

TD 2006/D34 - Income tax: capital gains: small business concessions: is an entity that has a 'controller' under section 152-30 of the Income Tax Assessment Act 1997 necessarily a small business CGT affiliate under paragraph 152-25(1)(b) of the Income Tax Assessment Act 1997 of that 'controller'?

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This document has been finalised by TD 2006/79.



Draft Taxation Determination

Income tax: capital gains: small business concessions: is an entity that has a ‘controller’ under section 152-30 of the *Income Tax Assessment Act 1997* necessarily a small business CGT affiliate under paragraph 152-25(1)(b) of the *Income Tax Assessment Act 1997* of that ‘controller’?

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This publication is a draft for public comment. It represents the Commissioner’s preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes. You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the way explained below. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don’t have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. No. Under paragraph 152-25(1)(b) of the *Income Tax Assessment Act 1997* (ITAA 1997), a person is a small business CGT affiliate of a taxpayer if the person ‘acts, or could reasonably be expected to act, in accordance with (the taxpayer’s) directions or wishes, or in concert with (the taxpayer)’. In determining whether a person acts in such a manner, the actions of the parties need to be considered.
2. The definition of small business CGT affiliate in paragraph 152-25(1)(b) of the ITAA 1997 does not include the relationship between the ‘controller’ of an entity and the entity itself. The relationship in these situations is considered to be dictated more by obligations imposed by law, formal agreements, fiduciary obligations and the like. Accordingly, companies, trusts, partnerships, etc, are not considered to be affiliates of the various officers, persons or entities (and vice versa) that are related to the company, trust or partnership in various capacities merely because of that relationship.

Example 1

3. Mr Wood carried on a farming business on land he had owned for many years. In due course, he devised a succession plan to enable his adult children to take over the farming operations. In accordance with the plan, a company owned and directed by the taxpayer's children acquired the stock and plant, entered into a lease agreement (which imposed certain restrictions on their farming activities) for the use of the land and commenced to carry on the business.

4. With the company owning the stock and plant the children make their own decisions relating to the farm operations. Mr Wood, however, retains financial control through provision of working capital and the use of the land via the lease agreement. Mr Wood's children consult with him before making decisions concerning the farming business. Mr Wood continues to work unpaid on the farm performing duties such as driving machinery, maintenance, fencing, and general farm work.

5. Mr Wood intends to sell the land and expects to make a capital gain. To qualify for the small business concessions, the land must be an active asset at certain times.

6. Although Mr Wood is not directly using the land in a business of his own, the land can still be an active asset if it is used in the business of a small business CGT affiliate (or of a connected entity).

7. In this case, Mr Wood is able to direct the company in relation to the carrying on of its business. By retaining control through financing the company and putting constraint clauses in the lease agreement as to the use of the land, Mr Wood is able to limit the company's activities. His ability to direct the company is supported by the close family relationship he has with the controllers of the company, the provision of advice, and finance and the performing of unpaid work around the farm.

8. In this situation, it is apparent that the company acts, or could reasonably be expected to act in concert with Mr Wood or in accordance with his directions or wishes. The company is therefore considered to be Mr Wood's small business CGT affiliate. Consequently, the land owned by Mr Wood but used in the company's business is an active asset. Mr Wood may qualify for the small business concessions if he satisfies the other conditions.

Example 2

9. Adam and his friend, Dave, started a golf shop five years ago. There was no formal partnership or written agreement and the arrangement was based on mutual trust and understanding and their long term friendship with a 50/50 split. They bought the shop as tenants in common in equal shares and used it to carry on their business. They each had an interest only loan from a bank to finance the purchase.

10. After two years, Adam joined a professional golf tour, sold his 50% interest in the business to Dave and allowed Dave to continue to use the co-owned shop to carry on the business. There was no formal written lease agreement between the two parties. The relationship was not strictly one of landlord and tenant, but rather a loose commercial one. The common understanding was that Adam would not be involved in the carrying on of the business and would not share in the profits from the business while Dave would ensure that the holding costs of the shop including the interest expenses were met.

