



Client Information Newsletter - Tax & Super

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Look before you leap: the small business CGT concessions

The CGT relief concessions that are available to small businesses can be very generous. However they can also be complex and confusing, so knowing a few of the finer details can go a long way to ensuring your small business can take best advantage of them.

About this newsletter

Welcome to Montague Partners' client information newsletter, your monthly tax and super update keeping you on top of the issues, news and changes you need to know. Should you require further information on any of topics please contact your adviser below:

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It's never too early to consider an escape plan, so when setting up a business structure consider the effect of the proposed structure on potential exit strategies down the track. The small business CGT concessions, if properly utilised, provide opportunities for smart exit strategies, and therefore consideration can be given on how you may be able to access and maximise the concessions in the future.

While all structures (companies, trusts, partnerships and sole traders) can access the small business CGT concessions, there are situations where a discretionary trust may receive greater advantages. For example, a

Look before you leap: the small business CGT concessions *cont*

company may find that it can reduce a capital gain via the small business 50% active asset reduction, but not have sufficient franking credits to pass on this benefit to shareholders in a tax-effective manner. Similarly, a unit trust may access the concessions but find that some of the benefit is undone via the application of certain CGT events (for example, a unit trust makes a payment to a unitholder containing a non-assessable amount).

Naturally the small business CGT concessions are only one factor that should be considered in choosing an appropriate business structure. For example, if a business intends to conduct research and development activities it may not be the best option to consider a trust structure only to find that the R&D tax incentive is only available to companies.

Don't just set-and-forget

It is important to be mindful of changes in legislation (which we can help you with), and this is especially true of the small business CGT concessions, which are the subject of frequent changes in law and interpretation.

Consider for example if a business is on the verge of not satisfying the \$6 million maximum net asset value test. Thought could be given to selling an asset to an associate, however it is necessary to identify the most appropriate time to take this action, as in the context of the maximum net asset value test this must be satisfied just before any "CGT event".

In one court case, it was deemed that a transaction occurred when a heads of agreement was entered into, not when the contract of sale was signed. In another case, shareholders signed a letter indicating their agreement to sell their shares. The letter stipulated a requirement of exclusive dealing between the parties and made reference to certain contractual conditions (including that the purchaser would undertake due diligence). The court found that the sale happened when the letter was signed, not when the ultimate contract was executed.

Maximum net asset value — know what to count

Satisfying the maximum net asset value test requires that the total of the net value of CGT assets, and the net value of the CGT assets of connected entities and affiliates (associated entities), does not exceed \$6 million. Net assets refers to the market value of the assets after subtracting liabilities that are related to those assets, as well as certain provisions.

A CGT asset is defined as any kind of property or a legal or equitable right that is not property. Depreciating assets and trading stock are both CGT assets. Do not exclude these assets merely because the profit on their disposal is taxed under a different regime. This may not be a common consideration today, but similarly while CGT assets acquired before 20 September 1985 may not attract CGT on disposal, they are still taken into account for the purpose of this test. The same is true of non-taxable Australian property held by non-resident taxpayers.

The provisions that may be deducted are for annual leave, long service leave, unearned income and tax liabilities. Be careful not to overlook these provisions if they are not disclosed in the financial statements.

Know what doesn't count

When applying the maximum net asset value test, certain assets may be disregarded. By maximising these exclusions, it may be possible to bring the aggregated net assets of the business and associated entities below \$6 million. This may be done, for example, by purchasing or improving an excluded asset and:

- maximising superannuation contributions, or
- making a bona fide gift to a recipient who is not connected to the taxpayer.

An asset that is owned by an individual and is being used solely for the personal use and enjoyment of that individual or their affiliate is an excluded asset. A holiday home may be an example of such an asset, but vacant

A CGT asset is defined as any kind of property or a legal or equitable right that is not property.

Look before you leap: the small business CGT concessions cont

land on which an individual intends to construct a holiday home will not qualify.

The ATO's view is that the use of an asset over its entire ownership period should be considered – not only how the asset was being used at the time of the CGT event. The Commissioner believes that any non-personal use of an asset at any stage of its ownership period can render it ineligible to be disregarded.

An individual's main residence is another example of an excluded asset, though it would not be fully excluded if the individual used it for income producing purposes, such that they could claim a deduction for interest during part of the ownership period.

A deduction for interest (if any were incurred) would be available if a part of the home were set aside exclusively as a place of business, was clearly identifiable as such, and was not readily adaptable for private use. A doctor's surgery located within a home is an example. Income producing use by an individual other than the owner would not prevent the dwelling to be excluded. For example, a doctor working from home may be well advised to ensure that their spouse owns the house outright.

Don't assume the sale price is the market value

The maximum net asset value test asks taxpayers to obtain a market value of relevant CGT assets, which is to be determined in accordance to common law principles. In most cases, the market value of an asset will be the price agreed to by parties dealing at arm's length.

