
Eligibility for CGT Small Business Relief – Not So Basic When It Comes to Shares and Trust Interests

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1 Overview

- 1.1 The purpose of this paper and accompanying presentation is to walk through the ‘landmine’ of issues relevant for those taxpayers accessing the small business capital gains tax concessions (**SBCGT concessions**) where the capital gains tax (**CGT**) asset is a share or trust interest.
- 1.2 Changes made to the rules in 2018 introduced additional requirements and a myriad of cross-referencing of sections resulting in an entire layer of complexity when looking to access the SBCGT concessions (**2018 changes**).
- 1.3 The paper will specifically consider the requirements to access the SBCGT concessions where the CGT asset is a share in a company or an interest in a trust, and will specifically consider the following:
 - (a) The additional basic conditions specifically applying to shares in companies and interests in trusts, including:
 - (i) practical guidance on the ‘80% test’;
 - (ii) applying the “modified active asset test”; and
 - (iii) how the rules apply where a company or trust owns an interest in other entities.
 - (b) How the “connected entity” requirements are modified for shares and trust interests.
 - (c) Does the holder of the share or trust interest need to be a business taxpayer?
 - (d) Calculating the direct and indirect small business participation percentages for:
 - (i) companies; and
 - (ii) trusts.
- 1.4 The accompanying presentation contains a number of case studies to provide a nuanced overview of the effect of the additional basic conditions (both simple and complex).
- 1.5 Due to the various cross-referencing of the SBCGT concessions, the format of the paper will walk through the additional conditions as they would be considered; rather than listing each of the above as its own section.
- 1.6 The paper will not consider the other topics as part of the webinar series as separate presentations will provide detailed information regarding other issues applicable to the SBCGT concessions (such as what is an active asset and the application of the SBCGT concessions).
- 1.7 References in this paper to ITAA 1997 is a reference to *Income Tax Assessment Act 1997*.
- 1.8 Annexure 1 contains an extract of the additional requirements in order to access the SBCGT concessions where the CGT asset is a trust or company interest. You will note the references to other sections of the ITAA 1997.

2 Additional SBCGT Concession requirements for trust and company interests

- 2.1 Assuming a taxpayer satisfies the basic conditions to access the SBCGT concessions in section 152-10(1) ITAA 1997, *'additional basic conditions'* are required to be met for *'shares in a company or interests in a trust'*.
- 2.2 Section 152-10(2) ITAA 1997 outlines these additional basic conditions in relation to a share or interest in the company or trust respectively – whereby the company or trust is known as *'the object entity'*.
- 2.3 These additional basic conditions can be summarised as follows:
- (a) the **modified active asset test** – whereby *'CGT asset would still satisfy the active asset test...if the assumptions in subsection (2A) were made'*;
 - (b) **additional condition relating to taxpayer** – the taxpayer either needs to satisfy the maximum net asset value (**MNAV**) test or be carrying on a business **just before** the CGT event;
 - (c) **additional condition relating to Object Entity** – the Object Entity must satisfy either the MNAV test or is considered a CGT small business entity where:
 - (i) *'the only CGT assets or annual turnovers considered were those of the object entity, each affiliate of the object entity, and each entity controlled by the object entity in a way described in section 328- 125;*
 - (ii) *each reference in section 328- 125 to 40% were a reference to 20%; and*
 - (iii) *no determination under subsection 328-125(6) were in force;*
 - (d) **CGT concession stakeholder test** – where just before the CGT event, either:
 - (i) the taxpayer was a CGT concession stakeholder in the object entity; or
 - (ii) CGT concession stakeholders in the object entity together have a small business participation percentage in the taxpayer of at least 90%.
- 2.4 Each of the four additional basic conditions will be considered under separate headings further below.
- 2.5 As mentioned in the Overview, additional basic conditions were introduced in 2018 (being the modified active asset test, additional condition relating to taxpayer and additional condition relating to Object Entity).
- 2.6 Despite the changes being introduced over 5 years ago, given the relative recency of the additional conditions, it is useful to appreciate the background in which such conditions were introduced and it assists in understanding the intended targeting of such additional conditions, and when they are to take effect.
- 2.7 Announced in the 2017 budget as improving the integrity of the concessions, the Government noted the following:
- "The Government will amend the small business capital gains tax (CGT) concessions to ensure that the concessions can only be accessed in relation to assets used in a small business or ownership interests in a small business. This measure will take effect from 1 July 2017. This measure is estimated to have an unquantifiable gain to revenue over the forward estimates period.*
- The concessions assist owners of small businesses by providing relief from CGT on assets related to their business which helps them to re-invest and grow, as well as contribute to their retirement savings through the sale of the business. **However, some taxpayers are able***

to access these concessions for assets which are unrelated to their small business, for instance through arranging their affairs so that their ownership interests in larger businesses do not count towards the tests for determining eligibility for the concessions.

The small business CGT concessions will continue to be available to small business taxpayers with aggregated turnover of less than \$2 million or business assets less than \$6 million.

This measure will improve the integrity of the tax system and ensure that these concessions are appropriately targeted.”

[emphasis added]¹

- 2.8 Below contains extracts from the Explanatory Memorandum to Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018 (**EM**) which introduced the most recent additional conditions.