11. *The shop is under a sale contract from which a capital gain is expected. Adam's net asset value is less than \$5 million. He would like to know if his 50% interest in the shop is an active asset at the time of sale. Adam's interest would be an active asset at that time if Dave, who uses the shop in his business, is a small business CGT affiliate of Adam.*
12. *As Adam was carrying on business in partnership with Dave, his interest in the shop was an active asset during the period before he sold his interest in the business to Dave.*
13. *However, at the time of sale, Adam's interest in the shop is not an active asset because Dave is not considered to be a small business CGT affiliate of Adam. This is because there is no evidence to indicate that Adam and Dave had acted together in pursuit of a common goal or purpose or that Adam had directed, or was able to direct Dave in the conduct of his business.*
14. *In spite of their friendship and the lower than normal rent for the use of the co-owned property in the business, it cannot be concluded that Adam was able to direct Dave in relation to his business operations. There no reason for Dave to act in concert with or in accordance with Adam's directions or wishes in relation to his business. Dave is not therefore considered to be a small business CGT affiliate of Adam.*
15. *Consequently, Adam does not satisfy the active asset test because his interest in the shop is not an active asset at the time of sale.*

Example 3

16. *Kate conducts a video rental and sale business through her wholly owned company. The company operates the business in a shop owned by a discretionary trust. Kate's parents are the trustees and the beneficiaries of the trust. The trust owns six shops. The market value of each shop is \$1 million and there is no amount owing on the properties. Kate's parents are not involved in the video business and reside interstate. They use a real estate agent to manage the leasing of the shops. The company pays a normal commercial rate to lease the shop under a formal lease agreement.*
17. *The net value of the CGT assets of the company is \$3.5 million. Kate wants her company to sell the business and move on to another business. However, if the company sells the video business, she is concerned that the value of the assets of the trust would be included in the company's net asset value calculation in working out if it satisfies the basic conditions for the small business concessions. The net value of Kate's CGT assets (apart from the value of her shares in the company) is \$1 million.*
18. *The trust is considered not to be a small business CGT affiliate of the company. There is no evidence indicating that the company and the trust act together in pursuit of a common goal or purpose or that the company is able to direct the trust in connection to the shop. There may be a family relationship between the controller of the company and the controllers of the trust. However, the lease arrangement is on a commercial basis. The trust is not expected to be participating in the business activities of the company.*
19. *The above facts do not demonstrate that the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of the company or in concert with the company. As such, the trust is not considered to be a small business CGT affiliate of the company. For similar reasons, Kate and her parents are also not considered to be small business CGT affiliates and hence the trust and the company are not connected. Therefore the net value of the CGT assets of the trust is not taken into account in working out whether the company satisfies the maximum net asset value test.*

Example 4

20. Sam, a sole trader, is selling his business worth \$1.5 million and wishes to obtain the small business concessions. Sam jointly owns with Bob (a friend) two residential rental properties, each with a market value of \$2 million. The rental properties are not mortgaged and they are owned by Sam and Bob as tenants in common in equal shares.

21. The maximum net asset value test requires the net value of the CGT assets of Sam, of any entity connected with him and of his small business CGT affiliate (excluding those assets not used in the business) to not exceed \$5 million.

22. As Sam and Bob are in receipt of income jointly from the rental properties they are in partnership (an entity). Further, as Sam has the right to receive at least 40% of the income or capital from the partnership he controls the partnership and thus the partnership is an entity connected with him.

23. If the partnership is a small business CGT affiliate of Sam, then the value of rental properties which are not used in the business is excluded from the net asset value calculation.

24. The partnership is not considered to be a small business CGT affiliate of Sam. The paragraph 152-25(1)(b) definition of affiliate is not directed at the relationship between the 'controller' of an entity and the entity itself. The relationship in these situations is considered to be dictated more by obligations imposed by law, formal agreement, fiduciary obligation and the like.

25. Therefore, as the partnership is an entity connected with Sam and not a small business CGT affiliate, Sam must include the net value of the rental properties in his net asset value calculation. As the net asset value is worked out to be \$5.5 million (\$1.5 million + \$4 million), the maximum net asset value test is not satisfied. Consequently, Sam is not eligible for the concessions.

Example 5

26. A small manufacturing group consists of a discretionary trust (Family Trust) and a company (Operating Co). Family Trust owns land and buildings worth \$3 million and has three beneficiaries being Martha and her two adult children (Alex and Ben). In the last few years Martha has received 50% of the distributions from the trust and Alex and Ben 25% each. Operating Co operates a business with net assets of \$4 million and is owned 100% by Alex.

