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Get a grip! – CGT

A discussion of the ten biggest bugbears that plague practitioners in the area of Captial Gains Tax – and tips for avoiding them

Despite the so-called simplification of language involved in re-writing the CGT provisions from the ITAA36 to the ITAA97, CGT remains a difficult area in the law to work with. We find it necessary to have the Act laid out before us every time we advise a client.

Here are some of the problems we have faced as issues have arisen in dealing with our clients. Read on.

1. The $500,000 retirement exemption limit

Few people are aware of the $500,000 retirement exemption limit, and this can cause problems as it is not an exemption that can be used by choice. Section 102-5 of the *Income Tax Assessment Act 1997* (ITAA 97) provides the method statement for the calculation of capital gains tax after the introduction of Divisions 115 and 152. Step 4 provides that if any of your capital gains qualify for any of the small business concessions, that you must apply these concessions to each capital gain as provided for in the method statement. This means that once the concession is applicable you are bound to apply it and cannot choose to retain the concession to offset a later capital gain unless there are alternative concessions that can be used in priority to the retirement exemption.

In addition, the $500,000 is a lifetime limit in respect of any one individual. At first $500,000 seems like a significant exemption. As taxpayers approaching and during retirement dispose of large amounts of CGT assets, the exemption limit is often reached quite quickly and if a taxpayer's respective RBL's are exceeded, then the contributions are taxed accordingly. Although the exemption is a step in the right direction, the Government should look at increasing the exemption to encourage investment and saving toward retirement.

2. "Connected with" an entity and the $5M net asset value test

Section 152-30 relevantly provides that:

(1) An entity is connected with another entity if:

(a) either entity controls the other entity in the way described in this section; or

(b) both entities are controlled in that way by the same third party.

(2) An entity controls another entity if the first entity,…..

(a) beneficially owns….interests in the other entity that carry between them the right to receive at least 40 per cent of any distribution of income or capital by the other entity; or

(b) if the other entity is a company – beneficially own……shares in the company that carry between them the right to exercise, or control the exercise of, at least 40 per cent of the voting power of the company.

The section is also complicated because the control test also includes control by, or together with, a small business CGT affiliate ("SBCGTA").

A problem can arise where a shareholder owns a significant holding, but less than 40 per cent, in two companies and these two companies are also held in common by other shareholders, (assuming that the shareholders are not immediate relatives or are otherwise SBCGTA). If the first company sells a CGT asset and seeks to apply the $5m test, it need not include each shareholder's interest in the second company or in any of their other assets, because it is not connected with any shareholder.

Another issue arises if the percentages of voting power and distributions are increased so that a shareholder can become a "CGT concession stakeholder" within the meaning of s 152-60. This ensures that the shareholder can obtain the small business roll-over benefits. Care must be taken in such an approach. More often than not, it is possible to trigger potentially adverse CGT consequences including value shifting and the company loss provisions including the inter-entity loss multiplication rules. Part IVA is also an obvious issue.

Finally, be aware that to satisfy the CGT concession stakeholder test, the shareholder must have both legal and equitable interests in shares. Taxpayers who hold shares as nominees or who are beneficiaries of discretionary trusts are at an obvious disadvantage.

3. The active asset test – building used in the course of carrying on a business

An active asset is defined in s.152-40 as an asset that you, your SBCGTA or an entity connected with you owns at that time and:

(a) use it, or hold it ready for use, in the course of carrying on a business;

An issue arises where a building is held by a trust and rented to a company owned 100 per cent by an individual. This individual is also the primary beneficiary of the trust holding the building.

Section 152-40(4)(e) provides that an asset whose main use…..is to derive rent will not be an active asset unless its main use for deriving rent was temporary.

The example to that subsection refers to the distinction between a house that is purely an investment property and one that is inherently used for the carrying on of another business. The problem is definitional in that s.152-40(4)(e) refers to the asset's "main use" in the course of carrying on a business. On a plain reading the clause suggests that, if the property in this case is used in the course of carrying on a business for rental, it should not be an active asset. However, if the trust is connected with the individual, the intention of the law is that it is most likely to be an active asset.

4. The 12 month "look through" rule in and the Division 115 concession

A lot of people think that the Division 115 50 per cent CGT discount concession is automatic. Many practitioners will not be aware of the 12 month "look through" rule.

An individual or other qualifying entity will not be entitled to the discount concession outlined if the 12 month "look through" rule is not satisfied.