However there are cases where the courts have found that market value and sale price have diverged. This may occur where a buyer is willing to pay more than an asset's intrinsic value because it has a particular adaptability or usefulness to them (for example, a parcel of land that a neighbour to it is keen to acquire).

Market value and sale price may also diverge in cases of aggregated disposals where, for example, a taxpayer is one of three equal shareholders who sell their shares to a single purchaser, where a premium is included due to the sale resulting in the buyer thereby obtaining control of the company.

Taxpayers who wish to argue that the proceeds from the sale of an asset are greater than its market value should remember that they bear the onus of proof. It is not enough to merely find flaws in the ATO's valuation. It would be wise to obtain the services of an independent professional valuer – preferably one with relevant experience in the asset being valued. Tax law is rife

with examples of the courts failing to accept a valuation because the methodology was flawed, so the valuer should clearly document the process they undertook and be prepared to justify it.

Active asset test, cautionary note

One condition that must be met to access the small business CGT concessions is that the CGT assets must be "active" assets. Remember to look back at an asset's use over its relevant ownership period to determine whether it satisfies the active asset test. Unfortunately some business owners incorrectly assume that an asset that is currently active has always been so.

To satisfy the active asset test, if the asset has been owned for less than 15 years, it must have been an active asset for at least half of the ownership period. Once an asset has been active for 7.5 years, it will always satisfy the active asset test no matter how long the asset has been owned. From that point, if it ceases to be active for any reason, this will not prevent it from satisfying the active asset test.

Whether a share or unit is an active asset depends on the underlying assets. Broadly, they will be active if 80% or more of the market value of all assets of the company or trust are active or otherwise included. A share (rather than asset) sale can often be preferable to the vendor, so disposing of any non-active assets (especially pre-CGT assets if possible) to enable the shares or units to get above this 80% threshold is another option to be considered.

Sometimes, being in business isn't enough

Certain assets are specifically excluded from being an active asset. One such exclusion applies to assets that have a main use by the taxpayer to derive rent, unless the main use for deriving rent was only temporary.

There is a misconception among some that this exception does not apply where the taxpayer carries on a business of leasing properties. The courts have rejected this argument, stating clearly that it does not matter if the taxpayer is in the business of leasing properties or not.

That is not to say that all income derived from allowing third parties to use property is considered "rent" for the purposes of the exclusion. The ATO has at various times previously ruled that income derived from a commercial storage facility, boarding houses, holiday apartments and caravan parks were not rent. Conversely it has also found that payments for short stays in a holiday unit were rent. The key factor to consider is whether the occupier has a right to exclusive possession and quiet enjoyment of the property. ■



Treasury amends LRBA requirements for SMSFs – again

As if the new transfer balance cap rules were not complicated enough, the government has passed legislation that complicates it further where an SMSF starts a limited recourse borrowing arrangement (LRBA) from 1 July 2017.

Treasury was concerned that some trustees would try to get around the \$1.6 million transfer balance cap (TBC) through the strategic use of an LRBA. Thankfully the new rules do not affect LRBAs entered into before 1 July 2017.

There was concern raised by some that the new rules would apply to refinancing existing loans, however guidance from the ATO makes it clear the new rules do not apply to existing loans that are refinanced or to contracts entered into before 1 July 2017 but not finalised until on or after that date.

NEW RULES IN PLAIN ENGLISH

What the new rules do in effect is ensure that a particular member of a fund is not able to manipulate arrangements to get around the TBC. The changes guarantee that the TBC rules apply appropriately where there is a repayment of an LRBA that transfers value from accumulation interests into retirement phase interests. It does this by creating an additional transfer balance credit. The credit is the amount equal to the increase in the value of a particular member's retirement phase superannuation interests that they receive. These rules only apply to SMSFs and complying superannuation funds with less than five members.

The particular member will receive a transfer balance credit when the superannuation provider (the SMSF) transfers a payment in regard to an LRBA that creates an increase in the value of the superannuation interest that is supporting the income stream they are receiving in retirement phase.

The timing of the credit arises at the time that the payment is made, however, the amount of the credit is only the amount by which the superannuation income stream has increased in value. The reason for this is to ensure that a member's transfer balance account reflects shifts of value between a fund's retirement phase and accumulation assets. This is no different to the way a transfer from an accumulation phase is dealt with at the time that a superannuation income stream is created.

Any repayment amount of an LRBA has the effect of increasing the value of the underlying superannuation interest. For this reason, where the repayment of the LRBA is sourced from the same assets that support the particular superannuation interest, it does not change the overall value of the superannuation interest because the reduction in the LRBA liability is offset by a corresponding reduction in cash. This, therefore, does not create a transfer balance credit. It is only when part or all of the income paying off the LRBA comes from an accumulation interest also held by the member that the credit applies.

