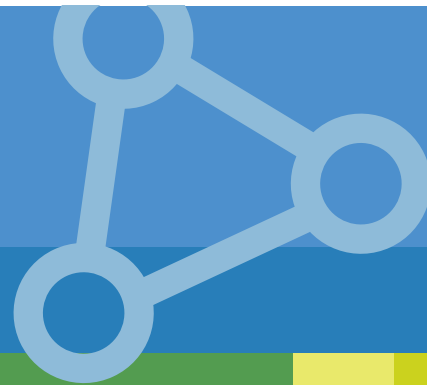


FirstTech

Strategic Update

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Small Business CGT Reforms

By Craig Day – Senior Technical Services Manager

Since the 2006 Budget, a lot of time and effort has gone into analysing the superannuation proposals and their potential impacts. However, of potentially greater importance to some clients are the announcements in relation to the small business CGT exemptions. Although not yet law, these announcements could result in a lot more people being eligible to reduce or eliminate large capital gains on the sale of certain business assets.

Proposed rules

Although the Government made a number of announcements in relation to the small business rules on Budget night (see small business CGT exemptions flyer*), one of the most important was its announcement to replace the current 50% controlling individual test with a 20% significant individual test that could be satisfied either directly or indirectly through one or more interposed entities.

Current rules

Under the current rules, where an active asset of a business is held in a company or trust, that company or trust is required to have a controlling individual at the time of the CGT event. This requirement to have a controlling individual applies where:

- an individual is selling their shares or units in the company or trust under the basic eligibility requirements¹, or
- a company or trust is selling an asset and an individual wishes to claim either the 15-year or retirement exemption in relation to any gain made by the company or trust. In this situation the person claiming the exemption must also be a controlling individual or their spouse.

Although the definition of controlling individual is different for companies and trusts, the two definitions generally require an individual to have at least a 50% controlling interest in the entity. To give an indication, this generally requires an individual to hold at least 50% of the shares in a company or to be beneficially entitled to at least 50% of the income and capital of a trust².

In a lot of situations, clients with small businesses have found themselves unable to claim the exemptions as no one individual had at least a 50% controlling interest in their company or trust. In addition, even where there was a controlling individual, only that controlling individual and their spouse³ were able to claim the 15-year or retirement exemptions – resulting in minor stakeholders missing out.

Advantages

By replacing the 50% controlling individual test with a 20% significant stakeholder test, the Government will effectively allow more people to take advantage of the small business CGT concessions by making them easier to qualify for.

The new rules will also allow clients that control a business through an interposed entity, such as a family discretionary trust, to qualify without the need to restructure.

Contents

Small Business CGT Reforms	1
Special Disability Trusts	3
Did you know?	3
Hypotheticals	4

* A summary of all the recommendations released on Budget night 2006 can be found in the small business CGT exemptions flyer.

1 Shares or units must satisfy definition of active asset – see ITAA 97 152-40.

2 This is a general discussion on controlling individual only – see ITAA 97 152-50 for specific definition.

3 Where they hold at least some interest in the entity.



Case Study 1

Joanne, Beth, Mel and Jane are all sisters who each own 25% of the shares in Daylong Pty, a company through which they run a child care business. Beth is much more ambitious than her sisters and has recently made an offer to buy her sisters' shares out, as she wants to take control and grow the business.

Under the existing rules, even if the shares met the definition of an active asset, Joanne, Mel and Jane would not generally be eligible to claim the small business CGT concessions on the sale of their shares, as DayLong Pty does not have a controlling individual. However, under the proposed rules, they would all qualify, as Daylong Pty would have at least one 20% significant individual at the time of sale and they all own more than 20% of the company.^{4,5}

A word of caution

Even though the new rules are proposed to apply for CGT events occurring from the 2006/07 year onwards, advisers should proceed with caution until more information is available. Although the new rules could allow some clients to claim the exemptions where they were previously ineligible, this will very much depend on the detail of the legislation and any consequential amendments the Government makes to the general rules as a result of the introduction of the 20% significant individual test.

For example, under the current rules, where an individual effectively owns more than 40% of an entity, the full value of the entity is included in the individual's \$5 million net asset value test⁶. Should this 40% interest be lowered, it could result in some clients having the full value of an entity included in the \$5 million net asset value test, resulting in the client becoming ineligible to claim the exemptions.



Case Study 2

Max and his three brothers each own 20% of the shares in a company that runs a warehousing business. The remaining 20% of shares in the company are divided evenly between Max's and his brother's spouses. The main assets of the company are a warehouse and goodwill. Max and his brothers are all getting older and they have made the decision to sell up and retire. As a result, Max and his brothers sell the warehouse and goodwill to a competitor.

Under the current rules, Max and his brothers would not be eligible to claim the 15-year or retirement exemptions on the gain made by their company, as they are not controlling individuals of the company. However, under the proposed rules, all eight shareholders would be able to claim the exemptions as they are all 20% significant individuals of the business or are the spouse of a significant individual that holds some interest in the company.⁵



Case Study 3

Dr Bob has been running his own medical practice for 10 years and is now retiring. Dr Bob's surgery premises are owned by his service company, BHS Pty Ltd, to which he pays rent and a service fee to provide staff. BHS Pty Ltd is wholly owned by Dr Bob's family trust, of which both Dr Bob and his wife are the sole income and capital beneficiaries.