Comments regarding modified active asset test

- 2.9 The EM noted that prior to the 2018 changes, circumstances could arise where an interest in an Object Entity could satisfy the active asset test, despite the Object Entity holding various minor interests in other companies/trusts which collectively are of significant value.
- 2.10 Example 2.3 of Chapter 2 of the EM noted the discrepancy where:
- (a) *Arnold carries on a small marketing business as a sole trader. He is a CGT small business entity (according to the general rules) for the 2019-20 income year.*
 - (b) *Arnold also owns 20 per cent of Channel Investments Trust, a trust that invests in a wide range of widely held trusts and companies.*
 - (c) *Channel Investments Trust has assets with a total net market value of \$2 million, of which \$1.95 million consists of shares in companies and units in trusts. Channel Investments Trust has never had a small business participation percentage exceeding 10 per cent in any other entity.*
 - (d) *On 20 April 2020, Arnold sells his interest in Channel Investments Trust.*
 - (e) Prior to the 2018 changes, Arnold may have potentially satisfied the basic conditions of relief as well as any other additional condition required at the time.
 - (f) This is despite the fact that such interest in the Channel Investment Trust may be considered passive in nature due to the minor interest held in those later companies/trusts.
 - (g) The modified active asset test would apply to prevent Arnold from accessing the SBCGT concessions as such value of investment held in Channel investment Trust that is not substantive would be considered a passive investment as opposed to an active investment.
- 2.11 Paragraph 2.20 of the EM notes that *‘the active asset test in section 152-35 is modified to adopt a look-through approach. Rather than treating shares or interests as active assets based on the activities of the underlying company, the **modified test looks through such membership interests to include the proportionate amount of the value of the assets of other entities (referred to as later entities) to which the interests ultimately relate’.***
- 2.12 Additional modifications are further made to ensure the inclusion of cash and financial instruments are subject to an integrity rule. Paragraph 2.21 of the EM notes: *‘If cash or*

¹ Budget Measures, Budget Paper No. 2 2017-2018, Pages 38 and 39

financial instruments are acquired or held for a purpose that includes ensuring the entity satisfies the new additional basic conditions they are disregarded’.

- 2.13 Finally, interests held in companies/trusts by the Object Entity requires the taxpayer to either hold a small business participation percentage of 20% or more; or be a CGT concession stakeholder. Paragraphs 2.23 and 2.24 of the EMA notes that:

‘2.23 [t]his condition prevents the concession from being available for interests in entities if most of the value of the assets of the entity is unrelated to its business activities. In such cases, while the entity carries on a small business, most of the value of the interest held by the taxpayer is not attributable to the small business and it is not appropriate for the small business concessions to apply to the disposal of the interest.

2.24 The condition also recognises that an investment is effectively passive in nature if an entity has an interest of less than 20 per cent in another entity.’

Comments regarding condition relating to the taxpayer

- 2.14 The condition removes the ability for a taxpayer to meet one of the basic conditions by being considered a CGT small business entity at any point in the income year.
- 2.15 Instead, where the MNAV test is not met, paragraph 2.25 of the EM notes that *‘the taxpayer must generally have carried on business just prior to the CGT event happening. This ensures that entities do not benefit from this concession where the relevant business activities are too remote to justify the entity receiving a concession for business activities’.*

Comments regarding condition relating to the Object Entity

- 2.16 The EM noted various examples of the SBCGT concessions being available for shares in Object Entities that could not be considered small businesses or having met the MNAV test.
- (a) Example 2.4 of Chapter 2 of the EM (Investment in large business) gives example of Karen, a sole trader who owns 30% of the shares in Big Pty Ltd, a large private company with an annual turnover exceeding \$20 million and assets exceeding \$100 million. Without the 2018 changes, the sale of Karen’s shares could have accessed the SBCGT concessions as Big Pty Ltd would not have been considered connected with/affiliated with Karen and Karen would have been a CGT concession stakeholder.
 - (b) Example 2.5 of Chapter 2 of the EM (Indirect investment in large business) gives example of Tien who owns a 20% interest in Investment Co, a company that carries on an investment business.
 - (i) Although Investment Co is a small business entity, it holds a 20% interest in Van Co, a transport company with a turnover and assets in excess of the required thresholds to be eligible for the SBCGT Concessions.
 - (ii) Again, without the 2018 changes, the sale of the shares by Investment Co in Van Co may have been eligible for the SBCGT concessions as Investment Co could have been considered a small business entity and the CGT concession stakeholder requirement was met.
 - (c) Example 2.6 of Chapter 2 of the EM (Passive investment entities) gives example of George who carries on a gardening business and is considered a CGT small business entity.
 - (i) George holds a 100% interest in G Trust, which holds a number of substantive investments in other entities, the values of which exceed \$6million.

- (ii) G Trust does not carry on a business and the units in G Trust were sold by George.
 - (iii) Without the 2018 changes, George may have been entitled to access the SBCGT concessions as George satisfied the turnover test and was a CGT concession stakeholder in G Trust.
- 2.17 The additional condition imposed on the Object Entity therefore sought to prevent *'the concession being available for interests in entities that are carrying on a business that is not a small business as it has both substantial aggregate turnover and net assets'*.²
- 2.18 This is done by requiring the Object Entity to be a CGT small business entity or meet the MNAV test provided:
 - (a) *'When working out if the object entity is a CGT small business entity or satisfies the maximum net asset value test, the turnover or assets of entities that may control the object entity are disregarded. This ensures that the outcomes for taxpayers do not depend upon the income or assets of third parties.'*³
 - (b) *'Further, for these purposes (and only these purposes), an entity is treated as controlling another entity if it has an interest of 20 per cent or more, rather than 40 per cent or more. This means that more entities are considered to be 'connected with' one another for the purpose of this test and need to count the assets or turnover of the other entity towards their aggregate turnover or the total net value of their CGT assets.'*⁴

² Explanatory Memorandum to Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018 at paragraph 2.27

³ Ibid at 2.28

⁴ Ibid at 2.29

3 CGT concession stakeholder test

3.1 Prior to the 2018 changes, the only additional condition required to be met by a taxpayer seeking to access the SBCGT Concessions where the CGT asset was an interest in the Object Entity, was the CGT concession stakeholder test.

3.2 As:

- (a) references to the CGT concession stakeholder are referred to in the newer introduced additional conditions; and
- (b) the CGT concession stakeholder test remains an additional condition to be met, it is apt to consider how this test is satisfied.

The legislation

3.3 Section 152-10(2)(d) ITAA 1997 requires either of the following to be satisfied just before the CGT event:

- (a) you (the taxpayer) are a CGT concession stakeholder in the object entity; or
- (b) CGT concession stakeholders in the object entity together have a small business participation percentage in you (the taxpayer) of at least 90%.

3.4 Section 152-60 ITAA 1997 states that '*[a]n individual is a **CGT concession stakeholder** of a company or trust at a time if the individual is:*

- (a) *a **significant individual** in the company or trust; or*
- (b) *a spouse of a significant individual in the company or trust, if the spouse has a small business participation in the company or trust at that time that is greater than zero.'*

3.5 Section 152-55 ITAA 1997 states that '*[a]n individual is a **significant individual** in a company or a trust at a time if, at that time, the individual has a **small business participation percentages** in the company or trust of at least 20%'*.