The purpose of the 12 month "look through" rule in s 115-45 is to "deny a discount capital gain on the disposal of a share in a company or interest in a trust where you would not have had discount capital gains on the majority of CGT assets underlying the share or interest if:

(a) you had owned them for the time the company or trust did, and

(b) CGT events had happened to them when the CGT event happened to your share or interest"

These amounts are calculated by both cost and value.

Only a majority is required so if any amount over 50 per cent of the company's assets fall within the "look through" provisions the company or trust will lose the benefit of the discount capital gains. Section 115-45 (2)-(7) then sets out the relevant conditions and method for calculating whether this percentage has been exceeded. The intricate methodology used makes the process difficult to follow.

This rule must be considered where a company has assets that turn over frequently. Trade debtors is an example of an asset which would be classified as a "new asset" under the "look through" rule. The obvious effect is that shareholders or unit holders could lose their discount capital gains on the disposal of their respective shares or units.

5. The 15-year exemption

Sections 152-105,-110 allow a CGT exemption where a CGT event occurs in relation to CGT asset owned continuously by the individual, company or trust for at least 15 years. In addition, the other conditions for small business relief, namely the $5 million net asset threshold, the controlling individual test and the active asset test, must be met.

Section 152-115 provides that this 15-year period will not be interrupted if there is a roll-over because of a marriage breakdown or the asset is compulsorily acquired or lost or destroyed. The Act does not provide the same relief for other roll-overs so that if a CGT event occurring due to a roll-over other than those mentioned above it will restart the 15-year clock. Roll-over relief has been provided in various forms throughout the income tax acts specifically to encourage business investment and development. The fact that the similar roll-over relief is not connected with the 15-year exemption only undermines this policy.

The absence of broader roll-over relief seems contrary to the fact that for a company or trust, the controlling individual need not be the same individual throughout the 15-year period although they must retire or be permanently incapacitated just before the CGT event. This allows a transferral of the 15-year exemption between individuals who may be unconnected but does not allow an individual to roll-over the asset between entities which are controlled by that person. The exemption is provided to assist in retirement of an individual and it seems more in line with this policy that the exemption should carry through with the individual rather than a company or trust.

6. Interpreting the main residence exemptions in Subdiv 118-B

Although there have been amendments made to this subdivision in the past few years, parts of the exemption are still problematic.

It is difficult to apply the partial exemption provisions in a practical manner. Partial exemption will be allowed if all or part of the dwelling was used for income-producing purposes during all or part of the ownership period. That is, when calculating the partial exemption you first need to calculate the proportion of time and floor area given over to income-producing activities during the period for which the dwelling was the main residence of the owner. The main residence exemption will then be reduced by this proportion.

The problem is that over a long period of ownership (or even a short period) these calculations become increasingly difficult to make accurately, especially where there is variation in the level of business activity from the dwelling. Taxation Ruling IT 2673 provides that part of a dwelling is taken to be used for income-producing purposes only if it has the character of a place of business. Although there seems to be a natural contradiction between the character of a main residence and the character of a place of business, the nature of businesses that are conducted from dwellings means that it is often difficult to discern when the line between a business and residence has been crossed.

In addition to this, Taxation Determination TD 1999/66 provides that while in most cases floor area will be used for apportionment, in some cases a more appropriate basis for apportionment may be the value of the area as a proportion of the whole. This adds a further degree of difficulty to calculating the partial exemption.

When dealing with this section, we advise our clients on the basis of TD 99/66, but always suggest that sufficient documentation be retained show their calculations.

7. Subdivision 126-A – Marriage Breakdowns is now out of date.

Section 126-5(1)(b) provides that there is roll-over relief if a CGT event happens involving an individual and his or her spouse or a former spouse because of a maintenance agreement approved by a Court under s 87 of the *Family Law Act 1975* ("the Act"). However, Section 87 of the *Family Law Act* was revoked by *Family Law Amendment Act 2000* effective as of 27 December 2000. Consequently, such main-

tenance agreements can no longer be used. There are three forms of binding financial agreements under Part VIIIA of the *Family Law Act*, one of which is similar to a s 87 agreement. No provision for this change has been made in the CGT legislation.

The effect of this is that to obtain roll-over relief under s 126-5(1)(a), court orders in relation to the financial matters must be obtained. Such orders can be obtained by consent in a relatively inexpensive fashion.