Treasury amends LRBA requirements for SMSFs – again *cont*

WHAT ABOUT EXCESS TRANSFER BALANCE?

It is clear from the new rules that this new form of transfer balance credit may cause a member to also have excess transfer balance. If this is the case, the member can roll back an amount equal to the credit through a commutation or partial commutation of the superannuation income stream. This commutation of the income stream will allow the member to have a transfer balance debit. When this causes a commutation of the superannuation income stream, this does not necessitate any changes to the underlying assets in the fund. However, the fund's access to the various earnings tax exemptions may be affected by doing so.

CONCLUSION

If you currently have an LRBA in place, rest easy. The government has made it clear that the new rules do not apply if you are refinancing an existing LRBA.

Contact us to get a full understanding of how these new rules apply and whether or not you need to be concerned by them. The simplest way to avoid the new rules is to ensure that any LRBA asset transferred to the assets underlying a superannuation pension are paid off from either or both of the income from the LRBA asset and cash in the superannuation pension, not from an accumulation asset. ■

TBC CREDIT TRANSACTIONS

There is a real concern the new rules will create a reporting nightmare. The problem is that every repayment will cause a TBC credit transaction to arise. Since every new TBC credit transaction must be reported to the ATO, this could create the situation of a large amount of reporting, which would be a nuisance to both the fund administrators and the ATO. This would also seem to go against the intent of the legislation.

For example if the fund made fortnightly payments to pay off the LRBA and part of that repayment comes from accumulation interest, then the fund must report to the ATO every fortnight.

LRBA_s ORIGINALLY PROPOSED TO COUNT TOWARDS TOTAL SUPER BALANCE

The original proposal was for LRBA_s to count towards the "total superannuation balance" so that it was increased by the amount of the asset that supports one or more of their superannuation interests that are subject to an LRBA. It was proposed that the amount by which an individual's total superannuation balance is increased is equal to a proportion of the outstanding balance of the LRBA.

The concern was that by including the LRBA in the total superannuation balance, it would in effect make LRBA_s pointless for the majority of those that wanted to use them. SMSF advisers lobbied the government hard to change its mind, and at least for the moment this proposal has not been progressed.

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Are those investment returns on **revenue** or **capital** account?

Investment returns can be on revenue or capital account. Similarly investment expenditure could also be on revenue or capital account. The distinction between revenue and capital is not always clear and the characterisation of a receipt will ultimately depend on the circumstances that apply to the taxpayer.

The distinction between an income and capital receipt has been likened to the fruit and the tree, where the capital amount is the tree and the fruit being the return of income from the capital. Generally an income receipt is regarded as an amount that is regular, recurrent or periodic and income tax applies to a net amount of income. A good example is dividend returns from a shareholding.

However, it is not always clear whether an amount should be treated as income or capital. What may appear to be a capital gain for example may in fact be classified more correctly as income where the taxpayer had a profit-making intention relevant to a particular transaction.

The intention of the taxpayer when the asset is acquired (or any subsequent change of intention) and the length of the ownership period may be relevant in determining whether a gain is on revenue or capital account. Note also where the amount is a capital return, the investor may have access to the CGT discount provisions which provides a better tax result than would be the case where it is fully taxed as ordinary assessable income.

Similarly the treatment of an outgoing as either on capital or revenue account is important to determine whether an immediate deduction is allowable or whether the outgoing forms part of the cost base of a CGT asset.

Matters to be considered when deciding whether an outgoing is revenue or capital in nature include:

- the character of the advantage sought by the outgoing
- the advantage sought by the taxpayer, and
- how the advantage comes about (for example, recurrent payments).

Generally, those holding assets fall into two categories – traders and longer term investors.

Traders on revenue account

Generally, where the holder of an asset carries on activities for the purpose of earning income from buying and selling such assets, that holder will be in the business of trading. Generally, a trader:

- holds assets as trading stock
- includes gross receipts from the sale of assets as income
- recognises expenses incurred in relation to trading activities as allowable deductions, and
- includes in assessable income investment returns such as interest, dividends and distributions.

Note that where the holder of an investment product enters into an isolated transaction with a profit making intention, they will generally not be considered to be in the business of trading. However, any net profit from the transaction will be assessable on revenue account.

Investors on capital account

Where investments are held with the intention of earning regular income from the holding of those investments only, the holder may be seen as generally being an investor and not carrying on a business.

This type of investor generally:

- does not include gross receipts from the sale of investments as income. Any net gain is assessable pursuant to the capital gains tax provisions
- cannot include capital losses from the sale of investments against income from any other sources except current or future capital gains (in other words, quarantining these losses)
- cannot include expenses incurred in relation to buying and selling investments as a deduction when incurred. These are taken into account in determining the amount of any capital gain or loss instead, and
- includes investment returns such as interest, dividends and distributions in assessable income. ■



Do you need to lodge your tax return early?

