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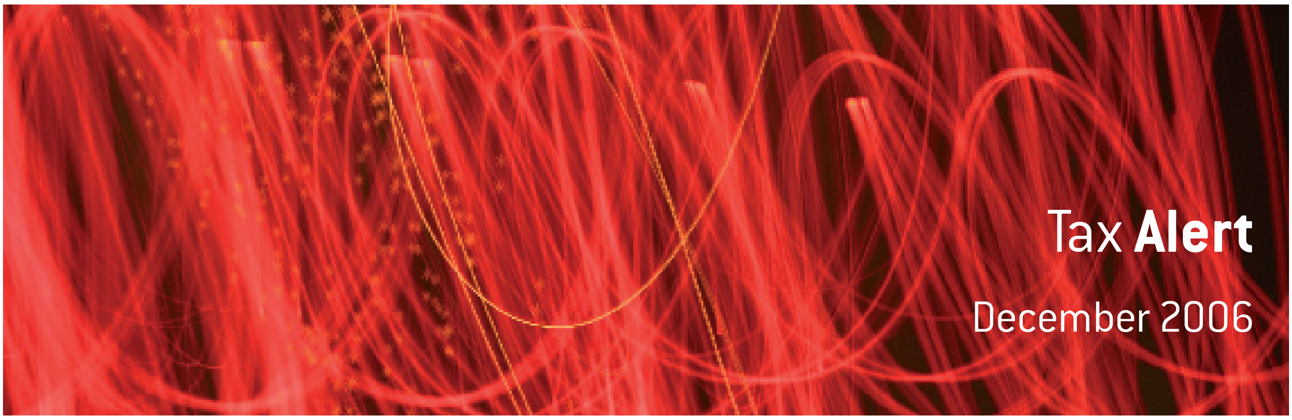


Small Business CGT Concessions - New Opportunities and Restructuring Implications

"On Thursday, 7 December 2006, the Government introduced the long awaited first tranche of draft legislation on the Small Business CGT Concessions. These measures are contained in Tax Laws Amendment (2006 Measures No. 7) Bill 2006 ("the Bill")."

The Bill includes the new significant individual test and other measures announced in the 5 May 2006 budget. These amendments should allow a greater number of taxpayers to access the concessions.
The measures largely take effect from 1 July 2006.

Significant Individual Test

Like the controlling individual test to be replaced, the new significant individual test must be satisfied in order to access:

> the Retirement Exemption (Subdivision 152-D); and

> the 15 Year Exemption (Subdivision 152-B).

In addition, where a CGT event happens in relation to a share in a company or an interest in a trust, the taxpayer must satisfy the significant individual test as a basic condition for accessing any of the Small Business CGT Concessions.

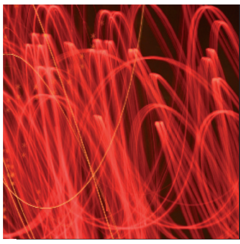
In order to satisfy the significant individual test, a company or trust must have at least one significant individual at the relevant time. A significant individual is an individual who has a small business participation percentage **("participation percentage")** in a company or trust of at least 20%.

The individual's participation percentage will be the sum of their direct and indirect participation percentages. The amount of a participation percentage will depend on the type of entity under consideration. That is:

- An entity's participation percentage in a company will be equal to the percentage of shares the entity holds in the company giving it access to dividends, capital and/or voting power;

- An entity's participation percentage in a trust where entities have entitlements to **all** of the income and capital (i.e. a unit trust) will be equal to the percentage of income and/or capital to which the entity is beneficially entitled;

- An entity's participation percentage in a trust where entities do **not** have entitlements to all of the income and capital (i.e. a discretionary trust) will be equal to the percentage of income and/or capital distributions to which an entity is beneficially entitled during the income year.



Importantly, the dividend, capital and voting entitlements, in the case of a company, or the income and capital entitlements, in the case of a trust, may differ. In these circumstances, the provisions deem the entity's participation percentage to be the smallest entitlement.

As previously mentioned an entity may have an indirect participation percentage in a company or trust. Broadly, in determining the entity's indirect participation percentage, its direct interest in the interposed entity is multiplied by the interposed entity's interest in the company or trust. For example, if an individual has an 80% direct interest in a unit trust which in turn has a 50% direct interest in a company, the individual's indirect participation percentage would be 40% (i.e. 80% x 50%).

In practical terms, the significant individual test will be easier to satisfy than the previous controlling individual test. Its required threshold of just 20% rather than 50% should allow multi-party structures to more readily access the Small Business CGT Concessions. The ability to satisfy the significant individual test through indirect interests should also mean that far more structures are able to be accommodated. The latter benefit is even more favourable than initially expected because of the Bill's introduction of a 90% test where a CGT event occurs in relation to shares in a company or interests in a trust (see below).