3.6 Section 152-65 ITAA 1997 states that '*[a]n entity's small business participation percentage in another entity at a time is the percentage that is the sum of:*

- (a) *the entity's **direct small business participation percentage** in the other entity at that time; **and***
- (b) *the entity's **indirect small business participation percentage** in the other entity at that time.*

3.7 In determining an entity's direct small business participation percentage, section 152-70 ITAA 1997 notes:

- (a) In relation to a company – the percentage that the entity has because of holding the legal and equitable interests in shares in the company:
 - (i) the percentage of the voting power in the company; or
 - (ii) the percentage of any dividend that the company may pay;
 - (iii) the percentage of any distribution of capital that the company may make, **or, if they are different, the smaller or smallest.**
- (b) In relation to a trust (where entities have entitlements to all the income and capital of the trust) – this percentage:
 - (i) the percentage of any distribution of income that the trustee may make to which the entity would be beneficially entitled; or

- (ii) the percentage of any distribution of capital that the trustee may make to which the entity would be beneficially entitled,

or, if they are different, the smaller.

- (c) In relation to a trust (where entities do not have entitlements to all the income and capital of the trust – e.g. a discretionary trust) – this percentage:

- (i) if the trustee makes distributions of income during the income year (the relevant year) in which that time occurs--the percentage of the distributions to which the entity was beneficially entitled; or
- (ii) if the trustee makes distributions of capital during the relevant year--the percentage of the distributions to which the entity was beneficially entitled,

or, if 2 different percentages are applicable, the smaller.

3.8 Additional issues are noted in relation to determining an entity's direct small business participation percentage, namely:

- (a) in relation to companies:

- (i) redeemable shares are ignored;⁵ and
- (ii) the weighting of voting power is ignored where such interest in a share is held jointly with another entity;⁶

- (b) in relation to discretionary trusts – where the trustee of the trust fails to make a distribution of income **and** fails to make a distribution of capital:⁷

- (i) if the trustee made a distribution of income or capital during the CGT event year, consider that year in determining the income or capital percentages; otherwise, consider the last income year before the CGT event year in which the trustee did make a distribution of income or capital;⁸
- (ii) despite the above adjustment, an entity holds a direct small business participation percentage of 0% in the trust at the relevant time if either:
 - (A) the trust:
 - (I) had a net income for the relevant year; and
 - (II) did not have a tax loss for the relevant year; or
 - (B) the trustee did not make a distribution of income or capital at any time before the end of the CGT event year.⁹

3.9 In determining an entity's (the **holding entity**) indirect small business participation percentage in another entity (the **test entity**), section 152-75 ITAA 1997 requires the following to be multiplied:

- (a) the holding entity's direct small business percentage in an intermediate entity; and
- (b) the sum of:
 - (i) the intermediate entity's direct small business percentage (if any) in the test entity at that time; and

⁵ 152-70(2) ITAA 1997

⁶ 152-70(3) ITAA 1997

⁷ 152-70(4) ITAA 1997

⁸ 152-70(5) ITAA 1997

⁹ 152-70(6) ITAA 1997

- (ii) the intermediate entity's indirect small business participation percentage in the test entity at that time (as worked out under the above).

Where there is more than one intermediate entity, the calculation is applied at each level.

- 3.10 Whether the CGT concession stakeholder test is met will either depend on:
- (a) an individual holds a 20% small business participation percentage interest in the Object Entity (or the spouse of that individual holds an interest in the Object Entity of greater than 0%); or
 - (b) an individual holding a 20% small business participation percentage interest or their spouse, and any other such persons holding a 90% interest in the taxpayer.
- 3.11 Such analysis also requires care to be taken in relation to various issues that may apply depending on the type of entity in which a direct small business participation percentage is being determined. The remainder of this section considers such common issues that may apply.

Discretionary trust issues in meeting 20% small business participation percentage

- 3.12 An overlooked issue may arise where there are discrepancies in the entitlements of the interest in the Object Entity.
- 3.13 For example, the small business participation percentage an entity has in a discretionary trust depends on:
- (a) if the trustee makes distributions of income during the income year (the relevant year) in which that time occurs--the percentage of the distributions to which the entity was beneficially entitled; or
 - (b) if the trustee makes distributions of capital during the relevant year--the percentage of the distributions to which the entity was beneficially entitled,
- or, if 2 different percentages are applicable, the smaller.**
- 3.14 Where the trustee of the discretionary trust makes a distribution of income **and** capital in an year and the percentages differ, the smaller percentage applies.
- 3.15 This may be problematic in circumstances where persons A and B are made presently entitled to income, whilst person C is made presently entitled to the capital in an income year.
- 3.16 In such circumstances, no person will be determined to hold a direct small business percentage in the discretionary trust as persons A, B and C will have both been entitled to either income or capital or the trust, but neither of the other (and the direct small business participation percentage considers the smaller percentage):

<i>Beneficiary</i>	<i>Income %</i>	<i>Capital %</i>	<i>Direct small business participation percentage</i>
A	50%	0%	0%
B	50%	0%	0%
C	0%	100%	0%

- 3.17 Care must therefore be taken prior to the test point in time in ensuring appropriate trustee distribution minutes are prepared.

