Division 152: Is it achieving anything?

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1 Introduction

Small business may be "small" but the volume of measures which address this sector of the economy is large.[1] Australia is not unique in this regard.[2] The taxation landscape is littered with measures that are designed with small business in mind. This is not surprising since taxation, from tax rate through to compliance costs, has traditionally been a major concern to small business.[3]

The Ralph Review has given specific attention to the reform of tax measures for small businesses.[4] One outcome is Division 152 of the *Income Tax Assessment Act 1997* ("the 1997 Act"). This division now houses the most significant capital gains tax (CGT) concessions for small businesses in Australia. The rhetoric behind the introduction of this Division is couched in terms of high-sounding goals like simplification, streamlining, reduction of compliance cost, and enhancing flexibility. Not only is the satisfaction of some of these goals debatable, there seems to be little regard for the underlying objectives of these concessions.

Amongst the sea of change, has the concessions lost sight of the objectives? This is the theme of this paper. In particular, this paper considers two sub-questions which also set the structure of the paper. First, what are the objective(s) of these small business CGT concessions? Second, to what extent is Division 152 satisfying these objective(s)? In looking at these questions, the design elements of Division 152 are examined, focusing on the rationale and appropriateness of these elements in respect of the objective(s).[5]

2 In Search of the Purpose

It is convenient to start the investigation by considering the policy drivers behind the small business CGT concessions. This part seeks to identify the purpose(s), and in the process considers the background, rationale and appropriateness of these purposes.

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[1] Just recently the government has released a statement entitled "Committed to Small Business" that set out the government policies in relation to small business. The statement is located at http://www.pmc.gov.au/small_business/docs/small_business.pdf (accessed on 8 July 2004).

[2] This is a common theme in most developed countries, such as US, Canada, UK, South Africa, and Australia.

[3] Small Business Council, *Taxation & Small Business in Australia: Discussion Paper*, (August 1989), Commonwealth of Australia, Canberra, p5. Regular survey by the Australian Chamber of Commerce & Industry also pointed to tax costs being a consistent and most significant constraint on business growth. See for example ACCI, "Survey of Small Business", Issue 19, May 2004.

[4] Ralph Review in this paper refers to the process commenced by the government in *A Platform for Consultation*, February 1999 ("the Discussion Paper").

[5] This paper is not delving into the technical intricacies and practical issues in relation to the application of Division 152, fascinating as they are, although some of these issues will be canvassed to the extent relevant.

2.1 Special Treatments for Small Business – the Rationale

Small business receives many special treatments in the tax system. The typical rationale advanced for conferring special treatments to small business are:[6]

1. The economic argument of market failure. The sheer size of established firms coupled with significant information asymmetry makes entry difficult (if not impossible). Small business typically does not have access to sophisticated capital market that facilitates its birth and growth. This makes it more difficult for small business to access funding.
2. Regressive nature of compliance cost. Compliance costs impose an onerous burden on small business. By comparison, large businesses are better able to absorb the additional costs as they have established administrative infrastructure. Small businesses thus tend to absorb a disproportionate burden of the compliance cost.[7]
3. Losses hit harder on small business. Large businesses can absorb the losses from other income streams; small businesses do not have such ability.
4. Importantly, small businesses are described as "the crucial ingredient in the economic machine".[8] They are the source of innovation and entrepreneurship.[9] They provide competition to larger firms. They are close to the community. They provide 'sub-contract' function to larger business.[10] Small business also operates within a fragmented and heterogenous market, which makes them more resilient to economic fluctuation,[11] and hence provides a buffer for the national economy.

In summary, it is widely accepted by many jurisdictions that there is a strong economic case to give special treatments to small business. Small businesses are considered to be a vital sector of the domestic economy; they are the source of much economic activity, and their activities provide flow-on benefits to the rest of the economy. In Australia, small businesses account for one-third of the Gross Domestic Product.[12] There are in excess of 1.2 million small businesses in Australia. They form

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[6] These reasons are based on: Freedman, J. "Small Business Taxation: Policy issues and the UK" in Neil Warren, Neil (ed) *Taxing Small Business: Developing Good Tax Policies* Conference Series No. 23, Australian Tax Research Foundation (2003) 13, p14-15; and Karlinsky S. "How Does the U.S. Income Tax Law Define Small Business? Let Me Count the Ways" in Neil Warren, Neil (ed) *Taxing Small Business: Developing Good Tax Policies* Conference Series No. 23, Australian Tax Research Foundation (2003) 45, p45-46.

[7] Evans, C, Ritchie, K. and Tran-Nam, B and Walpole, W. (1997) p 79-81; and Dirkis, M and Bondfield, B., *op. cit*, at p4.

[8] Karlinsky, S., *op. cit.*, p45.

[9] Buchwald, H. *Small Business Incentive and Canadian Tax Reform* (1973), CCH Canadian Limited, Canada.

[10] Hendy, Peter, "Threats to Small and Medium Sized Enterprises From Tax and Other Regulations" in Neil Warren, Neil (ed) *Taxing Small Business: Developing Good Tax Policies* Conference Series No. 23, Australian Tax Research Foundation (2003) 113, p116- 117.

[11] *Ibid.*

[12] Hendy, Peter, *op. cit.*, p116.

a large part of the business community.[13] They employ a substantial part of the workforce (including secondary labour forces, for example, casual, part-time, low-training, low-skills jobs)[14].[15] Indeed, it has long been recognised that "the health of the Australian economy depends significantly on the capacity of small business to operate efficiently and effectively."[16]

2.2 Is Funding A Purpose?

This economic case suggests that investments in small business should be encouraged. In particular, there is a strong need to provide funding for small business (due to market failure). This may be so, but is this the reason behind the small business CGT concessions? Although the availability of the concessions could, in theory, stimulate investment, there seems to be little evidence that this is the case. Anyhow, this rationale does not provide a very satisfactory explanation for the existence of the CGT concessions. In terms of providing access to funding or financing, many mechanisms are available to serve this function, whether as part of the tax system or as part of the commercial environment. These mechanisms include:[17]

- Venture and development capital funds. These are essentially collective investment vehicles that raise funds from investors and invest in business ventures, such as start-up small business. The introduction of the venture capital limited partnership provisions in recent times could make the provision of funding more attractive.
- Pool development funds, which are a concessionally taxed investment vehicles established under the *Pool Development Funds Act 1992*.
- High net worth individuals or so called "business angel" who are prepared to make the investment.
- ASX's Enterprise Market, which is a commercial mechanism that helps non-listed business to raise needed capital.
- Superannuation funds. The amount of monies under management by superannuation funds in Australia is increasing exponentially (following the commencement of the compulsory superannuation contribution regime). Not only is small business a natural target for superannuation funds, recent changes to

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[13] Over 96% of businesses have an annual turnover of less than $1 million. ABS, *Small Business in Australia- Update 1999-2000* (2001), para 1.1.

