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The \$6 million net asset value test for small business

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Taxpayers who seek to disregard a capital gain under the small business capital gains tax (CGT) concessions regime are likely to be audited and those who are not formally audited may face a phone review. The Australian Taxation Office's (ATO's) focus on a single aspect of this concessional regime is reflected in issues examined in some recent cases. Small business operators and their advisers need to be vigilant in planning for and applying the \$6 million maximum net asset value test (\$6 million test), an alternative requirement, within the second of the four basic conditions.¹

Small business operators must negotiate four complex steps in applying the current² CGT concessions to reduce or disregard a capital gain from a CGT event:

- First, a taxpayer must have a CGT event resulting in a capital gain that happens in relation to an asset owned by the taxpayer.³ Any CGT event (other than CGT event K7) must happen that results in a capital gain in relation to an asset owned by the taxpayer for the concessions to potentially apply.⁴ There must be a capital gain.⁵
- Second, one of two basic conditions (the small business entity (SBE) test or the \$6 million maximum net asset value test) must be satisfied (the \$6 million test is dealt with in this article).
- Third, the active asset test basic condition must be satisfied.
- Fourth, the four small business CGT concessions (the 15 year exemption, the 50% active asset reduction, the retirement exemption and the CGT rollover) must be applied and their requirements met.⁶

The \$6 million test is satisfied if, just before the CGT event, the net value of the taxpayer's assets is \$6 million or less.⁷

The \$6 million test:

- treats the taxpayer and its related entities as one economic entity; and
- involves consideration of what assets must be included, what liabilities can be included and the time at which the values of those assets and liabilities must be measured.⁸

Taxpayers with assets that exceed \$6 million can satisfy the \$6 million maximum asset value test by holding excluded assets and/or having included liabilities just before the CGT event.

Just before the CGT event

The net value of the CGT assets (market value of assets less liabilities) must be worked out "just before" the CGT event.⁹

In *Commissioner of Taxation v Byrne Hotels Qld Pty Ltd*,¹⁰ the Full Federal Court considered whether several liabilities incurred by the taxpayer in relation to the sale were liabilities of the taxpayer "just before" the CGT event:

- a real estate agent commission of about \$300,000 that the taxpayer incurred under an exclusive agency agreement;
- legal fees; and
- accounting fees.

The majority held that the real estate agent commission incurred on the sale of a hotel business was an included liability just before the CGT event, even though:

- the taxpayer was invoiced for commission after CGT event A; and
- the liability was contingent on the sale of the business being completed.

The majority found that the legal obligation to pay the commission was in the nature of a primary obligation that had arisen before the execution of the contract, rather than a purely contingent obligation.

The taxpayer was invoiced for the legal fees after entering into the sale contract, and the fees related to work done before and after entering into the contract.

The majority found that the legal fees for work done before the CGT event were an included liability.

In a second case, *Re Phillips and Cmr of Taxation*,¹¹ the Administrative Appeals Tribunal (AAT) found that the CGT event happened on 30 January 2006, but a

liability under the mortgage did not arise until 1 February 2006. It thus could not be taken into account as an included liability, as it was not a liability just before the CGT event.

In *Re Altnot Pty Ltd and Cmr of Taxation*,¹² the taxpayer argued that his 50% interest in a family holiday home was an excluded asset, since just before the relevant CGT event it was being used for his personal use and enjoyment. The AAT found that while the property was not available for rent at that time, it was not being used for his personal use and enjoyment. The home's continued use as a rental property over the prior seven years meant that it was not being used for the husband director's personal use and enjoyment.¹³ The husband was connected with Altnot under s 152-30(1) because he controlled Altnot within the meaning of s 152-30(2)(b) (he beneficially owned 50% of the shares and those shares carry with them the right to control at least 40% of the voting power in the company).

ATO ID 2003/744 decided that "just before the CGT event" refers to just before the "time of the CGT event" as specified in s 104-5 column 2 (which provides times for CGT events). For example for CGT A1, the time is the entering of the contract of sale, rather than settlement. In ATO ID 2003/745, the ATO decided that the relevant time for valuing shares was the market value of the shares just before the contract was signed, ie, 11:59 am in the case of a 12 pm contract (rather than an average share price of the day or part of the day).

