subject to the $500,000 lifetime limit for the spouse) as well as the interest of the significant individual (as both are CGT concession stakeholders).

The small business participation percentage is defined to be the lowest percentage interest that you have in rights to votes, income and capital. If a spouse has zero rights to one of these entitlements then they will not be considered to be a CGT concession stakeholder. Hence, a company or trust will not be able to shelter a capital gain by using the $500,000 retirement exemption in respect of a spouse in this instance.

This is usually an issue when a company has class shares on issue or where a trust is a hybrid trust.

4.1.3 Significant individuals unconnected with a business

In a discretionary trust the identity of a significant individual is determined by examining who receives distributions of income at year end. This allows some flexibility.

Given that you can have up to 8 CGT concession stakeholders in a trust (4 significant individuals with 20% and four spouses receiving some distribution of income and capital) this gives you the opportunity with the retirement exemption to distribute to someone that will allow eligibility for the retirement exemption.

For example, Tonia has made a capital gain in her discretionary trust. As Tonia is under 55, if she accesses the retirement exemption the money sheltered from tax by the retirement exemption must be contributed to superannuation. Tonia's parents are in their late 50's and are beneficiaries under her trust. If Tonia distributes at least 20% of the income and capital of the trust in the year the gain is made to her father, with a small amount to her mother then she will be able to access $1 million in retirement exemption and this amount can be paid to them in cash.

5 Getting the gain out tax free

In addition to considering eligibility the work should always be done to determine how the controllers of an entity will gain access to the amounts that have been sheltered from tax by the small business CGT concessions.

5.1 The 15-year retirement exemption

The 15-year retirement exemption does not usually cause a problem when it comes to accessing the funds sheltered from tax by the concession.

5.1.1 Companies and unit trusts

Where a company or unit trust accesses the 15-year retirement exemption it is possible to pay the amount out tax-free to the shareholder or unit holders in proportion to their interests if the amount is paid out within two years of the CGT event. If not paid out within this time then the amount is treated in the same way as the amount sheltered from tax by the small business 50% reduction (see further below).

The reason for needing to pay the amount out within two years under the rules in Division 152 is that otherwise a payment by the company may result in a dividend, and by a trust may result in CGT event E4. Note that the treatment if the amount is paid out on liquidation is the same as for the small business 50% reduction.

5.1.2 Discretionary trusts

In a discretionary trust that accesses the 15-year retirement exemption there is usually no need to pay the amount out using the two year payment rules in Division 152. This is because the payment of an amount to a mere object of a discretionary trust does not result in a CGT event occurring.

5.1.3 Some unusual implications of the 15-year retirement exemption

There are some unusual implications of the 15-year retirement exemption.

If the concession is accessed in an entity where there are persons that are not 55 years or older or are not retiring (but these criteria are met by a controlling individual) then the other people can benefit from payments of the exempt amounts.

The 15-year retirement exemption also allows an amount of a pre-CGT gain, where otherwise the eligibility criteria are satisfied, to use the 15-year retirement exemption rules to pay out the amount of the pre-CGT gain tax-free within two years of the CGT event.

If the amount of the 15 year retirement exemption is to be contributed to superannuation the whole amount of the proceeds of the CGT event that resulted in the 15-year retirement exemption are able to be contributed to superannuation subject to the separate $1 million lifetime limit[6] for small business concessions contributions.

Note to be subject to the separate $1 million limit the contribution must be made within 30 days of the payment being received from a company or trust under the two-year rule and a notification form must be given to the fund on or before the time that the contribution is made stating that the separate limit is

[6] $1.045 million in 2009

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taxation and commercial

to apply to the contribution. If the 15-year retirement exemption is accessed by an individual the time limit for the contribution to be made to the fund for the separate limit to apply is the later of when you are required to lodge your tax return for the year of the gain and 30 days after receiving the proceeds.