[14] Hendy, P., *op. cit.*, p117.

[15] Small businesses represent more than 96% of all private sector, non-agricultural business and account for 47% of employment in that sector in Australia. (Source: Commonwealth of Australia, Annual Review of Small Business 2002-2003.)

[16] Small Business Council, *Taxation & Small Business in Australia: Discussion Paper*, (August 1989), Commonwealth of Australia, Canberra. p5.

[17] See O'Connell, A. "Using Tax Concessions to Encourage Investment in SMEs" (2000) 28 ABLR 443 at p446-450.

legislation are designed to make such investment an even more attractive proposition.[18]

Leaving aside the merits of these mechanisms, the point to note is that these are specific mechanisms that are designed to encourage investment in small business. These are mechanisms that encourage funding by external parties that have money, as opposed to the individual entrepreneur that often has limited financial resources. It is difficult to see how a concession that merely provides a tax break to the owners upon sale could encourage the provision of funding by these external financiers.

Further, an examination of the provisions suggests that they are not directed towards the funding needs of small business; if they are, the access conditions would be inappropriate. Take the carve-out concerning assets owned by an individual. On the one hand it makes sense that these assets are excluded as they are personal and private, and are given concessional treatment under the tax system.[19] To include them into the net asset test would effectively be taking away their concessional nature. However, in the context of enabling small business to access funding, these assets are not irrelevant. By excluding them, the implicit assumption is that they do not form the pool of resources that the person can draw on for business purposes. This is just not the case. These assets could, and are, used to facilitate funding for start-up or growing business. For example, the personal home is often used as collateral to secure borrowing from financial institution. Even assets in self-managed superannuation funds can be used to some extent despite the investment restrictions.[20]

Likewise, the carve-out concerning assets of small business affiliates can be rather generous if viewed from the perspective of providing access to funding. This rule effectively excludes assets of close family members that are not used, or available to be used, in the business being disposed of. It is, for example, possible for a spouse of the taxpayer to own investment properties that exceed $5Million without affecting the taxpayer's ability to access the concessions under the net asset test.[21] Yet such assets can be used to facilitate access to funding.

2.3 CGT and Small Business

CGT became part of the Australian tax landscape in 1985. CGT was introduced to address the structural defect of the tax system.[22] The primary purpose of CGT provisions is not to raise revenue[23]; it is an integrity measure – it seeks to prevent ordinary income from being recharacterised as non-taxable capital gains to escape

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[18] Eg. amendment to the PDF legislation by the *Pooled Development Funds Amendment Act 2000.*

[19] Eg. exclusion of main dwelling in sub-division 118-B, exclusion for private use assets in s118-10, the concessionally taxed regime for superannuation funds in Part IX of ITAA36.

[20] See discussion in section 2.6.1.

[21] Of course, the spouse in his instance would not be able to claim any small business concession if she has an interest in the business and wishes to dispose of it.

[22] Draft White Paper, *Reform of the Australian Tax System* (1985), p78.

[23] In retrospect, this proposition seems questionable. The revenue raised from CGT nowadays is not insubstantial.

tax.[24] In classic terminology, CGT reinforces the equity of the tax system by bringing it closer to the widely accepted Haig and Simon's notion of comprehensive income – the notion that all income streams should be included in the tax base and be taxed at the same rate. Since capital gains are part of this income streams, they should be included in the tax base and be taxed at the same rate as other income streams. Equity is the dominant rationale.[25]

From the original inception the CGT provisions, Part IIIA of the *Income Tax Assessment Act 1936* ("ITAA36") has provided small business taxpayers with special treatment. The sale of goodwill was always concessionally treated under Division 19. The rationale for this is not apparent in the literature. It seems that the economic case outlined above provides as good a basis as any.

The CGT concessions stayed the same until 1 July 1997, at which time Divisions 17A and 17B were introduced. With the introduction of the *Income Tax Assessment Act 1997* ("ITAA97'), the concessions were rewritten into the new Act.[26] Then following the Ralph Review, Division 152 was born in 1999.[27] This division may be new but its substance is not completely new. Division 152 provides four CGT concessions for small business. These concessions both exempt and defer tax liabilities. In particular, these concessions are:

- 15-year exemption. This allows the entire capital gains to be excluded provided the assets are held continuously for at least 15 years.
- 50% active asset reduction. This concession excludes 50% of the capital gains that arise from taxpayer's active assets.
- Retirement concession. Under this concession, capital gains that are paid as an eligible termination payment to individual taxpayer are exempt from tax. This is subject to a lifetime limit of $500,000 and there is also a requirement to rollover the amount into a complying superannuation fund if the individual is less than 55 years of age.
- Replacement asset rollover. The capital gains that is used to acquire a replacement asset is excluded from assessable income in the year in which the gain arise. This is a deferral mechanism.

The provision of such concessions steers the tax system away from the ideal equity position.[28] What are the policy reasons for this? The rationale can be traced to the complaints that have been made against CGT since its inception, namely:

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[24] Evans, C. "Taxing Capital Gains: One Step Forwards or Two Steps Back?" (2002) 5 Journal of Australian Taxation 114 at p118.

[25] Neutrality and efficiency is also cited as reasons for the introduction CGT, although these are minor compared to equity. See Evans, C (2002), at p121.

[26] Ie. subdivision 118-C, Division 123 and subdivision 118-F. These divisions and subdivisions deal with the goodwill exemption, rollover relief and retirement exemption respectively.

[27] The Report of the Review of Business Taxation, *A Tax System Redesigned* (21 September 1999), ("ATSR").