- 3.18 Further, where the terms of the trust deed cause a discrepancy in the definition of distributable income for the trust and capital, thought should be had as to the effect such distributions will be had to the relevant percentages.
- 3.19 ATO ID 2012/99 considers the meaning of the phrase 'distributions of income' and capital in the context of subsection 152-70(1) ITAA 1997 and states that '*references to distributions of income in the context of determining an entity's direct small business participation percentage in a trust mean the income of the trust, determined according to the general law of trusts, to which a beneficiary could be entitled. Depending on the deed and/or actions of the trustee, this may be an amount that differs from the ordinary income of the trust*'.
- 3.20 ATO ID 2012/99 notes that provided there is sufficient power in the trust deed, a trustee may validly resolve to treat capital gains as income of the trust and distribute such amounts accordingly.
- 3.21 Thought should also be had as to the effect TR 2012/D1 has in determining the income distributable by a trust and in turn the effect on determining an entity's small business participation percentage in the trust. Specifically, it should be noted that the **draft** ruling takes the view the income of the trust should not include notional amounts and therefore such notional amounts (such as franking credits and deemed capital gains) may not necessarily be income 'distributable' for the purposes of calculating the necessary percentages.
- 3.22 The interpretative decision acknowledges the decision in *Commissioner of Taxation v. Bamford* [2010] FCAFC 6; 2010 ATC 20-163 whereby the High Court determined that the term 'income of the trust estate' took its meaning according to appropriate accounting principles and the terms of the trust instrument.
- 3.23 ATO ID 2012/99 considered the following example:
- (a) Capital gain of \$90,000 made by a trustee of a discretionary trust in relation to the sale of shares in a company (the Object Entity).
 - (b) The trustee's interest in the company was 50%.
 - (c) In addition, the trustee derived ordinary income of \$10,000.
 - (d) The usual discretionary trust provisions applied as well as a power to determine whether receipts are on capital or revenue account.
 - (e) Pursuant to the relevant power, the trustee resolved to treat the \$90,000 capital gain as income of the trust and to distribute it to beneficiary A.
 - (f) Beneficiary B was distributed the \$10,000 ordinary income.
 - (g) In determining the small business participation percentage held by beneficiary A and B in the Object Entity, it was noted that:
 - (i) Beneficiary A held a 90% direct small business participation percentage in the discretionary trust (\$90,000/\$100,000 total income noting no capital distribution).
 - (ii) Beneficiary B held a 10% direct small business participation percentage in the discretionary trust (\$10,000/\$100,000 total income noting no capital distribution).
 - (iii) The discretionary trust held a 50% direct small business participation percentage in the Object Entity.

- (iv) Beneficiary A therefore held a 45% indirect small business participation percentage in the Object Entity (90% * 50%).
- (v) Beneficiary B therefore held a 5% indirect small business participation percentage in the Object Entity (10% * 50%).
- (vi) Beneficiary A is therefore a CGT concession stakeholder in the Company as beneficiary A held a 45% small business participation percentage in the Company.
- (vii) Further, an individual holding a 20% small business participation percentage interest in the Object Entity has a small business participation percentage in the discretionary trust of 90%.
- (viii) It should be noted that if beneficiary B is a spouse of beneficiary A, they may also be considered a CGT concession stakeholder as they are a spouse of a significant individual (a person holding at least a 20% small business participation percentage interest in the Object Entity).
- (ix) The interpretative decision further notes that the above '*result would be different if the trustee had not resolved to treat the capital gain as income of the trust and had instead distributed the capital gain to beneficiary A as a capital distribution. The additional basic condition under paragraph 152-10(2)(b) would not be met because beneficiary A and B would each have a direct small business percentage in the trust worked out under item 3 of the table in subsection 152-70(1) of 0% (being the smaller percentage of the distributions of capital and income to which each beneficiary is beneficially entitled).*'

3.24 Where a trustee fails to make a distribution of income or capital, care must be taken as an entity will be considered to hold a direct small business participation percentage of 0% in the trust if the trust had net income in that income year and did not have a tax loss. Thought should be had as to whether any 'default income' provisions exist as the wording of such provisions may result in the trustee being deemed to have exercised a power to distribute such income to beneficiaries of the trust.

3.25 In light of the above, where discretionary trust are involved in the chain of entities in determining whether there is a CGT concession stakeholder, steps should be taken in advance to ensure the circumstances and appropriate distributions are made. Often revisiting a trustee's distribution minute after an income year in which a CGT event occurred, will be too late to determine and ensure appropriate considerations are made.

Trust (where entities have entitlements to all the income and capital of the trust) considerations

3.26 Care should be taken in reviewing the terms of any trust which requires a determination of the small business participation percentage as different rules apply where a trust is one where entities have entitlements to all the income and capital of the trust compared to a trust where entities **do not** have entitlements to all the income and capital of the trust.

3.27 That is, just because a trust is a unit trust, does not necessarily mean that all entities have entitlements to all the income and capital of the trust. Where discretionary powers or multiple classes of units exist in a unit trust, other rules may apply.

3.28 ATO ID 2015/8 further provides clarity in noting that the power to accumulate income of the trust will not in itself cause the trust to be one in which beneficiaries do not have entitlements to all the income and capital of the trust. This is because such accumulation power generally causes such accumulated income to form part of the capital of the trust

estate for distribution to such entitles with entitlements to all the income and capital of the trust.

- 3.29 In contrast, ATO ID 2015/8 notes that *'a trust instrument which gives the trustee discretion to appoint or distribute income or capital to one or more of a class of beneficiaries is a trust where entities do not have entitlements to all the income and capital of the trust. Although entities may become entitled to the income and capital of the trust as a result of the exercise of the trustee's discretion, those entitlements do not exist prior to that time'*.

Company issues in meeting 20% small business participation percentage

3.30 Much like how care must be taken in relation to discretionary trusts and the deviation of the income and capital distributed in a particular income year, care must be taken to understanding the various rights that attaches to shares in a company, when determining an entity's small business participation percentage.

3.31 Regarding a company, an entity's direct small business participation percentage depends on the rights attributed to shares on issue in the company and:

- (a) the percentage of the voting power in the company; or
- (b) the percentage of any dividend that the company may pay; or
- (c) the percentage of any distribution of capital that the company may make,

or, if they are different, the smaller or smallest.

3.32 Where different share classes are on issue providing different rights, the smaller percentage to the relevant right will determine an entity's direct small business participation percentage.