5.2 The $500,000 retirement exemption

The $500,000 retirement exemption when accessed by a company or a trust requires that the amount sheltered from tax by the concession be paid out within a prescribed time period. The time period is by the later of 7 days of making the choice to apply the exemption or of receiving the capital proceeds.

In addition the $500,000 retirement exemption contains a requirement that a choice be made in writing (and outside of the tax return) that the exemption is to be applied. Where there is more than one CGT concession stakeholder it is also a requirement that you nominate what percentage of the gain relates to which CGT concession stakeholder.

The age of the recipient of the payment at the time that it is received determines whether the amount may be paid in cash or whether it must be contributed into superannuation. When an individual accesses the concession it is their age at the time that they make the choice that determines whether the contribution needs to be made to superannuation.

If the amount of the $500,000 retirement exemption in respect of someone aged 55 or older at the time that the payment is received by the company or trust is to be contributed to superannuation under the separate $1 million lifetime limit it is a requirement that the contribution be made within 30 days of the payment being received and a notification form must be given to the fund on or before the time that the contribution is made stating that the separate limit is to apply to the contribution. Where the retirement exemption is accessed by an individual the time limit for the contribution to be made to the fund for the separate $1 million limit to apply is the later of when you are required to lodge your tax return for the year of the gain and 30 days after receiving the proceeds.

5.3 The active asset concession

Getting access to the amount sheltered from tax by the small business 50% reduction is often the most difficult process to achieve.

5.3.1 Companies

In a company the best way to access money sheltered by the small business 50% reduction is often to liquidate the company.

This is because, outside of liquidation, the amount would be a frankable dividend if paid out by the company.

On liquidation the amount is treated as a return of capital for the cancellation of the shares and can trigger a capital gain at the shareholder level. As a shareholder it is then possible to reduce any gain by potentially accessing the CGT general discount and the small business CGT concessions, if eligible.

5.3.2 Unit Trusts

In the case of a unit trust, like a company, the passing out of the amount sheltered from tax by the small business 50% reduction will likely cause a capital gain at the unit holder level (CGT events E4 or C2 are likely to occur).

As a unit holder it is then possible to reduce any gain by potentially accessing the CGT general discount and the small business CGT concessions, if eligible.

Unlike a company however there is no need to wind up the unit trust for the amount to be paid out as capital.

5.3.3 Discretionary Trusts

In a discretionary trust the amount sheltered from tax by the small business 50% reduction can simply be paid to a discretionary beneficiary (usually by exercising a power of capital appointment). Such a payment does not generally have CGT implications for the beneficiary (as CGT event E4 is taken by the ATO not to apply to a discretionary beneficiary).

5.4 Using the active asset rollover

The active asset rollover is, under the rules applying from 1 July 2006, merely a deferral of the capital gain. If a replacement asset is not acquired within the required time frame (beginning one year before and ending two years after the last CGT event for which the rollover is accessed) then the capital gain "pops up" again in two years time.

In two years time, **if** the eligibility criteria can be met to access the small business CGT concessions, then the capital gain might be sheltered from tax at that time by the retirement exemption. Note that this could be particularly useful where there is a significant individual or individual owning an asset that is 53 years old at the time of the CGT event. Deferring the gain for two years until they reach age 55 could allow a cash payment to be made to them rather than having an amount contributed to superannuation on their behalf.

In the minutes of the ATO NTLG Losses & CGT subcommittee meeting of November 2007 (published in May 2008) the ATO set out at point 23 that in their view, at present the retirement exemption cannot be applied following the choice to apply the small business rollover. Although there are clear indications in the Explanatory Memorandum (introducing the law changes from 1 July 2006) and in other sections in tax law that it is intended that the retirement exemption can apply after the small business rollover and though it is possible that the provisions could be read to allow the rollover to be used, the way that the current law is written does not in the ATO view allow for the rollover. The ATO has brought the matter to the attention of Treasury and it is hoped that a legislative change will occur.