Included assets

The expression "just before" the CGT event requires the taxpayer to include the net value of all CGT assets (all business and non-business use CGT assets) owned by the taxpayer; any entities connected with the taxpayer; and any of the taxpayer's affiliates or entities connected with the taxpayer's affiliates.¹⁴

Relevant CGT assets can involve the taxpayer's interests in connected entities. CGT assets held by affiliates of the taxpayer and connected entities must also be identified and considered and, if necessary, valued.

The definition of a CGT asset is broad.¹⁵ All CGT assets fall within the \$6 million test, even those CGT assets otherwise exempted from the operation of the CGT rules, because they may be a pre-CGT asset, a depreciating asset, a car or trading stock. In ATO ID 2003/166, the Commissioner expressed the view that Australian notes were held to be a CGT asset under the maximum net asset value test. There are exclusions that apply as discussed below.

Business use of CGT assets of affiliate or connected entity

CGT assets of the taxpayer's affiliate or an entity connected with the taxpayer's affiliate are only included

if these assets are used, or held ready for use, in the carrying on of a business by the taxpayer or another entity connected with the taxpayer (whether carried on alone or jointly with others).¹⁶ Although, these assets are subsequently excluded to the extent that they are used or held ready for use in the carrying on of a business by an entity that is connected with the taxpayer only because of the taxpayer's affiliate.

Special rules in s 152-47 may apply to deem a spouse and child as being affiliates. As Allerdice notes, under s 152-47, more assets of more entities (deemed affiliates and entities connected with affiliates) are included in the maximum net asset value test.¹⁷

Partners in partnerships

For taxpayers who are partners in a partnership and the CGT event happens in relation to an asset of the taxpayer or a CGT asset of the partnership (such as the sale of a partnership asset), the following assets are included in this test:¹⁸

- all the assets of the partnership if you are connected with it, and you would exclude the value of your interest in the partnership; or
- only your interest in the partnership if you are not connected with it and you would not count the assets of the partnership as a whole.

Entities holding shares or trust interests

Entities that own shares or trust interests calculate include these assets in the maximum net asset value test in a like same way as partners in partnerships.¹⁹

Excluded assets

The following exclusions apply (note that where an asset is excluded any related liability is also excluded):

- shares, units or other interests held in another entity;
- private dwelling;
- solely personal use assets;
- superannuation and life insurance; and
- non-business use of assets of affiliate and entity connected with taxpayer's affiliate.

Shares, units or other interests held in another entity

To prevent double counting the net asset value for a taxpayer, shares, units or other interests (apart from debt) held in another entity connected with the taxpayer or with an affiliate of the taxpayer are disregarded.²⁰ However, any liabilities related to such assets are included.²¹ Debt is included since this is a liability of the taxpayer and would not be accounted for in the net asset value of the affiliate or connected entity.²²

Private dwelling

If the taxpayer is an individual, their private dwelling and adjacent land (main residence)²³ are excluded if there is no business use or only incidental business use.²⁴ From a tax planning perspective holding an expensive main residence and adjacent land assists in meeting the maximum net asset value test as opposed to holding other types of assets. As noted above, it is clear from *Re Alnot Pty Ltd and Cmr of Taxation*²⁵ that the property must be used for the taxpayer's personal use and enjoyment.

The current market value of a dwelling is only included in the maximum net asset test to the extent that it is reasonable, having regard to the amount that the dwelling has been used to produce assessable income which would provide deductions for interest costs or would give rise to deductions for interest if interest had been paid.²⁶ Such interest in financing a home purchase is deductible if part of the home is set aside exclusively as a place of business and is clearly identifiable as such, and that part of the home is not readily adaptable for private use, for example, a doctor's surgery located within the doctor's home.²⁷ Under this hypothetical test, if an individual could be entitled to deduct part of the interest on a loan used to buy the home (for example, a dentist's surgery located within their home) then that business use percentage is multiplied by the current market value of the dwelling to determine its value.