27. Operating Co uses the land and buildings owned by the trust in its business. There is no formal lease agreement and the lease payments made are not regular. The amounts vary depending on cash flow of the Operating Co. On occasions, Operating Co pays certain expenditure for Family Trust.

28. The group is being taken over by a third party interested in acquiring the business and the premises. A contract has been entered into by both Operating Co and Family Trust to dispose of their assets to the purchaser. The condition of the contract is that the purchaser would buy the business from Operating Co only if the Family Trust also agrees to sell them the land and building. They expect to make capital gains.

29. Martha, Alex and Ben would like to know whether Operating Co and Family Trust satisfy the basic conditions for the small business concessions.

30. *The position of Operating Co is as follows: If Family Trust is connected with Operating Co, the \$3 million net value of the land and buildings must be included in its net asset value calculation. Family Trust will be connected with Operating Co if Martha, Ben and Alex are small business CGT affiliates of each other because the interests of any affiliates are added together to determine who controls each entity and hence whether the entities are connected.*

31. *It is considered that the family members are small business CGT affiliates of each other. The entities of which they are the controlling minds do not have a formal lease agreement between them specifying when and how much Operating Co is to pay for leasing the premises. Operating Co essentially pays any amount at any time. In addition Operating Co may pay certain expenses for Family Trust. Further, Family Trust has a history of not taking any legal action to recover any shortfall or refund any excess amount of the lease payments. These actions indicate the parties are acting in concert.*

32. *In these circumstances, Operating Co and Family Trust are connected because it can be concluded that the family members are small business CGT affiliates of each other (and hence their interests are added together resulting in them each controlling both entities). Consequently, the \$3 million net value of the land and building is included in the net asset value calculation of Operating Co resulting in the \$5 million limit being exceeded. Therefore, Operating Co cannot satisfy the basic requirements for the small business concessions.*

33. *The position of Family Trust is as follows: As Operating Co is connected with Family Trust, the land and building is an active asset. However, as a result of being connected, the net value of the Operating Co's CGT assets are included in Family Trust's net asset value calculation with the result that the \$5 million limit is also exceeded for Family Trust.*

Date of effect

34. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination.

Commissioner of Taxation

14 June 2006

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.*

Explanation

35. To qualify for the small business CGT concessions, a taxpayer must satisfy the basic conditions in Subdivision 152-A of the ITAA 1997. Two main conditions are in the form of tests. They are:

- the maximum net asset value test – the net value of the CGT assets of the taxpayer and certain related entities must not exceed \$5 million (sections 152-15 and 152-20 of the ITAA 1997); and
- the active asset test – the relevant asset must be an active asset of the taxpayer at certain times (section 152-35 of the ITAA 1997).

36. In determining if the taxpayer satisfies each of these tests, it may be necessary to identify any small business CGT affiliates of the taxpayer. Under the active asset test, a CGT asset can be an active asset of the taxpayer, even if it is not used directly by the taxpayer but is used in the business of a small business CGT affiliate of the taxpayer (subparagraph 152-40(1)(c)(i) of the ITAA 1997). Under the maximum net asset value test, the net value of the CGT assets of the taxpayer’s small business CGT affiliates (or any entities connected with them) which are used in the taxpayer’s business is included in the net asset value calculation.

Meaning of small business CGT affiliate

37. Apart from a spouse or child under 18 years of the taxpayer, a person can be a small business CGT affiliate of a taxpayer if the person ‘acts, or could reasonably be expected to act, in accordance with (the taxpayer’s) directions or wishes, or in concert with (the taxpayer)’ (paragraph 152-25(1)(b) of the ITAA 1997).

38. Whether a person acts in such a manner, is a question of fact dependent on all the circumstances of the particular case. The key consideration is the actions of the parties. If the parties act together in pursuit of a common goal or purpose or the taxpayer is able to direct the other person in relation to (not merely where the person is involved in, connected to or participating in) the carrying on of the business, these are factors that may support a conclusion that the parties act in concert¹ or the other person acts in accordance with the taxpayer’s directions or wishes.