[28] Evans, C, makes this argument especially in respect of the 50% CGT discount measures

- CGT fails to recognise the fact that the increase in value of a small business is often the small business owner's only reward for the risk undertaken. Often the small business owner receives minimal or low earnings from the business throughout the years of operations; the owner relies instead on the capital gains on the eventual sale as a reward.[29]
- Capital gains on sale of a small business are seen to be a substitute for superannuation.[30] It is generally much harder for small business to provide for the retirement of its employee(s) because the funds and capital of the owner are very much locked into the assets of the business. [31] Payment of capital gains tax at time of sale would thus effectively erode the 'retirement savings' of these individuals.
- CGT regime is also criticised on the basis that it did not recognise that gains made in the course of business expansion are often used by business owners to expand their business. The growth or expansion of small business often involves disposal of assets. The CGT regime tends to deplete the capital base and hence creates a limitation or disincentive to business expansion.[32]

The introduction of Divisions 17A and 17B had these concerns in mind. Division 17A inserted a roll-over relief for small business, and Division 17B inserted a retirement exemption for small business taxpayers. The former division is said to enable the growth of small business, that is to "ensure that a lack of capital does not constrain the growth and development of small business."[33] The latter division is a recognition by the Government that "small business proprietors plough all their saving into their business which is both their livelihood and their retirement savings plan",[34] and hence it is considered desirable to provide an exemption from tax if the proceeds are used for retirement.[35]

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[29] Small Business Council, *Taxation & Small Business in Australia: Discussion Paper*, (August 1989), Commonwealth of Australia, Canberra, p 14.

[30] Small Business Council, *Taxation & Small Business in Australia: Discussion Paper*, (August 1989), Commonwealth of Australia, Canberra, p14; and Sandow, T. "Small Business Rollover and Exemption", South Australian State Convention, Taxation Institute of Australia, April/May 1998, p1.

[31] Russell, D. "Small Business Rollover and Exemption Provisions", Taxation Institute of Australia, 23rd October 1999, at p4.

[32] Small Business Council, *Taxation & Small Business in Australia: Discussion Paper*, (August 1989), Commonwealth of Australia, Canberra, p 14.

[33] Para 7.5 of the EM to the *Taxation Law Amendment Act (No. 1)*, Act 16 of 1998. The Treasurer press release on 24 March 1997 (Treasurer's Press Release No.20) stated the object as "to enable taxpayers actively involved in managing and operating the business through company to obtain rollover relief without separately selling active assets of the company."

[34] Costello, Peter, "Budget Speech 1996-97", 20 August 1996. (url: http://www.budget.gov.au/1996-97/speech.asp, accessed on 30 May 2004)

[35] Para 1.3 of the EM to *Taxation Law Amendment Act (No. 3)*, Act 147 of 1997.

2.4 Recent Reforms

The Ralph Review stated the following as the reasons for the creation of Division 152:[36]

- to reduce compliance cost;
- to rationalise the small business CGT concessions;
- to provide greater flexibility in accessing the concession.

The reform of the various CGT measures tends to focus on the economic growth objective.[37] This is consistent with the economic case to encourage small business investment. By providing an attractive tax environment, the concessions encourage investments and reinvestment by individuals, and hence bolster the overall economic growth.

However, these statements failed to accurately reflect the true reasons for the concessions. The reasons put forth by the Ralph Review are nothing more than grand policy statements; and they are more about the deficiencies of the mechanics of the pre-existing concessions. Owing largely to the narrow terms of reference,[38] the Ralph Review provided little additional explanation concerning the need for such concessions.[39] Apart from acknowledging in passing the objective of providing access to funds and providing for retirement needs of small business operators,[40] none of the reports is concerned with the underlying purposes.[41] The necessity for the concessions seems to be accepted as given.

2.5 To Reduce Compliance Costs?

It has long been recognised that compliance costs impose a higher burden on small business. [42] It is thus not surprising that the Ralph Review refers to compliance cost reduction as a purpose for the introduction of Division 152. This is arguably an empty policy goal that is not delivered in practice. Indeed, the approach adopted by the

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[36] ATSR Recommendation 17.6, and para 1.2, 1.3 of EM to the *New Business Tax System (CGT) Bill 1999*.

[37] Evans, C., *op. cit*., at p126.

[38] The aim of the Ralph Review is stated to provide tax neutral reform that increase economy growth.

[39] The objectives are: to optimise economic growth, promote equity and promote simplicity and certainty. ATSR, p13. These are restatement of the standard criteria of equity, efficiency and simplicity.

[40] Eg. in ATSR at p587.

[41] Ie. the Dicussion Paper, the ATSR, and the Treasurer's Press Release No. 58 of 21 September 1999 (Attachments E and F thereto) and Treasurer's Press Release No. 59 of the same date.

[42] Yellow Pages Small Business Index *Working Overtime: A National Survey of the Paperwork Burden* on Small Business Background Paper 3 Small Business Deregulation Task Force (October 1996); House of Representatives Standing Committee on Industry, Science and Technology *Small Business in Australia – Challenges, Problems and Opportunities: Recommendations and Main Conclusions* (David Beddall MP, chairman), January 1990 (Beddall Report) at p29; Small Business Deregulation Task Force (Charlie Bell, Chairman), Commonwealth, *Time For Business: Report of the Small Business Deregulation Task Force* (1996); Small Business Council, *Taxation & Small Business in Australia: Discussion Paper*, (August 1989), Commonwealth of Australia, Canberra, p20-21.

Ralph Review may well be misplaced. The general thrust of the Ralph Review tends to focus exclusively on legal simplicity as oppose to what has been referred to as "economic simplicity", which refers to the resources, including time and costs incurred by taxpayer to comply with the requirements of the tax system.[43] Viewed in this way, a research study has indicated that compliance costs continue to impose a significant burden and stress to small businesses.[44]

The compliance costs associated with Division 152 can be significant. Although the division arguably satisfies the Ralph Review goal of providing a more streamlined provisions in the sense that Division 152 is logical and has a systematic layout, the compliance costs associated the provisions are a totally different matter. Whilst there are no formal attempts to measure the compliance costs associated with Division 152, there is however, plenty of anecdotal evidence from practitioners that the application of the provisions in practice is complicated.[45]

In applying the concessions, many issues need to be considered. Too many. To illustrate, consider a disposal of a business operated under a single company structure. To decide whether the concession is available, it is necessary first to decide whether the company is selling the business or whether the shares in the company are being sold. Then it is necessary to decide whether the assets being disposed of are "active assets", again different tests apply depending on the answer to the first question. If shares are being sold, it is necessary to consider whether there is a controlling individual. The CGT concession stakeholder(s) also need to be identified. Then the net value of relevant assets of these individuals as well as entities "connected with" with them need to be aggregated in order to test for the satisfaction of the $5Million threshold. This list can continue, but the point is made that many complex questions need to be addressed in applying the concessions.