3.33 Consider the following example:

- (a) Adam, Ben and Carol wish to start a business together in a company, and due to their relationship, they hold certain voting priorities.
- (b) David has agreed to provide some funding and does not wish to have any voting power.
- (c) Elaine wishes to have a minor interest in the company.
- (d) To evidence the distinction in the rights, A and B share classes are issue providing dividend/capital distribution and voting rights respectively and as follows:

<i>Share Class</i>	<i>Adam</i>	<i>Ben</i>	<i>Carol</i>	<i>David</i>	<i>Elaine</i>
A	20%	20%	20%	30%	10%
B	35%	35%	20%	0%	10%

- (e) As a result of the differing rights, the small business participation percentage in the Company would be as follows:

	<i>Adam</i>	<i>Ben</i>	<i>Carol</i>	<i>David</i>	<i>Elaine</i>
SBPP	20%	20%	20%	0%	10%

- (f) Importantly, David and Elaine may not be considered a CGT concession stakeholder in the company and without considering any further test, they may not be eligible to satisfy the CGT concession stakeholder test.

- 3.34 Accordingly, where multiple share classes are on issue, care must be taken to understand the rights and review the relevant corporate documentation.
- 3.35 Another common scenario where the percentages may diverge can arise where employee share arrangements are implemented through the use of dividend only shares.
- 3.36 In such circumstances where employees hold dividend only shares, as they have no entitlement to any dividend, their direct small business participation percentage may be 0%. Further, due to the uncertainty as to the entitlement of income for non-dividend only shares, such holders of those shares may have a direct small business participation percentage of 0% due to the ability for the directors of the company to exercise their discretion as to the receipts of any dividends. This is due to the interpretation of the wording “any dividend that the company may pay” or “any distribution of capital that the company may make” noting that where discretion exists to preference one class of shares over another makes it impossible to be considered to have a right to any dividend (as a discretion may be exercised to the contrary).
- 3.37 It is noted, however, that where such shares are redeemable, 152-70(2) ITAA 1997 operates to ignore such shares in the calculation of the small business participation percentage.
- 3.38 ATO TD 2006/77 provides confirmation and examples that ‘[a]ll classes of shares (other than redeemable shares) issued by a company are taken into account in determining if the company has a significant individual under section 152-55 of the Income Tax Assessment Act 1997 (ITAA 1997)’.
- 3.39 Consider the following examples from TD 2006/77:
- (a) Multiple share classes with equal distribution rights – Example 1:
- (i) *2. Bedrock Co has two different classes of shares, A and B, which have equal distribution rights. Only the A class shares have voting rights. Each class of shares is held by different shareholders - the A class shares being held in equal proportions by Fred and Barney and the B class shares being held in equal proportions by their respective wives, Wilma and Betty.*
- (ii) *3. The directors of Bedrock Co can decide to make a distribution of income or capital to either class of shares to the exclusion of the other class of shares. There is the possibility of any of the shareholders receiving 50% of a distribution from the company, depending on the exercise of the directors' discretion.*
- (iii) *4. In this situation, Bedrock Co does not have a significant individual. There is no specific individual who has the right to receive at least 20% of any distribution the company may make. Fred and Barney (who each hold 50% of the voting power) might receive 50% of a distribution or they might not receive anything at all, depending on how the directors exercise their discretion.*
- (b) Employee dividend only share – Example 3:
- (i) *7. A company has A class shares and one D class share issued to a key employee. Gus holds 20% of the A class shares, which have full voting and distribution rights. The D class share has dividend rights only, payable at the discretion of the directors.*
- (ii) *8. The company does not have a significant individual. Gus may receive 20% of a distribution if the directors do not exercise their discretion to make a distribution to the D class shareholder, but he will receive less than 20% of*

the distribution if the discretion is exercised. That is, Gus does not have the right to receive at least 20% of any distribution made. His 'notional' 20% interest is reduced to below 20% because of the directors' ability to make distributions to the D class shareholder.

- (c) In support of ignoring redeemable preference shares – Example 4:
- (i) 9. XYZ Co has 100 ordinary shares and 1 redeemable preference share on issue. Michelle and ABC Co each own 20 ordinary shares. Catherine owns the redeemable preference share.
 - (ii) 10. The redeemable preference share has voting rights equal to the ordinary shares, preferential dividend rights, a return of capital right but no right to participate in surplus capital on winding up. The ordinary shares have voting rights, dividend rights and rights to participate in surplus capital on winding up.
 - (iii) 11. In this situation, the redeemable preference share is ignored for the purpose of determining if XYZ Co has a significant individual. Accordingly, as Michelle has the right to exercise at least 20% of the voting power in the company and receive at least 20% of any distribution the company may make (excluding redeemable shares), she is a significant individual of XYZ Co.

3.40 Notwithstanding the comments in TD 2006/77, care should be taken in relation to the specific wording of the rights themselves as the inclusion or absence of certain terminology may yield a different outcome in the analysis.

3.41 Consider the following rights to a class of shares:

- “(i) any vote in respect of any such shares held by them at any meetings of the Company but shall be entitled to receive notice of such meetings and to attend thereat; or*
- (ii) participate in a distribution of surplus assets (if any) remaining after payment of the amount paid up on all shares in the capital of the Company but shall be entitled to receive in respect of any such shares, such dividends, capital or other distributions (if any) other than on a winding-up as in respect of each class the Directors may from time to time determine to pay. The Directors may determine a dividend be paid on any one or more of such shares and any such declaration, payment or distribution shall be binding upon all members of the Company.”*

and compare it to the following terms (the difference emphases for convenience):

- “(i) any vote in respect of any such shares held by them at any meetings of the Company but shall be entitled to receive notice of such meetings and to attend thereat; or*
- (ii) participate in a distribution of surplus assets (if any) remaining after payment of the amount paid up on all shares in the capital of the Company but shall be entitled to receive in respect of any such shares, such dividends, capital or other distributions (if any) other than on a winding-up as in respect of each class the Directors may from time to time determine to pay. The Directors may determine a dividend be paid on any one or more of such shares and any such declaration, payment or distribution shall be binding upon all members of the Company,*

provided that the holders have no right to payment of a dividend until such time as the directors of the company resolve that the holders of the shares have a right to payment of a dividend’.

3.42 One could argue that the inclusion of the emphasis leads to an interpretation that unless other actions are taken, holders of the share was not entitled to receive dividends and

therefore such shares on issue would have no effect on the calculation of dividend entitlement percentages in determining an entity's direct small business participation percentage.