In each case it will depend upon the individual circumstances which method should be used and indeed in some cases it may be appropriate not to have roll-over relief. It is surprising that these sections have not been amended in the past 12 months considering that the legislative solution is simple, obvious and seemingly uncontentious.

8. Problems with Division 115 and the discount CGT concession

Section 115-15 provides that:

> "To be a discount capital gain, the capital gain must result from a CGT event happening after 11.45am…….. on 21 September 1999".

This clause prevents many CGT events from qualifying for the discount capital gain. Section 115-25(3) sets out a list of CGT events which cannot qualify including CGT events D1-3, E9, F1, F2, F5, H2, J2, J3 and K1 and states that they do not qualify because they cannot meet the requirement that the asset be acquired at least 12 months before the event.

We recently had a matter where a client had received a substantial amount of money in relation to a restrictive covenant on the disposal of business which is a CGT event D1. Section 115-25(3) prevents such proceeds received from qualifying for the Division 115 discount.

If the disposal had been wholly in relation to goodwill, it would have been a CGT event A1, and the taxpayer would have been able to receive the Division 115 CGT discount concession.

In this situation, it is important to recognise that the CGT discount will not apply to the entire amount received from the disposal of the business and that different CGT events may arise the sale of business.

9. CGT Event G1

While several CGT events could happen upon liquidation of a company and distribution of the income and assets of the company to shareholders, the anti-overlap provisions of s 118-20 ITAA 97 ensure that no part of a liquidator's distribution is not taxed as both a dividend and capital gain.

Section 47 may deem a liquidator's distribution, whether interim or final, to be wholly or partly an assessable dividend and also goes on to treat certain distributions that would otherwise be on capital accounts as ordinary income. Section 47 must be taken into account when advising in regard to CGT consequences of distributions made by liquidators.

CGT event G1

An interim distribution by the liquidator will usually trigger CGT event G1 if:

- a liquidator makes a payment to a shareholder in respect of a share, and
- some or all of the payment is neither an actual dividend nor deemed to be a dividend by section 47.

Exceptions to this are if the distribution involves a disposal of the share (CGT event A1) or CGT event C2 applies.

This means that the cost base and reduced cost base of shares acquired after 19 September 1985 must be reduced by the non-dividend element of the payment. If that element of the payment exceeds the cost base the excess is treated as a capital gain.

However, CGT event G1 'disregards' any payment by a liquidator if the company is dissolved within 18 months because of section 104-135(6). Therefore, if the company is liquidated within 18 months of the payment being made to a taxpayer who has self assessed on the basis of a CGT event G1 and not CGT event C2, the taxpayer will have treated the capital gain incorrectly. As a consequence, different amounts of the net capital gain can arise depending on the cost base of the shares. In this event the interim distribution is taken to be part of the proceeds of a CGT event C2 when the shares are cancelled.

Taxation Determination TD 2001/27 (at para 17) states that upon receipt of a distribution from a liquidator, shareholders can assume that a company will be dissolved within 18 months and self assess on the basis of a CGT event C2 happening. If the company is not liquidated within this time the general interest charge will generally be waived if the shareholder amends his or her return (to treat the distribution as CGT event G1 within a reasonable time TD 2001/D2 para 15).

10. CGT event C2

CGT event C2 happens when a taxpayer's ownership of an intangible CGT asset (which includes shares) is cancelled, satisfied or expires under section 104-20(5). In regard to shares in a company, CGT event C2 happens because the rights that attach to shares in a company end upon the shares being cancelled.

In the case of a voluntary winding up by the members, it is sometimes difficult to determine the exact time at which the CGT event happens. TD 2000/7 provides practical assistance by stating that CGT event C2 happens when the company is deregistered. Thus acknowledging that deregistration of the company will usually occur three months after the liquidator advising ASIC that the company has held its final meeting of members.

Practice notes:

- Where post-CGT assets are held in a company in which the taxpayer has pre-CGT shares, a capital gain is unlikely to arise under CGT event K6. This is because CGT event K6 happens at the same time that CGT event C2 happens (ie: when the company is deregistered – section 104-230(5)), by which time the company will have no assets.
- If the conditions for the discount capital gain concession are otherwise met, a capital gain that arose from CGT event C2 or CGT event G1 will qualify as a discount capital gain in accordance with Division 115.

Conclusion

These issues have highlighted the difficult nature of CGT and how each problem must be approached analytically. ■

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