Solely personal use assets

Assets solely for the personal use and enjoyment of an individual or the individual's affiliate are excluded.²⁸ A spouse or child is not automatically an affiliate. Any income producing use of the asset will prevent this exclusion.²⁹

Also, the asset must be used by the individual or the individual's affiliate at the time of the CGT event. In ATO ID 2009/34, the ATO expressed the view that vacant land that was intended to build a main residence was not excluded as the land was not being used solely for the personal use and enjoyment of an individual or the individual's affiliate.

Further, in ATO ID 2011/37 the building was being used for personal use of the taxpayer but the type of use changed over the taxpayer's ownership period (used as rental for five years and then used as the taxpayer's residence). The Commissioner ruled that the private use must be for the entire ownership period and thus the asset was not excluded under s 152-20(2)(b)(i). Under a different view, the maximum net asset value test must be satisfied at a point of time, ie, just before the CGT event, and to avoid doubt this should include looking at the use of the asset for a reasonable period of time before and after the CGT event.³⁰ Consideration must be given to

the time concepts developed in cases such as *Re Alnot Pty Ltd and Cmr of Taxation*³¹ and *Commissioner of Taxation v Byrne Hotels Qld Pty Ltd*.³²

The Commissioner ruled in ATO ID 2011/41 that for the purpose of the maximum net asset value test, the use of the taxpayer's holiday house by others where rent is paid would mean that the house is not excluded. *Re Alnot* required a use for the taxpayer's personal use and enjoyment for the exclusion.

Although, in ATO ID 2011/39 the Commissioner ruled that, for the purposes of the maximum net asset value test, where the taxpayer's holiday house was used by the spouse and children in conjunction with the taxpayer's use, the house would be excluded. Additionally, in ATO ID 2011/40, the Commissioner ruled that where the taxpayer's holiday house is also used by others but where no rent is paid, the house would still be excluded. There is some doubt about this view given the requirement in s 152-20(2)(b)(i) that the "asset being used solely for the personal use and enjoyment of the individuals or the individuals' affiliate" must be satisfied at a point of time, ie, just before the CGT event. To avoid doubt this should include looking at the use of the asset for a reasonable period of time before and after the CGT event.³³

Superannuation and life insurance

For individuals exclusions also apply for:

- rights to capital amounts payable out of a superannuation fund or an approved deposit fund;
- rights to an asset of a superannuation fund or an approved deposit fund; and
- life insurance policies.³⁴

From a tax planning perspective holding assets in a superannuation fund assists in meeting the maximum net asset value test.

Non-business use of assets of taxpayer's affiliate and entity connected with taxpayer's affiliate

The assets of a taxpayer's affiliate or an entity connected with the taxpayer's affiliate are excluded if those assets are not used, or held ready for use, in a business carried on by the taxpayer, or another entity connected with the taxpayer (whether the business is carried out alone or together with others).³⁵

Valuing assets

The requirement that the taxpayer must include the net value of the relevant CGT assets "just before" is onerous, particularly where the relevant assets include trading stock or assets held by other entities.³⁶

The onerous nature of the valuation requirement compels careful planning to ensure that valuations of the relevant CGT assets are made “just before” the relevant CGT event. The onerous nature of these requirements is easily demonstrated if a pharmacist proposing to dispose of her 75% in Pharmacy A while holding interests in Pharmacy B (20%), Pharmacy C (35%) and Pharmacy D (25%). The trading stock in each of the pharmacies must be valued just before the CGT event. Similarly liabilities must also be valued at that time.

Valuation often results in tax disputes. In *Re Syttadel Holdings Pty Ltd and Cmr of Taxation*,³⁷ the taxpayer failed to discharge the onus of proof in its method of valuation. The taxpayer’s valuer calculated the market value for the taxpayer’s marina of \$4.5 million but this value relied on an unusual practice to adopt a market value by referencing offers made and the sum at which a vendor was prepared to sell, rather than the sale value. The Commissioner’s valuer used conventional approaches of capitalisation of operating profit and direct comparison.