- 3.43 Such a position was accepted in *Commissioner of Taxation v Devuba Pty Ltd* [2015] FCAFC 168 with the Court noting at paragraph 10:

*“The 2008 resolution took away that right and **deprived the company of an ability to declare a dividend on her shares unless and until the directors first resolved that the holders of the Dividend Access Shares had a right to payment of a dividend.** The 2008 resolution **expressly limited Devuba’s ability to pay a dividend to the holder of the Dividend Access Share by excluding from the holder of the Dividend Access Share any right to a dividend “until such time as the directors of the company resolve[d] that the holders of the dividend access shares have a right to payment of a dividend”.** Devuba’s ability “to pay” any dividend to the dividend access shareholder was made dependent upon the prior determination by the directors. Devuba’s ability to declare a dividend was correspondingly restricted. The determination of the directors contemplated by the 2008 resolution was not that the dividend be declared by the directors, but that the holder of the Dividend Access Share should be determined to become entitled to the future exercise of a discretion which had otherwise been removed. No such determination had been made by the directors in respect of the Dividend Access Share and, therefore, as at 19 May 2010 **the company could not declare a dividend to the holder of that share.**”*

[emphasis added]

4 Modified active asset test

- 4.1 This test requires the interest in the Object Entity to satisfy the active asset test (provided for in section 152-35 ITAA 1997) if the assumptions in subsection 152-10(2A) ITAA 1997 were made.
- 4.2 As other sessions of this series will consider the active asset test in detail this paper will only seek to consider:
- (a) when a share or trust interest in an Object Entity will be considered an active asset; and
 - (b) the modifications to that test for the purposes of meeting the test regarding to the sale of an interest in the Object Entity.

80% test

- 4.3 Section 152-35 ITAA 1997 notes that a share or trust interest will satisfy the active asset test if:
- (a) the taxpayer has owned the asset for 15 years or less and the asset was an active asset of the taxpayer for a total of at least half of the period specified in subsection (2); or
 - (b) the taxpayer has owned the asset for more than 15 years and the asset was an active asset of the taxpayer for a total of at least 7 ½ years during the period specified in subsection (2).
- 4.4 Subsection 152-35(2) ITAA 1997 states the period:
- (a) begins when the taxpayer acquired the asset; and
 - (b) ends at the earlier of:
 - (i) the CGT event; and
 - (ii) if the relevant business ceased to be carried on in the 12 months before that time or any longer period that the Commissioner allows.
- 4.5 As other sessions of this series would have discussed, section 152-40(1) ITAA 1997 outlines when an asset is an active asset:
- (1) *A CGT asset is an active asset at a time if, at that time:*
- (a) *you own the asset (whether the asset is tangible or intangible) and it is used, or held ready for use, in the course of carrying on a business that is carried on (whether alone or in partnership) by:*
 - (i) *you; or*
 - (ii) *your affiliate; or*
 - (iii) *another entity that is connected with you; or*
 - (b) *if the asset is an intangible asset--you own it and it is inherently connected with a business that is carried on (whether alone or in partnership) by you, your affiliate, or another entity that is connected with you*
- 4.6 Subsection 152-40(3) ITAA 1997, however outlines the relevant test where the CGT asset is a share in a company (that is an Australian resident) or an interest in a trust (that is a resident trust for CGT purposes) for the income year in which that time occurs.
- (3) *A CGT asset is also an active asset at a given time if, at that time, you own it and:*

(a) it is either a share in a company that is an Australian resident at that time or an interest in a trust that is a resident trust for CGT purposes for the income year in which that time occurs; and

(b) the total of:

(i) the market values of the active assets of the company or trust; and

(ii) the market value of any financial instruments of the company or trust that are inherently connected with a business that the company or trust carries on; and

(iii) any cash of the company or trust that is inherently connected with such a business;

is 80% or more of the market value of all of the assets of the company or trust.

4.7 That is, the share or trust interest must be active for the period provided for in section 152-35 ITAA 1997 (at least 7 ½ years if the interest is held for 15 or more years, otherwise, at least half the period of time the interest was held). This will be achieved if at least 80% of the market value of the active assets of the Object Entity in which the taxpayer holds the share or trust interest are active assets of the Object Entity or are inherently connected with such business.

4.8 It is noted that impractical to apply the 80% test on a day to day basis and therefore provisions apply to enable a share or trust interest to continue to be an active asset where 'it is reasonable to conclude that the share or interest is still an active asset at the later time'.¹⁰

4.9 Whereas there is settled case law when a CGT asset is an active asset (and other presentations may consider this accordingly), ambiguity may arise in determining whether financial instruments or cash 'are inherently connected with' the business.

4.10 The ATO website notes:

Inherent connection requires more than just some form of connection between the cash or financial instrument and the business. Examples of things inherently connected to a business include:

- *a permanent or characteristic attribute of the business — for example, goodwill or trade debtors (invoices owed to you by customers)*
- *excess funds the business has as a result of*
 - *a temporary spike in trading activity*
 - *the sale of a business asset*
- *a financial instrument that is inherently connected with a business that the owner of the financial instrument runs (rather than any business a related entity runs).*¹¹

4.11 Where relevant company and trusts are holding significant cash reserves, thought should be had as to whether there is an appropriate rationale for such excess liquidity (as opposed to utilize such funds to reinvest or declare as a profit). The absence of reasonable explanations

¹⁰ Subsection 152-40(3A) ITAA 1997

¹¹ <https://www.ato.gov.au/business/income-and-deductions-for-business/concessions,-offsets-and-rebates/small-business-cgt-concessions/small-business-cgt-concessions-eligibility-conditions/active-asset-test/#Activeassets>, accessed 13 November 2023, last modified 30 Aug 2023 QC 52271

of such inherent connection may result in such cash (or financial instruments) not being an active asset and may adversely affect the 80% requirements.