Further, the volume of materials that taxpayers need to wade through is immense. There are currently no less that 75 ATO Interpretative Decisions concerning the small business CGT concessions.[46] This would be burdensome to professional tax practitioners let alone the individual small business taxpayer.

Division 152 is certainly not driving to lessen paperwork. In this regard, it is difficult to see how it is reducing compliance costs. First, the issues that arise need (or should be) to be documented. Further, unlike most choices within the CGT legislation, certain choices within Division 152 require specific written elections, namely those concerning the retirement exemption and the replace asset rollover.[47] Whilst the rationale behind the written election is understandable, the point here is that this all adds to the compliance costs.

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[43] Tran-Nam, B. and Glover, J. "Tax Reform in Australia: Impacts of Tax Compliance Costs on Small Business" (2002) 5 J Aust Tax 338 at p344.

[44] *Ibid.*

[45] As noted by the articles referred to in footnote 88.

[46] Counted as at 7 May 2004. There are also two Tax Determinations, one still in draft form (TD 2000/D19 and TD 2001/14); one addendum to a Tax Ruling (TR 1999/16A); one Class Ruling (CR 2003/85).

[47] Sub-section 103-25(3).

The aim to reduce compliance cost may be very noble and, undoubtedly, politically popular. The so called Simplified Tax System for small business is said to have failed badly on this ground;[48] it is doubtful whether Division 152 is any better on this ground. Sadly, the game may well have been lost before it has started. Compliance cost reduction and CGT tend to be mutually exclusive. It was acknowledged long ago by the often-quoted Asprey Committee:[49]

> "It is a tax which, in any administrable form, must be complex and difficult, and produce some anomalies and inequities of its own. There is no doubt whatever that any revenue it raises could be more cheaply and easily raised in other ways. By the criterion of simplicity it fails."

2.6 A Substitute For Superannuation?

The concessions can be seen as a substitute for superannuation. By specifically mentioning "retirement", the 15 years exemption and the retirement exemptions provide two clear examples where retirement of the individual taxpayer is in the mind of the drafter of the legislation. Arguably, even the other two concessions may well be directed towards this end. In giving an exemption for capital gains, these provisions effectively deliver a tax-free lump sum to the taxpayers. This is analogous to the sort of benefits that an individual could obtain under the superannuation regime. In this sense, the concessions exist as a substitute.

2.6.1 Appropriateness of this Goal

It is highly doubtful that the concessions can provide a perfect substitute for the superannuation regime. Superannuation provides a highly regulated and protected environment for the accumulation of savings. The fact that superannuation funds are concessionally taxed means that, all else being equal, money in this environment will grow at a faster rate compared to money invested elsewhere. By comparison, unless the small business is doing well, the growth rate is unlikely to be same; and worse still, the capital could even be lost (because of the inherent business risk).

Using these concessions as a substitute is based on the thinking that small business taxpayers are often not in a position to put any savings into a traditional superannuation environment.[50] Implicit here is the conception that monies put into a superannuation environment are not available to be used in the taxpayer's business, and since small business taxpayer is short of money (and difficult to access funding) this makes superannuation contributions unattractive. One basis for this view is that money cannot be taken out of the superannuation environment easily due to the onerous preservation and condition of access rules.[51] This remains accurate.

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[48] It has been called the "not so simply tax system" in Moretti, C. "STS Exposed", Taxation Institute of Australia, Seminar Paper, 18 May 2001. Also, see Wolfers, L and Millers, J. "The Simplified Tax System: Is this Governmentspeak for 'Complex'" (2001) 35 TIA Journal 374, and Newby, J. "Simplified Tax System: Oasis or Mirage?", Taxation Institute of Australia, Seminar Paper, 20 March 2001.

[49] Asprey, K. Taxation Revenue Committee- Full Report (1975), p414.

[50] See footnote 30 and associated text.

[51] *Superannuation Industry (Supervision) Regulations*, Part 6, Reg 6.01 – 6.30A, and Schedule 1.

The second basis for this view is the significant investment restrictions imposed on superannuation funds.[52] A number of developments in recent times may however raise doubt as to the continuing validity of this belief. Firstly, the popularity of self-managed superannuation funds (SMSF) is growing.[53] Such funds are easy to set up, and importantly, as the members (or their company) can be the trustee, the monies in an SMSF is more controllable. Secondly, and most significantly, amendments to the investment rules now effectively enable SMSFs to invest in real business property.[54] The funds can either purchase new property or buy the property from the members,[55] and subsequently make the property available to the members by way of commercial rental arrangement. This provides a very effective and legitimate way to pass cash (that used to be locked within the superannuation fund) back to the members, and hence their business.

2.6.2 A Flawed Design

Not only can this goal be faulted on the ground of appropriateness, the mechanics of the provisions itself raise questions as to whether the provisions can provide an adequate substitute for superannuation.[56] The retirement concession in sub-division 152-D sets a lifetime limit of $500,000 for each individual.[57] The size of this limit is a mystery, and importantly, it does not compare well with the retirement taxation regime. In the arcane world of retirement taxation, the notion of reasonable benefit limit (RBL) is analogous to the function of the life-time limit in sub-division 152-D. RBL sets the maximum amount, based on government policy, that as individual taxpayer can obtained without being penalised by a higher rate of tax. The point to observe is that RBL is indexed, the lifetime limit in sub-division 152-D is not. The lump sum RBL in 1997/98 (the first income year of operation of Division 17B) is $454,718, and currently (2003/04 income year) it is $588,056. If the lifetime limit in the retirement concession is indexed in the same manner it would be $646,616 by now. Without an automatic inflationary adjustment mechanism the lifetime limit is becoming more and more disadvantageous each year. Consequently, the taxpayer would be much worst off compare to the tax treatment under the superannuation environment – the substitute is too imperfect.

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[52] These restrictions include: the sole purpose test in section 61 of the *Superannuation Industry (Supervision) Act 1999* (“SIS Act”), arm’s length rule in section 109, prohibition on borrowing in section 67 (which also prohibits giving of charge over assets (Reg 13.13)), prohibition on acquisition of assets from members in section 66, prohibition on owning ‘in-house asset’ in Part 8 of the SIS Act.