39. The likelihood that the way the parties act, or could reasonably be expected to act, in relation to each other would be based on the relationship between the parties rather than on formal agreements. Relevant factors may include the existence of a close family relationship or friendship between the parties and any agreement or common understanding between the parties about how the parties are to act in relation to each other.

¹ *IPT System v. MTIC Corporate Pty Ltd* (2000) 158 FLR 349; (2000) 36 ACSR 454; (2001) 19 ACLC 386, *Bank of Western Australia v. Ocean Trawlers Pty Ltd* (1995) 13 WAR 407; (1995) 16 ACSR 501 and *Adsteam Building Industries Pty Ltd v. Queensland Cement & Lime Co Ltd (No. 4)* [1985] 1 QdR 127; (1984) 14 ACLR 456; (1984) 2 ACLC 829.

‘Controller’

40. For the purposes of the small business CGT concessions, an entity is a ‘controller’ of another entity if, it has at least a 40% interest in the other entity, subject to the Commissioner’s discretion to determine otherwise if the control percentage is at least 40% but less than 50% (section 152-30 of the ITAA 1997). For example, a shareholder of a company who holds 50% of the voting shares is a ‘controller’ of the company.

Application of the principles to other relationships

41. The definition of ‘small business CGT affiliate’ in paragraph 152-25(1)(b) of the ITAA 1997 does not include the relationship between the ‘controller’ of an entity and the entity itself. They are independent concepts. The provision is not directed at situations where parties act in a certain way in relation to each other based on such things as formal agreements or relationships, legal requirements, fiduciary obligations and the like. The affiliate concept requires something more than the mere relationship.

42. The relationship in these situations is considered to be dictated more by obligations imposed by law, formal agreements, fiduciary obligations and the like. Accordingly, companies, trusts, partnerships, etc, are not considered to be affiliates of the various officers, persons or entities (and vice versa) that are related to the company, trust or partnership in various capacities merely because of that relationship.

Note: that the definition of small business CGT affiliate for CGT purposes differs from the definition of STS affiliate for the purposes of the Simplified Tax System in Division 328 of the ITAA 1997. Thus, the guidance in the Taxation Ruling TR 2002/6 should not be relied on in determining who is a small business CGT affiliate.

Note

43. As noted in the Treasurer’s Press Release No. 38 of 2006 (9 May 2006), the Board of Taxation’s report on its Post-Implementation Review of the small business CGT concessions contains a number of administrative recommendations. This Draft Taxation Determination is part of the Commissioner’s response to Recommendation 6.5 of the Board’s report. The Board’s report also contains a number of legislative recommendations. This Draft Taxation Determination may be affected by the legislative change relating to Recommendation 6.7 of the Board’s report.

Appendix 2 – Your comments

44. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date. (Note: The Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

Due date: 11 August 2006

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2002/6

Subject references:

- active asset
- active asset test
- basic conditions for relief
- capital gains
- capital gains tax
- CGT assets
- CGT small business relief
- maximum net asset value test
- small business CGT affiliate
- small business relief

Legislative references:

- ITAA 1997 Subdiv 152-A
- ITAA 1997 152-15

- ITAA 1997 152-20
- ITAA 1997 152-25(1)(b)
- ITAA 1997 152-30
- ITAA 1997 152-35
- ITAA 1997 152-40(1)(c)(i)
- ITAA 1997 Div 328

Case references:

- Adsteam Building Industries Pty Ltd v. Queensland Cement & Lime Co Ltd (No. 4) [1985] 1 QdR 127; (1984) 14 ACLR 456; (1984) 2 ACLC 829
- Bank of Western Australia v. Ocean Trawlers Pty Ltd (1995) 13 WAR 407; (1995) 16 ACSR 501
- IPT System v. MTIC Corporate Pty Ltd (2000) 158 FLR 349; (2000) 36 ACSR 454; (2001) 19 ACLC 386

Other references:

- Treasurer's Press Release No. 38 of 2006

ATO references

NO: 2006/9001

ISSN: 1038-8982

ATOlaw topic: Income Tax ~~ Capital Gains Tax ~~ small business relief - 'active asset test'
Income Tax ~~ Capital Gains Tax ~~ small business relief - 'maximum net asset value test'