- 4.12 Similar assets that may cause difficulty in meeting the 80% active asset requirement are significant loans made from trading entities to others. Often where excess cash are not declared out of the trading entity as profit, loans are put in place to enable certain persons to invest. Without any further evidence that such loan is inherently connected with a business (for example the business of money lending), such loans owed to the trading entity would not be active for the purposes of the test. This is often an issue that lies dormant until a taxpayer wishes to rely on the SBCGT Concessions and identifies that they have held multiple years of significant non-active loans.
- 4.13 In circumstances where an Object Entity holds an interest in other trusts or companies, the 80% active asset test should be applied at each successively level (subject to the modified active asset test discussed further below).
- 4.14 TD 2006/65 notes at paragraphs 15 and 16 that:
- '15 If an entity owns a share in a company or interest in a trust that is an active asset because the company or trust satisfies the '80% test', the share or interest is included in that entity's '80% test' calculation to determine if the underlying interests in the entity are themselves active assets.*
- 16. As the active asset test requires a CGT asset to be an active asset for at least half a particular period (generally the ownership period), the '80% test' must also be satisfied for that same period for a share in a company or interest in a trust to satisfy the active asset test.'*
- 4.15 The Tax Determination provides the following example:
- (a) Bill owns all the units in a unit trust (UT1).
 - (b) UT1 owns all the units in another unit trust (UT2).
 - (c) UT2 owns all the shares in a private company (C1).
 - (d) All of UT2's other assets are active assets. The market value of the C1 shares is 15% of the market value of all the assets owned by UT2.
 - (e) C1 owns an active asset, the market value of which is 50% of the market value of all C1's assets. All entities are Australian residents.
 - (f) As C1's active assets are only 50% of the market value of all its assets, the shares in C1 will not be an active asset for UT2 purposes.
 - (g) All other assets of UT2's are active and therefore the active asset test will be met at the UT2 level as 85% of the assets are active.
 - (h) Accordingly, the units in UT1 will be considered active.

Modified active asset test

- 4.16 In addition to the taxpayer having to meet the general active asset test above, an additional basic condition must be met where the active asset test is rerun at the Object Entity level with modifications applying to the general test.
- 4.17 The modifications in section 152-10(2A) ITAA 1997 to the above active asset test can be summarised as follows:

- (a) Modification 1 – financial instruments and cash (referred to in subsections 152-40(3)(b)(ii) and (iii) ITAA 1997) are not included in the active asset calculation if they are acquired with a purpose to only meet the active asset test;
 - (b) Modification 2 – a share or interest held by the Object Entity in a company or trust (the **later entity**) are not included in the calculation of the Object Entity’s active asset;
 - (c) Modification 3 – the Object Entity’s active assets include the market value of:
 - (i) assets owned by later entities covered under section 152-10(2B) ITAA 1997; and
 - (ii) active assets of those later entities are those provided for in section 152-40(3)(B) ITAA 1997 as modified under the above;
 - (d) Modification 4 – other than in relation to requirement 2, all assets of later entities are considered assets of the Object Entity (i.e. the assets of the later entities are included in the active asset test but not the shares and units the Object Entity holds in those later entities);
 - (e) Modification 5 – the market value of assets held by the Object Entity in later entities is the product of the asset’s market value and the Object Entity’s small business participation percentage in the later entity.
- 4.18 In relation to Modification 3, at the relevant test time, the market value of the active assets of the following later entities are included in the Object Entity test:
- (a) later entities where the taxpayer of the Object Entity has a small business participation percentage in the later entity of at least 20% or the taxpayer is a CGT concession stakeholder of the later entity (i.e. a spouse of a person who holds a 20% small business participation percentage in the later entity);
 - (b) the later entity is a small business CGT entity or satisfies the MNAV test on the following basis:
 - (i) the only CGT assets or annual turnovers considered were those of the later entity, the Object Entity, each affiliate of the Object Entity, and each entity controlled by the Object Entity in a way described in section 328- 125 ITAA 1997;
 - (ii) each reference in section 328- 125 ITAA 1997 to 40% were a reference to 20%;
 - (iii) no determination under subsection 328-125(6) ITAA 1997 were in force.
- 4.19 The rationale for each of the above Modifications were provided for in the EM.
- 4.20 Regarding Modification 3 and only covering assets held by later entities who are considered ‘small business’:
- (a) Paragraph 2.18 of the EM notes:

*“In determining if an entity is a CGT small business entity or satisfies the maximum net asset value test at a time, this test also operates differently to the ordinary rules. First, **it does not include the turnover or value of assets of entities that can control the object entity. This ensures that the outcomes for taxpayers do not depend upon the income or assets of third parties for which the taxpayer has no control.**”*
 - (b) Paragraphs 2.19 and 2.20 of the EM explains the reduction of the connected entity tests from 40% to 20% and the inclusion of Modifications 2, 4 and 5:

‘2.19...if it has an interest of 20 per cent or more in that other entity at that time, rather than 40 per cent or more. This means that more entities are considered to be ‘connected with’ one another for the purpose of this test and need to count the assets or turnover of the other entity towards their aggregate turnover or total net CGT assets....

2.20 In effect, for the purposes of this test, the active asset test in section 152-35 is modified to adopt a look-through approach. Rather than treating shares or interests as active assets based on the activities of the underlying company, the modified test looks through such membership interests to include the proportionate amount of the value of the assets of other entities...to which the interests ultimately relate.’

- (c) Paragraph 2.23 of the EM explains the added conditions to Modification 3 requiring there to be a CGT concession stakeholder in the later entity to prevent *‘the concession from being available for interests in entities if most of the value of the assets of the entity is unrelated to its business activities. In such cases, while the entity carries on a small business, most of the value of the interest held by the taxpayer is not attributable to the small business and it is not appropriate for the small business concessions to apply to the disposal of the interest’.*

4.21 Modification 1 was included as an *‘integrity rule. If cash or financial instruments are acquired or held for a purpose that includes ensuring the entity satisfies the new additional basic conditions they are disregarded...Its application is expected to be limited, but it ensures there is no incentive for taxpayers to engage in artificial arrangements to seek to allow entities to satisfy the test’* – paragraph 2.21 of EM.

4.22 In applying the modified active asset test, the following steps should be taken to differ from the general active asset test:

- (a) Ignore all cash and financial instruments that were only obtained to satisfy the active asset test.
- (b) Run the active asset test for the Object Entity only considering active assets for later entities who:
- (i) have a CGT concession stakeholder; and
 - (ii) are small business CGT entity or satisfies the MNAV test (with the adjustment to connected entities from 40% to 20%).
- (c) Do not include the value of the shares in those later entities and apportion such active asset based on the Object Entity’s small business participation percentage in the later entity.
- (d) Interests held by the Object Entity in other entities that are not active are included as non-active assets.