[53] The growth rate is recently cited at 20%. Jackson, Mark “Self managed superannuation funds—examining the developments in regulations and compliance” (url: http://www.ato.gov.au/print.asp?doc=/content/45072.htm, accessed on 28 May 2004).

[54] Following changes made by the *Superannuation Legislation Amendment Bill (No. 4) 1999*. This is an exception to the in-house asset restriction under paragraph 71(1)(g) of *Superannuation Industry (Supervision) Act 1993* (SIS Act).

[55] Acquisition from members are usually prohibited, but acquisition of ‘business real property’ is an exception: sub-section 66(2) of the *SIS Act*.

[56] Although, this may just be a case of bad drafting.

[57] Sub-section 152-320(1).

2.7 What is the Purpose?

Many purposes can be identified, but none seem to offer a fully satisfactory explanation. Compliance cost reduction has been advanced as a reason, but this can be discounted almost immediately. A solid economic case can be put forth to justify the concessions. This is the argument that states that investment in small businesses ought to be encouraged because they comprise a significant sector of the national economy. Whilst the economic case undoubted still exists, nowadays it is not the main function of the concessions to encourage investment in small business, and in particular, to address the funding difficulties of small business. There are arguably much more appropriate and direct means to provide such a function. The point that CGT small business concessions do not exist to address compliance costs, nor to encourage investment in small business, is emphasized by the fact that the government made no mention of such roles in a recently released statement.[58]

The special position and unique characteristics of small businesses provide a far better explanation for the existence of the concessions. The prevalence of small businesses in the economy makes them a very politically attractive target. In addition, one particular characteristic of small business is the fact that business operators' wealth are all within the business itself, and that it forms the bulk, if not all, of their retirement savings. Consequently, the concessions are considered to be a substitute for superannuation. Despite the flaw in the design and changes to the superannuation regime, which arguably weaken the concessions' role as a superannuation substitute, this still represents an important purpose.

The purpose of the concessions may thus be stated in this manner: to level the playing field between small and not-so-small business.[59] One facet of levelling the playing field is through the use of the concessions as a replacement superannuation system for small business operators. In addition, another way of levelling the playing field is to address the burden of compliance costs. Not that the concessions reduce the compliance burden in any way; rather, the interesting perspective is to see the concessions as providing a monetary compensation in an imperfect tax system, that is, to compensate for the high compliance costs burden faced by small business. In this regard, a paper recently observed that the Ralph Review "abandoned legislative simplicity, seeking instead to address the additional compliance costs through tax concessions."[60]

3 Availability of Concessions

This raises an interesting question: how effective is this compensation in levelling the playing field? One recent study concludes that the CGT concessions (in general and not just Division 152) are inadequate in this regard because the concessions "are mainly of benefit when selling or retiring from a business as opposed to running

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[58] Cited previous in footnote 1. Given the political nature of the statement made by the government, these reasons would have been mentioned even if they were only slightly significant.

[59] Russell, D., *op. cit.,* at p3.

[60] Dirkis, M. and Bondfield, B. "Small Business: The First Casualty of Tax Reform Compliance Costs" , Taxation Institute of Australia (31 March 2004), (url: http://www.taxinstitute.com.au/CDA/Stories/Individual/1,1030,43585,00.html, accessed on 11 May 2004).

one."[61] This is just one study, and the verdict is still unclear. Yet, it seems doubtful whether concessions alone can ever provide adequate compensation for the higher compliance burden.

Although this is an interesting question, it is beyond the scope of this paper to consider this question fully.[62] The rest of this paper considers just one question: who can access the small business CGT concessions? The availability of the concession is a significant issue in this context because the field cannot be made level if small businesses that are meant to be targeted are not in fact in a position to obtain the concessions. Compensation, no matter how much, is useless if no one can access it. That is, to what extent are the concessions accessible to the target audience?

3.1 Target Audience

It is therefore necessary to first establish the target audience. From the name of the concessions it is apparent that the target is "small business". The notion of "small business" would thus set the boundary between those who can access the concession and those who cannot. The hard part is to define "small business".

Small business is not defined in the legislation. The phrase "small business" does not even appear in Division 152, apart from the title to the division, sub-divisions and the guides to the various subdivisions. A review of the literature makes it clear why this is the case. Small business is something that is recognisable on sight, but is difficult to define; there is in fact no universally accepted definition of small business.[63] The small business sector is a heterogenous collection of industries and entity types, with diverse characteristics, features, and interests. A number of typical characteristics may nonetheless be identified:[64]

- It is independently owned and operated;
- It is closely controlled by owners who also contribute most, if not all, of the working capital; and
- Principal decision-making rest with the owners.

Since qualitative characteristics such as these are too vague to operationalise, legislation tends to adopt a quantitative element as a proxy. There are no shortages of definitions in Australia.[65] The Small Business Council back in 1989 defined small business as "any business which is not a public company, a subsidiary of a public company, or an entity in which a public company has a controlling interest, and which in the non-manufacturing sector has less than 20 employees and in the manufacturing

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[61] Dirkis, M and Bondfield, B., *op. cit*, at p46.

[62] To properly deal with this question would require extensive studies that involve the collection of empirical data.

[63] For a good review of the characteristics and definitions see Holmes, Scott, and Gibson, B. "Definition of Small Business", Final Report, The University of Newcastle, 5 April 2001.

[64] House of Representatives Standing Committee on Industry, *Science and Technology Report, Small Business in Australia: Challenges, Problems and Opportunities* (1990).

[65] For a good summary of these see Payne, G. "Problems with Current Tax Concessions for Australian SMEs" in Neil Warren, Neil (ed) *Taxing Small Business: Developing Good Tax Policies* Conference Series No. 23, Australian Tax Research Foundation (2003) 83.

sector has less than 100 employees, or is a business in respect of which the owners make all the critical decisions".[66] The Australian Bureau of Statistics defines small business in terms of employment.[67] Likewise, the Australian Chamber of Commerce & Industry in its Survey of Small Business used number of employee as a determinant of business size.[68] The Simplified Tax System uses a turnover-based definition.[69] The multiplicity of definitions is not unique to Australia; there are no less than 42 ways to define small business in the US tax law.[70]

3.2 Targeting the Target

In Division 152, asset value is used as the proxy. This is captured in the "maximum net asset value test" which sets a fixed threshold of $5,000,0000.[71]

Why is net asset chosen? No reasons have been given for this. Presumably, because the concessions are dealing with capital gains, it is considered 'logical' to use asset value as a mean of delineating the boundary. Accepting net asset value as an appropriate proxy for the quantum of the threshold is itself debatable. Again, there are no clear justification for the choice of $5 Million. Perhaps it is merely a policy decision; although, it does make one wonder whether it is too low or too high.

