Attachment E

IMPROVING AND STREAMLINING SMALL BUSINESS CAPITAL GAINS TAX PROVISIONS

The Government will significantly improve the way in which capital gains tax relief is delivered to small business. The reforms will:

- increase the level of benefits available to small business taxpayers;
- improve the operation of the law by merging and rationalising the existing provisions; and
- provide greater flexibility in how small business taxpayers can access the various benefits.

Key features

The reform will replace the 50 per cent goodwill exemption that applies to small businesses with net assets of under $2.3 million with a 50 per cent active asset exemption for all small businesses with net assets of up to $5 million.

The Government will also rationalise the eligibility criteria for small business capital gains tax relief. Compliance costs will be reduced accordingly.

As a result of these reforms and the general reforms to the taxation of capital gains outlined in Attachment D, capital gains tax will no longer be an impediment to investment by small business.

Under the package of capital gains tax reforms announced by the Government, individuals operating a small business will:

- be eligible for the 50 per cent exclusion from capital gains tax outlined in Attachment D;
- be eligible for the 50 per cent active assets exemption on the balance of the capital gain;
- be able to elect to roll the remaining 25 per cent of the gain into replacement assets; or
- be able to apply the remaining 25 per cent towards the $500,000 capital gains tax retirement exemption.

In addition, as outlined in Attachment F, small business taxpayers will be exempt from capital gains tax where active assets are held for 15 years or more.

Further details are provided in the appendix to this attachment.

Commencement

The measure applies to capital gains tax events from 21 September 1999.

Current arrangements

Taxpayers with net business assets of under $2.3 million are eligible for a 50 per cent exemption for the goodwill component of a capital gain arising on the disposal of the business. Taxpayers with net capital gains tax assets of up to $5 million are eligible to roll over capital gains into replacement assets (but not goodwill) or to apply the gain towards a $500,000 capital gains tax retirement exemption.

However, there is a restriction that, for any one disposal, a small business cannot benefit from more than one of:

- the goodwill exemption;
- the small business rollover; or
- the retirement exemption.

Why change is needed

The capital gains tax rollover relief, retirement exemption and goodwill exemption provisions have the same underlying objective of providing small business people with access to funds for retirement or expansion.

The interaction between the existing provisions is unnecessarily complex and, as a consequence, the law is not operating effectively. Examples are:

- the rollover provisions to prevent tax avoidance through taxpayers rolling gains into goodwill and then using the goodwill exemption; and
- the goodwill exemption has been litigious and is difficult to administer because the precise meaning and valuation of 'goodwill' are elusive.

Small business taxpayers will now be able to benefit successively from all of the concessions for any one disposal. This will reduce unnecessary compliance costs for taxpayers in working out which concession they should claim.

Appendix to Attachment E

Improving and Streamlining Small Business Capital Gains Tax Provisions — Further Details

Key design features

The small business assets exemption will use the same general eligibility rules as the small business rollover and retirement exemption, including the following:

- The asset must be an active asset or be a company share, trust unit or other membership interest where the taxpayer is a controlling individual of the entity carrying on the business.
  - An active asset is an asset used in the business (for example, land and buildings) or an intangible asset inherently connected with the business (for example, goodwill and intellectual property). Land and buildings are also an active asset if used in a business operated by a connected entity.
    - An example of a non-active (passive) asset is a share portfolio or a property used predominantly for rental purposes.
- There is a limit of $5 million on the net value of the assets that the taxpayer and entities connected with the taxpayer can own.

Rationalisation of existing small business rollover and retirement provisions

The main amendments to the existing small business rollover and retirement provisions are as follows:

- Membership interests (which will now extend beyond shares in a company and units in a unit trust) will qualify for the small business capital gains tax provisions where the taxpayer is a controlling individual of the relevant entity.
- The definition of controlling individual for the small business rollover will no longer require the controlling individual of a company to be both a director and an employee of the company. It will now only require the controlling individual to be an employee or a director of the company.
- The retirement exemption requires that a director and owner of a small business company resign the directorship to gain access to the exemption. The director will now no longer be required to resign the directorship.
- If, apart from the employee requirement, the taxpayer would be a controlling individual of a company or trust which is the operating entity of a small business which sells active assets, the taxpayer will now be eligible for the retirement exemption if he or she:
  - is an employee of the operating entity, or
  - is effectively an employee of the operating entity via an entity that is ‘connected with’ the taxpayer or is its ‘small business capital gains tax affiliate’ (as defined in the capital gains tax small business provisions).

- The retirement exemption will be extended to a capital gain arising from the disposal of a company share or trust unit or other membership interest where the taxpayer is a controlling individual of the entity carrying on the business. It will ensure that small business taxpayers who sell membership interests in the entity operating the business are treated similarly to those who directly sell business assets.

- If the asset is a membership interest, it will have to satisfy a 'look through' rule to the company's or trust's assets requiring that 80 per cent or more of the entity's total assets be active assets for at least half of the period the assets were owned for the membership interest to qualify for the small business concession.