CGT Concession Stakeholder

The Bill largely retains the concept of the CGT concession stakeholder. This is now defined as either a significant individual or the spouse of a significant individual who has a participation percentage of more than zero. As with the existing legislation, a CGT concession stakeholder is relevant in circumstances where:

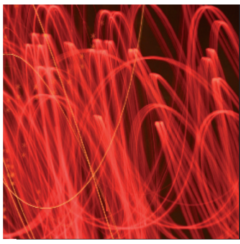
- the Retirement Exemption is being accessed and it is necessary to pay the CGT exempt amount to a CGT concession stakeholder;
- the 15 Year Exemption is being accessed by a company or trust and it is necessary to have the requisite stakeholder's control percentage to access monies from the company or trust; or
- a CGT event happens in relation to shares in a company or interests in a trust.

From a practical perspective, it is noteworthy that the CGT concession stakeholder concept together with the significant individual test will enable up to 4 husband and wife combinations to access the concessions.

Shares and Trust Interests

Like the previous legislation, the Bill requires that if a CGT event happens in relation to shares or trust interests, not only will the company or trust (known as the "object company" or "object trust") need to satisfy the significant individual test, but also "you" will need to be a CGT concession stakeholder. The reference to "you" in this context is to a taxpayer who has a CGT event happen in relation to their shares/trust interests.

In addition, the legislation now proposes an alternative test to "you" being a CGT concession stakeholder in the object company or trust. That is, the requirement that CGT concession stakeholders in the object company have a 90% participation percentage in "you". Because the participation percentage is able to accommodate indirect interests, this is a particularly powerful alternative to the usual requirement that you are a CGT concession stakeholder. In effect, it provides relief for many structures that have continually been unable to access concessions because shares or interests are owned by trusts or companies rather than individuals



The following example is provided in the Bill:

A discretionary trust sells shares in an operating company (the object company). Anna receives 90% of the distributions from the trust and the trust has a 50% interest in the object company.

In this example, the trust will not be a CGT concession stakeholder in the object company because it is neither a significant individual or the spouse of a significant individual with the requisite interest in the object company. The trust is not an individual. However, the trust can satisfy the alternative 90% test because Anna is a CGT concession stakeholder in the object company (her indirect participation interest in the object company is 45% which is at least 20%) and her participation interest in the trust is 90%.

Practical Implications from these Measures

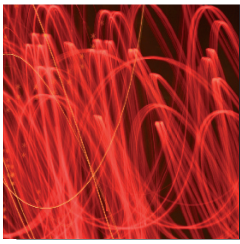
The measures contained in the Bill have considerable implications for the type of business structures that may qualify and take full advantage of the Small Business CGT Concessions. It is strongly recommended that tax advisors revisit any advice provided in this area for CGT events that have occurred in the current income year as some taxpayers that either did not qualify or were unable to take full advantage of all concessions may now qualify. Moreover, any advice that has been given in relation to CGT planning and structures may also need revisiting.

The Bill will perhaps give rise to a "mind shift" in determining optimal structures for small to medium enterprises. Structures with "depth" such as companies and unit trusts that are held by other companies and trusts, rather than "flat structures", may now be more viable from a CGT planning perspective. For instance, a unit trust with up to five equal discretionary trust unitholders should now be able to take advantage of these measures.

Other Measures in Draft Legislation

In addition to introducing the significant individual test, the 90% test and refining the CGT concession stakeholder concept, the Bill also introduces a number of other changes that will assist taxpayers in qualifying for the concessions. Some of these include:

- The maximum net asset value test will now take into account negative net asset values of connected entities. Previously, negative balances would count as zero balances;
- The maximum net asset value test now takes account of provisions for annual leave, long service leave, unearned income and tax liabilities where
- The maximum net asset value test in relation to a partnership will now only apply to the specific partner in the partnership rather than the partnership as a whole;
- The active asset test will now only require the asset to have been active for the lesser of seven and a half years or half of the period of ownership. It will no longer also require that the asset is an active asset just before the CGT event;
- The "80% look through test" (for assessing whether shares in companies or interests in trusts are active assets) will treat cash and financial instruments inherently connected with the business as active assets for the purposes of applying the test;
- The 15 Year Exemption will now only require that a company or trust taxpayer has a significant individual for any period totalling 15 years during the period of ownership.
- A payment of an amount disregarded by the Retirement Exemption will now be deemed to be an eligible termination payment, overcoming the need to facilitate a termination of employment;
- The Retirement Exemption may now apply to the "gifting" rather than just the "sale" of CGT assets; and



> Replacement Assets for the purposes of the Small Business Replacement Asset Rollover (Subdivision 152-E) may now include improvements to assets the taxpayer already owns.It can be expected that many of these changes will have widespread application.

Measures Still to Come

Importantly, further measures already announced are not included in the Bill. These include the maximum net asset value test threshold being increased from $5M to $6M. In addition, small businesses with an annual turnover of less than $2M are expected to be able to access the concessions without satisfying the maximum net asset value test.

These measures are not intended to apply until 1 July 2007.

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