This aside, a more serious criticism is the fact that it is not indexed. Inflation may not be high in recent times, but the value of money still falls. Thus, overtime, the pool of businesses that would be entitled to obtain the CGT concessions would shrink. Interestingly, by comparison, indexation existed back in the days of the goodwill exemption.[72]

The appropriateness of the threshold quantum cannot be decided in a vacuum. A lot hinges upon whose assets and what assets are included in the test. In relation to the sort of assets that need to be counted, the legislation begins by including all CGT assets, which is a broadly defined notion.[73] Certain specific items are then carved out.

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[66] Small Business Council, *Taxation & Small Business in Australia: Discussion Paper*, (August 1989), Commonwealth of Australia, Canberra, p1.

[67] Australian Bureau of Statistics, *Small Business in Australia* (1997), p1.

[68] Small business is defined to be those with 1 – 19 employees. ACCI, Survey of Small Business, Issue 19, May 2004.

[69] Under the STS measures business with an annual turnover or receipt of less than $1 Million exclusive of GST are classified as small business under the STS regime.

The ATO annual compliance program also relies on annual turnover to divide the small from the large (Australian Taxation Office, Compliance Program 2003-2004.)

[70] Karlinsky S. *op. cit.*, p59.

[71] Section 152-15.

[72] Old section 160ZZRAA of ITAA36.

[73] Ie. CGT assets cover any kind of property, as well as legal and equitable right (s108-5(1)). Eg. in the context of a small business taxpayer it could cover: Cash; Land and building; Plants and equipment; Shares in a company; Units in a unit trust; Options; Debts owed to the taxpayer; Right to enforce contractual obligations; Interest the taxpayer has in a partnership.

These exclusions are limited, and largely relate to personal use items, and items that would otherwise cause double counting.[74]

On top of this, the legislation contains comprehensive aggregation rules. Section 152-15 aggregates the assets of the business (ie. the taxpayer), entities "connected with" the business, and "small business CGT affiliates" or entities connected with the CGT affiliates. The notion of "control" is used to establish whether an entity is connected with another. [75] In general terms, the necessary control exist where the entity owns, directly or indirectly, 40% of the interests in another entity.[76] This is the case where the interest is fixed, such as in a company or fixed trust; but in the case of discretionary trust, the rule looks to the ability to influence trust distributions,[77] and actual distributions made in the last four income year.[78]

The "connected with" test deals with the non-human entities; to bring in the human, the notion of "small business CGT affiliates" is adopted. Again the scope is broad. The first part of the definition includes the taxpayer's spouse and children under 18 years of age. This makes sense and is reasonable. But the definition also extends to cover any person who could reasonably be expected to act in accordance with the taxpayer's wishes.[79] This is very broad. It is also very vague and could give rise to many uncertainties. For instance, how to determine when someone is reasonably expected to act as directed?

It is immediately apparent that the coverage of the aggregation rules is broad. Whilst it is understandable that aggregation rules are necessary to prevent abuse of the concession- for example, by splitting asset ownership[80]- a major concern is that such broad rules have the danger that they unfairly and unintentionally deny the concessions to some taxpayers. The most striking example in this regard is the way the rule used to operate in relation to control of discretionary trust.[81] The old rule was so broad that just about any discretionary objects of the trust (which typically would include charities) can be regarded as having the requisite control and hence a "connected entity". This would thus require the inclusion of assets of all these

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[74] Section 152-20, and Para 1.12 of EM to the *New Business Tax System (Capital Gains Tax) 1999 Bill.*

[75] Section 152-30(1).

[76] Although where the "control percentage" is between 40% and 50%, the Commissioner has discretion to determine that there is no control: sub-section 152-30(3).

[77] Sub-section 152-30(2).

[78] Sub-section 152-30(5). This rule is assuming passage of the measures introduced under *Tax Law Amendment (2004 Measures No. 1) Bill 2004.* This Bill was introduced into parliament on 19 February 2004. Pass the House on 1 April 2004. Has been referred to the Senate Economics Legislation Committee which is due to report back on 12 May 2004.

[79] Sub-section 152-25(1).

[80] Assets need not be held directly by the taxpayer seeking to claim the concessions. Family members, associates, as well as the vast array of entities are available, and often use, as a vehicle to house assets.

[81] Ie. The rules that used to apply before the passage of the*Tax Law Amendment (2004 Measures No. 1) Bill 2004*.

discretionary objects, with the consequence that the threshold would fail in most small business that has a trust as part of its structure.[82]

3.3 Other Restrictions

The above threshold test is tough, but it represents only one of many that need to be satisfied to access the concessions. There is a condition that looks to the activities carried on by the taxpayer – the so called "active asset" test, which requires the assets to be in some way associated with the carrying on of a business of the taxpayer, or the taxpayer's CGT affiliates.[83] There are also conditions that provide time constraint. As part of the active asset test, the active status of the asset needs to be maintained for at least half of the ownership period (or up to a maximum of 7.5 years). In the context of the retirement exemption, there are rules prescribing the timing of the ETP remittance.[84] Similarly, the small business roll-over relief provides another instance where there is a time constraint. To access the roll-over relief, the taxpayer must acquire a "replacement asset" within one year before the CGT event and no later than 2 years after the CGT event.[85] These constraints make sense and, in some respects, perhaps could be regarded as being rather generous. They are difficult to fault as they are undoubtedly integral to the core operation of the various concessions.

However, one particular constraint that deals with the degree of ownership is unduly restrictive. This degree of ownership requirement becomes relevant in situation involving company or trust. The person seeking the concessions needs to be a so called "CGT concession stakeholder". This means the person needs to be either a "controlling individual" or a spouse of a controlling individual.[86] To be a controlling individual, the person needs to be entitled to at least 50% of the voting power, dividend and other distributions of the company; or, entitle to at least 50% of income and capital of a trust.[87] The implications of these restrictions are further elaborated below.