Included liabilities

An entity includes a liability under the maximum net asset value test where it relates to an included CGT asset just before the CGT event.³⁸ The following liabilities of an entity are specifically included:³⁹

- provisions for annual leave;
- provisions for long service leave;
- provisions for unearned income; and
- provisions for tax liabilities.

The term “liability” is not defined and its ordinary meaning includes legally enforceable debts due for payment and to presently existing obligations to pay either a sum certain or ascertainable sums.⁴⁰ Thus, loans directly related, such as to finance the acquisition or expansion of the business, are included liabilities. Further, loans not directly related to a specific asset but to general business assets, for example, a bank overdraft or other short-term financing facility, are included liabilities.⁴¹ Certain liabilities related to excluded shares, units or other interests in entities connected with the taxpayer or with an affiliate of the taxpayer are also included.⁴²

Excluded liabilities

A liability not related to the CGT assets of the taxpayer just before the CGT event is not taken into account in determining the net value of the CGT assets. A liability does not include contingent liabilities, future obligations or expectancies.⁴³ A contingent liability is a liability that will become due only on the occurrence of an event that may or may not happen. The ATO provides

the following examples of amounts that are not included in liabilities in determining net value as follows:⁴⁴

- provisions for possible obligations to pay damages in a pending lawsuit;
- provisions for liabilities in respect of an earn-out contract;
- provisions for the guarantee of a loan;
- accounting liabilities arising as a result of receiving prepaid income;
- expenses that are not yet due; and
- provisions in general for such things as quantity rebates.

In *Commissioner of Taxation v Byrne Hotels Qld Pty Ltd*,⁴⁵ the majority of the Federal Court adopted a broad meaning of liability in finding that a real estate commission fee constituted a liability just before the CGT event, notwithstanding that the payment was subject to contract completion.

The AAT considered the liability inclusion rule in *Vaughan v Cmr of Taxation*.⁴⁶ The taxpayer, a beneficiary of a family trust, and sole shareholder and director of the trust’s trustee company, received a capital gain of \$6 million from the trust’s sale of units in the 2007 financial year. The Commissioner claimed that the net assets were above the former \$5 million net asset value threshold. The AAT held that a debt of \$2 million that was owed by the family trust to one of the unit trusts did not relate to any specific assets of the family trust under the requirements of being a liability related to an asset. Also, an amount of \$1.2 million held in the bank account of the taxpayer could not be reduced by a liability (debit balance in a linked account) used to purchase a residence that was owned by his spouse. The liability was attached to an asset which was not owned by the taxpayer, a connected entity or an affiliate. The AAT also said that the fact that the liability arose from the use of multiple linked accounts with the one institution did not alter this outcome. Guarantees given by the family trust and the taxpayer in respect of loans made by one of the unit trusts could not be taken into account, as they were excluded being contingent liabilities and not a presently existing legal obligation.

In *Bell v Cmr of Taxation*,⁴⁷ in a unanimous decision, the Full Federal Court held that the taxpayer trust did not satisfy the maximum net asset value in respect of a \$6 million capital gain. First, the Full Federal Court found that a liability from a \$1 million debit balance bank account related to an excluded asset (the family home) and thus was not an included liability. Second, the court found that that a \$2 million loan liability of the trust that financed a capital distribution to the taxpayer beneficiary was not related to the assets of the trust and thus was not

an included liability. It could not be said that the liability related to assets of the trust merely by reason only of having been undertaken to preserve existing assets of the trust to avoid the need for the trust to outlay its existing cash.