4.23 It should be noted that where there are various later entities of an Object Entity, added complexity is required to obtain the necessary financial information to determine whether each later entity satisfies the 80% modified asset test or not. Proper care should be taken to therefore review such information prior to determining a position at the Object Entity level.

5 Additional condition relating to taxpayer

- 5.1 Inserted as an integrity measure, subsection 152-10(2)(b) ITAA 1997 requires the taxpayer (the person holding the interest in the Object Entity) to either:
- (a) satisfy the MNAV test; or
 - (b) carry on a business just before the CGT event.
- 5.2 It is no longer possible for the taxpayer to either:
- (a) cease to run a business before the CGT event; or
 - (b) carry on a business after the CGT event in the income year to be eligible to access the SBCGT Concessions.

6 Additional condition relating to Object Entity

- 6.1 Finally (albeit being the third additional basic condition listed) the Object Entity must either be a small business CGT entity or satisfy the MNAV test subject to the following modifications:
- (a) the only entities considered in this additional test are the Object Entity, each affiliate of the Object Entity, and each entity controlled by the Object Entity in a way described in section 328- 125 ITAA 1997 (the connected with definition);
 - (b) each reference in section 328- 125 ITAA 1997 to 40% were a reference to 20%;
 - (c) no determination under subsection 328-125(6) ITAA 1997 were in force.
- 6.2 The effect of such modifications to the usual tests in determining whether an entity is a small business CGT entity or satisfies the MNAV test are as follows:
- (a) unlike the 'standard' MNAV test, the net value of CGT assets of entities connected with the Object Entity's affiliates are not included;¹²
 - (b) unlike the 'standard' MNAV test and definition of small business entity, specifically regarding entities connected with the Object Entity, entities that control the Object Entity are not included in the calculation;¹³
 - (c) by reducing the threshold to be connected with another entity from 40% to 20%, entities that would not have been caught under the standard tests are included for the purposes of determining whether the Object Entity is a small business CGT entity or satisfies the MNAV test.

¹² Section 152-15 ITAA 1997

¹³ Section 328-125(1)(a) ITAA 1997 states the meaning of connected with an entity includes where either entity controls the other entity, but section 152-10(2)(c) ITAA 1997 adjusts the test to only include 'each entity controlled by the object entity'

7 Disclaimer

7.1 This paper covers legal and technical issues in a general way. It is not designed to express opinions on specific cases. It is intended for information purposes only and should not be regarded as legal advice. Further advice should be obtained before taking action on any issue dealt with in this paper.

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Annexure 1 – Extract of legislation detailing additional conditions

Section 152-10 Income Tax Assessment Act 1997

...

Additional basic conditions for shares in a company or interests in a trust

(2) The following additional basic conditions must be satisfied if the CGT asset is a share in a company, or an interest in a trust, (the object entity):

- (a) the CGT asset would still satisfy the active asset test (see section 152- 35) if the assumptions in subsection (2A) were made;
- (b) if you do not satisfy the maximum net asset value test (see section 152-15)--you are carrying on a business just before the CGT event;
- (c) either:

- (i) the object entity would be a CGT small business entity for the income year; or
- (ii) the object entity would satisfy the maximum net asset value test (see section 152-15);

if the following assumptions were made:

- (iii) the only CGT assets or annual turnovers considered were those of the object entity, each affiliate of the object entity, and each entity controlled by the object entity in a way described in section 328- 125;
- (iv) each reference in section 328- 125 to 40% were a reference to 20%;
- (v) no determination under subsection 328-125(6) were in force;
- (d) just before the CGT event, either:
 - (i) you are a CGT concession stakeholder in the object entity; or
 - (ii) CGT concession stakeholders in the object entity together have a small business participation percentage in you of at least 90%.

(2A) For the purposes of paragraph (2)(a), in working out whether subsection 152-40(3) applies at a given time (the test time) assume that:

- (a) an asset of a company or trust is covered by neither:
 - (i) subparagraph 152-40(3)(b)(ii) (about financial instruments); nor
 - (ii) subparagraph 152-40(3)(b)(iii) (about cash);if the company or trust acquired that asset for a purpose that included assisting an entity to otherwise satisfy paragraph (2)(a) of this section; and
- (b) paragraph 152-40(3)(b) does not cover an asset that:
 - (i) is a share in a company, or an interest in a trust, (the later entity) ; and
 - (ii) is held at the test time by the object entity directly or indirectly (through one or more interposed entities); and
- (c) subparagraph 152-40(3)(b)(i) also covers each asset that:
 - (i) is held at the test time by a later entity covered by subsection (2B); and
 - (ii) is, for that later entity, an asset of a kind referred to in subparagraph 152-40(3)(b)(i), (ii) or (iii), as modified by paragraphs (a) and (b) of this subsection; and

(d) subject to paragraph (b) of this subsection, all of the assets of the object entity at the test time included all of the assets of each later entity at the test time; and

(e) for the purposes of paragraph 152-40(3)(b), the market value at the test time of an asset held by a later entity were the product of:

(i) the asset's market value, apart from this paragraph, at the test time; and

(ii) the object entity's small business participation percentage in the later entity at the test time.

(2B) For the purposes of paragraph (2A)(c), this subsection covers a later entity if:

(a) at the test time:

(i) your small business participation percentage in the later entity is at least 20%; or

(ii) you are a CGT concession stakeholder of the later entity; and

(b) either:

(i) the later entity would be a CGT small business entity for the income year that includes the test time; or

(ii) the later entity would satisfy the maximum net asset value test (see section 152-15) for a notional CGT event taken to have happened at the test time;

if the following assumptions were made:

(iii) the only CGT assets or annual turnovers considered were those of the later entity and of the entities referred to in subparagraph (2)(c)(iii);

(iv) each reference in section 328-125 to 40% were a reference to 20%;

(v) no determination under subsection 328-125(6) were in force.