3.4 Complexities

It is undoubtedly the case that Division 152 represents a big improvement over previous provisions. Its structure is more logical and streamlined. Its rules are also more flexible. Yet, the provisions are complex.[88] To be fair, perhaps this is inevitable given the diverse range of ownership structures and entities that the provisions need to

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[82] Although the harsh outcome is arguably unintentional, but the Commissioner was applying the rule strictly as written in the legislation: ATO *Interpretative Decision ID2002/921*.

[83] Section 152-35.

[84] That is, payment of the ETP must be made no later than: 7 days after making the choice, or, 7 days after receiving the proceeds from the CGT event: sub-section 152-325(3).

[85] Sub-section 152-420(1).

[86] Section 152-60.

[87] See section 152-55. In the case of non-fixed trust, ownership interest is determined by the person's proportionate share of the actual distribution made during the year.

[88] This is underscored by the titled, and also the content, of two recent papers: Fitzalan, K. "The CGT Small Business Concessions: Small Doesn't Mean Simple" Taxation Institute of Australia, 6th April 2004, and Noolan, A. "The CGT Small Business Concessions: Small Business Concessions Not Simple Business Concessions" Taxation Institute of Australia, 6th April 2004.

deal with. Be this as it may, the point here is that the degree of complexity that taxpayers, or their advisers, need to navigate erodes much of the benefits that flow from it, and certainly undermines its ability to level the playing field. A brief consideration of the provisions associated with the retirement exemptions serves to illustrate the complexity.

3.4.1 Inconsistency

An examination of the provisions reveals some striking inconsistencies. The sub-division 152-D concession is entitled the "Small Business Retirement Exemption". Despite the name, there is no formal requirement to retire.[89] In contrast to this, the concession in sub-division 152-B contains a retirement requirement.[90] Yet, this Sub-division is entitled "Small Business 15-year Exemption". So much for legislative clarity!

More serious inconsistency exists within the mechanics of Sub-division 152-D itself. Adopting the drafting style of the small business concessions, this sub-division contains separate provisions dealing with situations where an individual makes the capital gains and the situation where a company or trust makes the capital gains. In the case of an individual making the capital gains, the payment to the individual is automatically deem to be an eligible termination payment (ETP);[91] whereas in the case where company or trust makes the capital gains, some form of retirement, or at the very least an event of termination of employment is required. This is not a specifically stated requirement in the sub-division, but it is a conclusion that flows from the ETP requirement. Sub-section 152-325(6) requires an ETP to be paid by the company or trust. Under the tax legislation, a payment can only be an ETP if there is a termination of employment.[92] Consequently, the procedures required to satisfy the conditions of the concessions are different between individuals making capital gains and companies or trusts making capital gains.[93] The confusion that this creates seem to be unwarranted and unnecessary. It is not clear what mischief, if any, will be created by granting an automatic ETP status to payment made by company or trust in situation where the other conditions in the provisions are otherwise satisfied.

3.4.2 The Retirement Requirement

The need to "retire" or to terminate employment for the purpose of paying an ETP seems unrealistic and contrary to usual sale practice. Small business owners are often required by new purchaser to continue to work in the business after it has been sold. This is at odds with the retirement requirement. If the person continues to work for the business as part of the condition of sale, it would be difficult to establish that the sale is "in connection with retirement". This requirement is unnecessary; it is merely a relic of the interface between the concessions and the age-old and complex ETP

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[89] Payne, Gary, *op. cit.* 107.

[90] Ie. "in connection with retirement" condition in s152-105(d), for individual making the gain, and s152-110(d), for company or trust making the gain.

[91] Sub-section 152-310(2).

[92] Section 27A(1) of ITAA36.

[93] The ATO acknowledges this difference in ATO ID 2003/748.

provisions. Further, from a policy perspective, continuing employment is good. Not only can the person continue to contribute to the business, and hence the economy and tax revenue, but these individuals also often have tacit know-how that is invaluable.

The situation is made more complicated because it is not clear what is sufficient to constitute retirement for the purpose of the concessions. For instance, is it sufficient to reduce the working hours, or does the person need to cease working and start a 'retirement' life-style. The ATO has taken a practical line in its administration of the termination requirement,[94] but much still depends on the facts and hence much uncertainties exist.[95]

3.4.3 Timing of Roll-Over

If an ETP is received by an individual of less than 55 years of age, the amount needs to be roll-overed into a complying superannuation fund or other authorised entity.[96] A subtle and unnecessary difference concerns the timing of this roll-over. A point to note upfront is that the timing of the roll over is not fully spelt out within Division 152. Regard needs to be had to subdivision AA of Part III of the ITAA36, which is not for the light-hearted. It is not the place here to analyse that subdivision, suffice to say that the provision requires the amount to be paid "immediately".[97] The result is that, if the capital gain is made by the individual, the amount must be rolled-over by the time of lodgement of the tax return.[98] If the company or trust made the gains, an additional 7 days are available following the lodgement of the company or trust tax return to roll-over the amount.[99]

3.5 Who Really Can Access The Concession?

On first glance Division 152 appears relatively flexible. The concessions are available to both Australian tax resident and non-resident.[100] The rules are designed to cover a range of business ownership vehicles, with the concessions potentially available to an individual, either as a sole trader or in partnership, through to a company or a trust. Even a superannuation fund could access the concession in some limited cases.[101] However, this flexibility disappears very quickly in practice.

The design of the rules mean that only a very narrow range of businesses could access the concessions. Unless the taxpayer seeking the concessions owns the business directly, a significant hurdle will arise in the form of the "controlling individual" and

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[94] In ATO Interpretative Decision ID 2002/493, the Commissioner considers that cessation of employment can occur if there is a termination of employment capacity. Eg. a person who is both a director and employee, can terminate either role to satisfy the cessation requirement to pay out an ETP.

[95] See Noolan, A., *op. cit.*, at p14.

[96] Eg. Complying ADF, life assurance company (s27A(12)).

[97] See s27A(12) and s27D(1).

[98] Sub-sections 152-305(1) and 152-310(2).

[99] Sub-section 152-325(3).

[100] ATO Interpretative Decision ID 2003/199.

[101] Probably at most the 50% active asset reduction. See Noolan, A., *op. cit.*, at p9. Indeed, in such limited cases, the superannuation fund is also likely to be at risk of breaching the SIS rules.