Under the current rules, Dr Bob would not be eligible to claim the small business retirement exemption on the sale of the surgery, as BHS Pty Ltd does not have a controlling individual. However, under the proposed changes it is suggested that Dr Bob could potentially claim the small business CGT retirement concession on the sale of the surgery premises, as BHS Pty Ltd indirectly satisfies the '20% significant individual test' through Dr Bob's family trust.

“In the business world, everyone is paid in two coins: cash and experience. Take the experience first; the cash will come later.”

– Harold Geneen

4 Assumes shares satisfy definition of active asset – see ITAA 97 152-40.

5 Assumes eligible under other requirements.

6 Proposals were announced in the Federal Budget 2006 to increase this threshold to \$6 million.

Special Disability Trusts

by Vicki Leaton – Technical Services Analyst

Planning for family members with severe disabilities? Concerned about the effect of the social security means test of private trusts and gifting rules? Here is a strategy tip: consider delaying the establishment of a 'special disability trust' until 20 September 2006.

From 20 September 2006, parents and immediate family members of a person with a severe disability will be able to establish a special disability trust worth up to \$500,000. The limit will be increased annually on 1 July in line with the Consumer Price Index (CPI). The trust allows parents and family members to cater for the current and future accommodation and support needs of a 'principal beneficiary', which includes disabled children, grandchildren or siblings.

Provided certain conditions are met, the special disability trust will be exempt from the social security and veterans' affairs means test. Any amount above the limit will be included as an assessable asset for the principal beneficiary with a severe disability.

The following example shows how indexation of the assets test exemption limit may affect a special disability trust:

20 September 2006	Assets test exemption limit is \$500,000.
1 January 2007	Parents gift \$500,000 to the special disability trust, and this money is invested. No assets are assessable.
1 July 2007	CPI is 2% (assumed), meaning that assets test exemption limit is raised to \$510,000.
1 July 2008	Return on investments in the special disability trust for the 2007 calendar year is \$8,000 and the total assets are \$508,000. As this amount is less than the assets test exemption limit, no assets are assessed.

Providing the income and assets from the trust are used for the principal beneficiary's care and accommodation, the trust's income is exempted from the income test for the principal beneficiary and any family member who has gifted to the trust.

A special disability trust must meet certain requirements which include:

- be 'protective' in nature
- have only one principal beneficiary (ie the person for whom the trust is established)
- the principal beneficiary must meet the eligibility criteria
- provide only for the accommodation and care needs of the principal beneficiary
- have a trust deed that contains clauses set out in the model trust deed
- have an independent trustee, or alternatively have more than one trustee
- comply with the investment restrictions
- conduct independent audits when required, and
- provide annual financial statements.

Did you know?

The Income Maintenance Period (IMP), which is currently calculated only on 'leave' entitlements received on termination of employment, will now include 'termination' payments. This includes bona fide redundancies and approved early retirement schemes.

In addition, the IMP which currently applies to allowances only will be extended to the Disability Support Pension (DSP). Permanently blind applicants will be excluded from the application of the IMP on the DSP, because they are not subject to means testing. Both amendments will commence from 20 September 2006. For more information, call Centrelink on 132 300 and speak to a Financial Information Service (FIS) Officer.

* For 'principal beneficiary' eligibility requirements, refer to question 4 in the Q&A contained in the website link below. For more information, visit http://www.facs.gov.au/internet/facsinternet.nsf/disabilities/carers-future_planning.htm, email your questions to special.disability.trusts@facsia.gov.au or call 1800 081 549.

Hypotheticals

Q1. Fabio is aged 66 and commenced an allocated pension (AP) 12 months ago when he retired. Now he has decided to go back to full time employment. Can Fabio roll over his AP back to super and how long can he remain there?

A. Yes, he can, because an ETP can be rolled over at any age and is not subject to the work test rules. It can remain in the super phase indefinitely, because from 10 May 2006 cashing restrictions were abolished for members aged 65 or over.

Q2. Martine is considering commencing a pre-retirement pension while salary sacrificing her entire salary to super. Martine and her husband then intend to use her pension income and his salary to fund their living expenses. Is Martine's an effective salary sacrifice arrangement?

A. Whether or not a salary sacrifice arrangement is effective is determined by the principles in TR 2001/10, not by the amount salary sacrificed. Therefore, provided Martine's 100% salary sacrifice arrangement involves her agreeing to sacrifice future entitlements, it will generally be effective. An effective salary sacrifice arrangement may be limited in amount by restrictions other than those contained in TR 2001/10, such as industrial instruments and employer remuneration policy.

Q3. Mitchell has been retrenched and is entitled to a termination payment which includes amounts of unused annual and long service leave. Mitchell has asked to have his unused leave payments salary sacrificed to super. What are the tax consequences of doing so?

A. The view of the ATO in TR 2001/10 is that a salary sacrifice arrangement in respect of a leave entitlement for past services is not effective, with the resulting payment still forming part of Mitchell's assessable income. If Mitchell had arranged to salary sacrifice leave entitlements for future services before they accrued to him, such an arrangement would be effective. However, despite the ability for the salary sacrifice arrangement to be effective in these circumstances, State legislation and/or industrial legislation may not permit such amounts to be salary sacrificed.

FirstTech online Budget page

On 9 May 2006, Treasurer Peter Costello ushered in a new era in retirement planning when he presented the annual Budget papers to parliament. Many of you are now probably working through how these momentous changes will affect your clients.

To help you understand the potential implications of these changes, FirstTech has developed an online Budget page located in the FirstTech section of FirstNet Adviser, which contains a range of tools for you and your clients. Log on at colonialfirststate.com.au

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