Determine value of liabilities

The value of the included liabilities is based on the legally enforceable debts due for payment and presently existing obligations to pay either a certain sum or ascertainable sums just before the CGT event or inextricably connected to the CGT event and an integral and necessary part of the CGT event.⁴⁸

Calculate net value of the CGT assets

The maximum net asset value test is met if, just before the CGT event, the sum of the net value of the CGT assets does not exceed \$6 million for CGT assets owned by the taxpayer; any entities connected with the taxpayer; and any affiliates of the taxpayer or entities connected with such affiliates.⁴⁹

This amount can be positive, negative or nil. The negative value of any entities connected with the taxpayer or any of the taxpayer's affiliates is also included in the calculation of net asset value.⁵⁰

In *Re Tingari Village North Pty Ltd and Cmr of Taxation*,⁵¹ the taxpayer company sold a mobile home park business and the land on which the business was situated for a capital gain of \$2.1 million in November 2005. However, the AAT held that the various assets and liabilities of connected entities were not properly taken into account so the taxpayer failed the maximum net asset value test. The AAT, though, reduced the shortfall penalty from 50% (for recklessness) to 25% for lack of reasonable care. As Norbury notes, this penalty highlights the need for proper instructions and preparation prior to lodging a taxation return.⁵²

Analysis

The *net asset value basic condition* allows higher turnover businesses (that exceed the \$2 million threshold) and lower net asset value businesses (less than \$6 million) access to the small business CGT concessions. The \$6 million net asset value test involves often difficult to determine borderlines involving:

- included assets;
- excluded assets;
- calculations of the value of the CGT assets;
- included liabilities;
- excluded liabilities;
- calculations of the value of liabilities; and

- calculations of the net value of the CGT assets.

The case law reflects the Commissioner's focus during audits. Particularly contentious are the timing of when an asset or liability is included (ie, just before the CGT event), the valuation of assets and determining excluded liabilities. Also, whether an asset is solely for personal use is often disputed as seen in the number of ATO Interpretative Decisions.

For many small businesses, a significant part of their wealth is tied up in goodwill and commercial property and these often act as a substitute for their retirement savings. The CGT concessions are critical upon selling business assets and/or restructuring the business into a company or trust. The alternative net asset value basic allows the operator of small businesses that have appreciated in value to access the four small business CGT concessions since under the SBE test lower turnover small businesses (under \$2 million), as well as high net asset value small businesses, (less than \$6 million) are eligible, as well as higher turnover and lower net asset value businesses.

Care, however, must be taken by small businesses and their advisers, given the opaque nature of Div 152 and possible ignorance of the CGT implications of decisions when small businesses commence operations and as they grow or exit their businesses. If they don't plan for these basic conditions, they may become ineligible.

Tax practitioners need to be proactive in dealing with their clients to ensure eligibility and to maximise the four CGT concessions. Concession requirement checklists, second opinions from CGT specialists and ATO private binding rulings (as appropriate) should be employed to eliminate costly problems.⁵³ Such matters occur typically where complex business arrangements have changed structures or on the disposal assets.