"CGT concession stakeholder" requirements.[102] Any individual selling shares in a company, or interests in a trust, needs to satisfy these requirements. The restriction imposed is best illustrated by way of an example. Suppose a company is owned by two totally unrelated individuals, say A and B. If A owns 60% of the shares, he will be a controlling individual and a CGT concession stakeholder, and hence can potentially claim the concessions if he sells his shares in the company. B with only 40% cannot.

This imposes a serious constraint on the type of ownership structure that can access the concession. Two unrelated individuals could only both obtain the concessions if they each have 50% interest in the business. This means the concessions would not be available if more than two individuals come together to operate a small business. This is very unrealistic; it fails to recognise that many small businesses involve partners whose interests are not evenly split as to 50% each. Indeed, many small businesses often have more than two partners!

The concessions seem to be designed for only "mum and dad" businesses.[103] Using the above example, if B is A's spouse, then B would be a CGT concession stakeholder, and hence on this basis both could obtain the concessions. The provisions also contain specific exceptions that allow spouses to own certain assets without that assets being included in the net asset value test. By contrast, if the same assets are owned by an entity "connected with" the taxpayer, the assets would need to be included as part of the net asset value test.

The policy rationale for these rules is not stated anywhere. There may be a policy reason to confine the operation of the concessions in this manner, but with respect, the appropriateness of such policy is highly questionable. Why should the concessions not be available to small businesses that otherwise satisfied the definition but for the fact that the owners are not "mum and dad"? After all no matter which definition of "small business" is adopted,[104] this group does not refer merely to "mum and dad" businesses. This is far too narrow. Not only is it common for people to enter into business with their friends, business involving siblings are not uncommon. Yet, these arrangements could have difficulties accessing the concessions without some fancy structuring.

This raises the next point: the rules are highly structure-sensitive. Even within a family context, significant roadblock can exist in this regard. For instance, only in very limited circumstances can an asset held by another entity be regarded as active asset. This can be quite restricting in terms of family businesses. It is not uncommon for assets to be owned by the father where he started up the business, but if the son now operates the business and then decides to sell the business together with the assets, it would seem that the exemption would not be available in relation to the assets held by the father.[105]

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[102] These rules were outlined above on section 3.3.

[103] Payne, G., *op. cit.*, p105.

[104] See section 3.1 above.

[105] Petersson, G. "The New Business Tax System: Life After Ralph CGT Reforms", (2000) 3 The Tax Specialist 202 at p210.

Further, the rule is biased against common business structures. In Australia, it is relatively common for discretionary trusts to hold family business assets directly or indirectly. This is often done for asset protection purposes, which arguably is more important to small businesses as their livelihood is more at risk. However, the rules governing the concessions are such that the presence of a discretionary trust could deny ability to claim the small business concessions. There are two aspects to this. First, there is the excessive scope of the "connected with" test mentioned previously, which fortunately is being mitigated by amendments. The second aspect concerns the "controlling individual" requirement. An individual selling shares in a company that carried on a business could potentially access the full range of the small business concessions. Whereas, if the same shares are owned by a discretionary trust, in which the individual is a beneficiary, the trust and hence the individual, would not be able to access any of the small business concessions as there is no controlling individual to speak of.

The difference is not just limited to trust. The tax outcome is also different between companies and individuals. An individual selling a business directly, or selling shares in a company that operates a business, could have all capital gains exempt or deferred under the small business concessions. By contrast, whilst a company selling its business can potentially disregard or defer all its capital gains under the concessions, the individual that owns the company would not be able to receive the proceeds tax-free, even though the individual would be able to do so had they sold the shares directly. The 50% active asset reduction is "trapped" in the company.

It is submitted that the concessions as they stand are highly restrictive and cannot be accessed by as many small business taxpayer as are desirable. This is largely not because they are not small businesses, but because their ownership structure does not match the narrow profile of the Division 152 rules. The inherent complexities referred to previously do not help either. The tax treatments do vary depending on who owns the asset, who sells the asset and how the sale transaction is structured. Just like criticism on the old concessions in Division 17A and 17B,[106] the ability to access the concession depends very much on the correct ownership structure existing from the start, as well as selling the correct assets by the correct entity.

Ownership structure matters very much under Division 152. This implies that access to the full concessions requires careful, and perhaps even long term planning, and accurate technical advice. Yet this is a luxury that many small businesses do not have. Small business operators tend to focus on the operation or growth of the business rather than tax efficient structure for sale; and more often than not, they seek advice on the brink of sale. The concessions place a high reliance on competent professional advisers, which small business taxpayers may not have access to due to cost issues. The lack of knowledge on the part of the small business operators complicates the matter.[107] Consequently, many small businesses may be missing out on the concessions than should otherwise be the case.[108]

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[106] See Sandow, T. "Small Business Rollover and Exemption", South Australian State Convention, Taxation Institute of Australia, April/May 1998.

[107] A study has indicated that small business taxpayers tend to overestimate their level of taxation knowledge; the actual state of their technical understanding is rather poor. McKerchar, M.

4 Conclusion

This paper begins by raising the question whether the small business CGT concessions have lost sight of the objectives. It is submitted that the reasons behind the existence of the concessions have become very muddled. The concessions do not really function, and are in fact ill-suited to encourage investment in small business. The concessions fail miserably on the compliance reduction argument. The only role where they are holding some ground is in providing a substitute for superannuation for small business operators, although the need for this role is itself debatable in recent times.

If a broader perspective is adopted, the concessions may be regarded as a means to level the playing field between the small and non-so-small business by functioning as a compensation for the additional compliance burdens faced by small business. The ability of the concessions to achieve this goal seems flawed. Not only may the adequacy of the compensation be questioned, the difficulties in accessing the concessions really raise doubt as to the ability of the concessions to provide such compensation in any event. Many taxpayers may be benefiting from the concessions, but it would be more interesting to see how many well-deserved small businesses are missing out because they do not fit within the tight paradigm of the concessions.

"Understanding Small Business Taxpayers: Their Source of Information and Level of Knowledge of Taxation" (1995) 12 Australian Tax Forum 25.

[108] The alternative way of stating this is that the concessions may be claimed by taxpayers in circumstances where technically they should not be entitled to it.

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DIVISION 152:

IS IT ACHIEVING ANYTHING?

Raymond Yu

25 November 2004