If you are planning to permanently leave Australia before the end of the financial year, you may be able to have your tax return lodged early. Generally, the ATO only accepts early lodgment of individual returns in certain prescribed circumstances.

If you are a resident of Australia for tax purposes, returns lodged before the end of the financial year will be accepted if you are leaving Australia, will cease to be a resident of Australia for tax purposes, and you won't be deriving any Australian sourced income (except in the form of interest, dividends and royalty income). The same applies to those who are already not a resident for tax purposes.

If you will still receive Australian sourced income – besides interest, dividends and royalties – after leaving Australia, you will be required to lodge your return in the usual tax time period (that is, from July 1). The same applies if you have a Higher Education Loan Program (HELP) or Trade Support Loan (TSL) debt, and of course if you are not leaving Australia permanently. And don't forget that using the services of this firm also gives you access to extensions of time to lodge (ask us about this if relevant).

Note that refunds of franking credits may only be claimed by people who were Australian residents for tax purposes at the time the related dividend was received.

If you meet the eligibility requirements to be able to lodge an early return, you need to:

- collect payment summaries from each of your employers along with any other details regarding income earned while in Australia (payslips are not sufficient as they may not contain final payment details)

- contact the ATO (or have us do that for you) to talk about any outstanding debts, and lodging of any tax returns for earlier years
- consider any recent legislative changes (which we can help you with) that may affect your circumstances when preparing your early return.

Working holiday makers (that is, people on a 417 or 462 visa) who intend to lodge before the end of the current income year will need to supply additional information to help ensure the ATO arrives at the correct outcome due to the changes in the law from January 1, 2017. This includes a note showing income earned from July 1, 2016 to December 31, 2016, any working holiday maker income earned from January 1, 2017 to June 30, 2017, and any deductions associated with those income periods. There is no need to lodge two separate tax returns.

And if you are overseas during the timeframe for lodging your return, but will continue to be an Australian resident for tax purposes or will keep earning Australian sourced income in the form other than only interest, dividends and royalty income, you can have our firm lodge on your behalf. ■



SMSF stats just keep getting better

The ATO has recently released the latest of what has become a regular update on the state of the SMSF market. The *Self-managed super fund statistical report*, with the latest covering the quarter to March this year, has become an anticipated overview for many in the SMSF arena — containing as it usually does some good news. This quarterly update is no exception.

The statistical report is put together from the vast swathe of data gathered by the ATO from lodgments, returns, registrations and auditor contravention reports. As getting all of the relevant statistics together can take some time, relying as this effort does on all returns and so on being completed, some of the data used in this ATO report is sourced from very recent financial years. Otherwise the data reflects that state of play for the period January 1 to March 31, 2017.

As at the end of March 2017, the total number of SMSFs was 590,742, with total members of 1,120,117. The most common age (although this goes back to July 2016) of a trustee was 60 to 69 (28.3% of the overall SMSF population), with the next most evident age being 50 to 59 (26.2%). Close behind however is the peak-earning 35 to 49 age group, at 23.3%. Even the younger 25 to 34 year olds had a presence, at 4%.

The latest data for the March quarter 2017 however shows that most of the newly established SMSFs were driven by 35 to 44 year olds (30.5% of new funds). The next age groups to jump into the SMSF pool were the 45 to 49 year olds (17.9%) and the 50 to 54s (14.9%). The 25 to 34s mentioned above increased their presence, with 11.5% of new funds, and there were even younger than 25 year old trustees establishing 1.2% of new funds.

While the number of establishments is an easily measured score, being based on Australian Business

Register registrations, having the ATO on hand can give other insights not readily available without the ATO's tax data available — specifically, the members' most recently lodged individual tax return as at the date of establishment.

For example, most new SMSF trustees for the March 2017 quarter earned between \$100,000 and \$150,000 a year, although this was a slim majority (15.2% of the total). The next most-common earnings range was \$40,000 to \$60,000 (14.9%), closely followed by the \$60,000 to \$80,000 and \$20,000 to \$40,000 ranges (both 14.5%).

The \$80,000 to \$100,000 earners made up 12% of new SMSF trustees. As you can see, there is no real outstanding income range that could be said to define newly established SMSF members. Interestingly there were also 10.7% of new SMSF members with taxable earnings between zero and \$20,000, which would most likely be explained by factors not covered by these particular ATO statistics.

The average assets per member (at July 2016) was \$589,636. However average assets per each fund was recorded at \$1,111,732. How this breaks down into retirement benefits for each individual is further illustrated by the data for the number of members per fund. Most SMSFs (that is, 69.8%) are two member funds, and 22.7% are single member funds. Only 3.9% of SMSFs have the maximum of four members, with a similar result (3.7%) having three. ■