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Footnotes

1. Income Tax Assessment Act 1997, s 152-10(1)(c)(ii) (ITAA 1997).

2. This article focuses on the current Div 152 rules applicable to CGT events happening in 2007–08 and later income years.
3. Above, n 1, s 152-10(1).
4. Above, n 1, s 152-10(1)(a)–(b).
5. *Re Taxpayer and Commissioner of Taxation; sub nom Case 8/2006 (ATC)* 2006 ATC 151; (2006) 63 ATR 1014; [2006] AATA 508; BC200604539.
6. Above, n 1, ss 152-10(1)(a) and (b). Any CGT event (other than CGT event K7) must happen that results in a capital gain in relation to an asset owned by the taxpayer for the concessions to potentially apply.
7. Above, n 1, s 152-10(1)(c)(ii). For CGT events prior to 1 July 2007 the threshold was \$5 million.
8. This basic condition does not need to be fulfilled for the retirement exemption in respect of CGT events J5 and J6.
9. ATO ID 2003/745.
10. *Commissioner of Taxation v Byrne Hotels Qld Pty Ltd* (2011) 196 FCR 524; 83 ATR 261; [2011] FCAFC 127; BC201107817.
11. *Re Phillips and Cmr of Taxation* (2012) 88 ATR 297; [2012] AATA 219; BC201202203.
12. *Re Almot Pty Ltd and Cmr of Taxation* [2013] AATA 140; BC201309285.
13. In respect of the former CGT small business affiliate rules, it is noted that the AAT did not apply the \$6 million test to the wife’s CGT assets (50% interest in the holiday home) because she was not connected with the taxpayer company as she did not own any shares in it. She was not a CGT small business affiliate of the taxpayer company as required by s 152-15(a)(iii) of the ITAA 1997. The Commissioner appealed this decision in *Commissioner of Taxation v Almot Pty Ltd* (2014) 218 FCR 556; [2014] FCA 362; BC201402673 where the Federal Court set aside the AAT’s decision and remitted the matter to the Tribunal for rehearing and determination in accordance with its reasons.
14. Above, n 1, s 152-15.
15. Above, n 1, s 108-5.
16. Above, n 1, s 152-20(3).
17. R Allerdice “The latest changes to the small business CGT concessions” (2009) 43(10) *Taxation in Australia* 592 at p 596.
18. *ATO Advanced Guide to Capital Gains Tax Concessions for Small Business 2010–11* p 18, available at www.ato.gov.au.
19. Above, n 18.
20. Above, n 1, s 152-20(2)(a).
21. Above, n 1, s 152-20(2)(a). This rule applies for CGT events occurring after 23 June 2009.
22. Above, n 1, s 152-15(b)–(c).
23. “Dwelling” and “adjacent land” are defined in the CGT main residence exemption.
24. Above, n 1, s 152-20(2)(b)(ii); *ATO Advanced Guide*, above, n 18, p 20.
25. Above, n 12.
26. Above, n 1, s 152-20(2A).
27. *ATO Advanced Guide* to capital gains concessions 2010–11 above, n 18, p 18.
28. Above, n 1, s 152-20(2)(b)(i).
29. See ATO ID 2009/33 (interest earned on a bank account).
30. Tax Counsel Pty Ltd “Maximum net asset value test” (2011) 46(2) *Taxation in Australia* 10–11.
31. Above, n 12.
32. Above, n 10.
33. Tax Counsel Pty Ltd, above, n 30, pp 10–11.
34. Above, n 1, s 152-20(2)(b)(iii)–(v).
35. Above, n 1, s 152-20(3).
36. Above, n 1, s 152-15.
37. *Re Syttadel Holdings Pty Ltd and Cmr of Taxation* (2011) 84 ATR 683; [2011] AATA 589; BC201106432.
38. Above, n 1, ss 152-15, 152-20. For CGT events from 1 July 2009.
39. Above, n 1, s 152-20(1)(b).
40. Taxation Determination, TD 2007/14.
41. Taxation Determination, TD 2007/14.
42. Above, n 1, s 152-20(2)(a).
43. Above, n 1, s 152-20(2)(a).
44. *ATO Advanced Guide*, above, n 18, at 19.
45. Above, n 10.
46. *Vaughan v Cmr of Taxation* (2011) 85 ATR 608; [2011] AATA 758; BC201108271.
47. *Bell v Cmr of Taxation* [2013] FCAFC 32c; BC201301526.
48. *ATO Advanced Guide*, above, n 18, at 19.
49. Above, n 1, s 152-20 for the net value of the CGT assets; see s 328-125 for when an entity is connected with another entity; see s 328-130 for what constitutes an affiliate.
50. Above, n 1, s 152-15(b)–(c).
51. *Re Tingari Viillage North Pty Ltd and Cmr of Taxation* (2010) 78 ATR 693; [2010] AATA 233; BC201001911.
52. M Norbury “When is a business not an active asset?” (2010) 45(1) *Taxation in Australia* 55 at p 57.
53. Institute of Chartered Accountants Australia (ICAA) “CGT advice flagged as insurance risk” 19 March 2012, available at www.charteredaccountants.com.au (accessed 1 November 2013). The article cites Cathie Thompson, Professional Indemnity Underwriting Manager for Vero Insurance. The ICAA notes that negligence claims against providing CGT advice are increasing. CGT has been featuring in large claims against accountants (claims exceeding \$1 million). In *Briar Holdings Pty Ltd v Capolingua* (1997) 37 ATR 135; BC9703306, an accountant was liable in negligence for failure to provide CGT advice so as to obtain CGT rollover relief to preserve the pre-CGT status of an asset under a restructure.