NORTON & SMAILES
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The $2 Million Turnover Test – Small Businesses Tax Concessions Become More Accessible

The recent changes to the small business tax concessions have many important implications for small businesses. The changes present small business owners with the opportunity to access a range of tax concessions that may not have been previously available. The new law replaces, and to some extent supplements, the various existing eligibility criteria and introduces a single standard eligibility criterion that applies across the small business tax concessions.

From 1 July 2007, a small business entity can choose to apply a broad range of tax concessions (as outlined below) where its aggregated turnover is less than $2 million for an income year. As the concessions are aimed at providing small businesses with significant tax savings, the new test provides for a number of ways in which the concessions can be accessed. Importantly, the test considers the turnover for previous income years as well as the *likely* turnover in the current income year, such that a business may still access the concessions in circumstances where its turnover in the current income year is in fact greater than $2 million.

The changes came into effect on 1 July 2007 (with the exception of the fringe benefits tax concessions which apply from 1 April 2007), and provide concessions for:

- Capital gains tax;
- Goods and services tax;
- Fringe benefits tax; and
- Pay as you go instalments.

Issues to Consider Before the Concessions Can Be Accessed

While the $2 million turnover test increases the availability of tax concessions to small businesses, many issues must be considered in its application. It is important to closely analyse any business dealings that may not be at arm's length, as these will impact on the calculation of annual turnover.

There are also specific provisions applying to businesses that do not operate for the entire income year. This is particularly relevant to any business starting up or winding down during the income year. Under the new law, businesses with a turnover of less than $2 million that do not operate for the entire income year do not necessarily satisfy the test.

In calculating the business's aggregated turnover, the turnovers of 'affiliated' entities as well as that of any entity 'connected with' the business are aggregated into one figure. This becomes increasingly important where one entity acts under the direction of another, or where one entity controls another. Therefore, while the tax concessions are not necessarily denied to businesses connected with or affiliated to other entities, special rules apply to those businesses with beneficial ownership or rights in other entities or that are beneficially owned by other entities, as well as those who have received certain trust distributions.

Contact: Chris Smailes or Alan Krawitz or Chris Bates.

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Disposal of Small Business Assets – Non-Concessional $1 Million Super Contribution

1 July 2007 has come and gone and this has meant that the opportunity to contribute $1 million in non-concessional contributions is no longer available. However there is still the opportunity for small business owners to contribute above the non-concessional cap limit of $150,000 a year (or $450,000 for three years brought forward).

This lesser known opportunity to make contributions from the disposal proceeds of small business assets to a lifetime limit of $1 million (indexed annually) is excluded from the non-concessional cap limit and instead will form part of the capital gains tax (CGT) cap.

This situation therefore presents, for example small business owners who are under 65 and in partnership with their spouses, the opportunity to contribute $2.9 million ($1.450 million from each spouse) from the disposal of small business CGT assets into their superannuation fund.

This opportunity also exists for small business assets held in a company or trust and it is at the discretion of the small business owner whether to have an eligible contribution included as part of the CGT cap or not.

Capital gains which were rolled into superannuation in conjunction with the small business retirement exemption before 10 May 2006 do not reduce the CGT cap. Contributions made under the small business retirement exemption on or after 10 May 2006 do reduce the CGT cap, but are subject to a lifetime limit of $500,000. Thus, to utilise the maximum benefits from the $1 million CGT cap it is necessary that contributions are made under the 15 year exemption.

To maximise the value of contributions it may be beneficial to elect not to use the small business active asset 50% reduction. Not making this election will result in a larger capital gain which can then be rolled over into superannuation using the small business retirement exemption.

The following example is given in the explanatory memorandum to the Bill which introduced these provisions:

Ruth, aged 59, sells an active asset used in her small business which she has owned continuously for over 15 years. The proceeds from the sale are $1.1 million. She qualifies for the CGT exemption in Subdivision 152-B and disregards the capital gain of $390,000 on this basis. Ruth would like to contribute the entire proceeds to her superannuation fund.

Assuming Ruth has not previously made any contributions or used her CGT cap, she may elect to contribute $1 million under the cap exemption and have the remaining $100,000 count towards her non-concessional contributions cap. This would allow her to make an additional $50,000 worth of non-concessional contributions in the year without exceeding her annual cap.

Alternatively, as she is under 65, she may use the bring forward to contribute $450,000 and only use her CGT cap for the remaining $650,000. This will leave Ruth with a CGT cap of $350,000 for use in the future. However, any further non-concessional contributions made in that year, and the following two years, will exceed her non-concessional contributions cap and result in an excees contributions tax liability.

Note that if Ruth had her capital gain disregarded under the Subdivision 152-D exemption instead she would have only been able to contribute the capital gain (ie, up to $390,000) and not the capital proceeds under the cap exemption.

The contributions that are eligible for the CGT cap include:

1. Capital *proceeds* from the disposal of an asset that qualifies for the small business 15 year exemption.
2. Capital *proceeds* from the disposal of an asset that would have qualified for the small business 15 year exemption but did not qualify for one of the following reasons:
   a. the disposal did not result in a capital gain;
   b. the asset was not held for 15 years and the relevant individual was permanently incapacitated at the time of the CGT (but was not permanently incapacitated at the time the asset was acquired); or
   c. the asset was a pre-CGT asset.
3. Capital *gains* disregarded under the small business retirement exemption up to a lifetime total of $500,000.

Contact: Chris Smailes or Daniel Fry or Alan Krawitz or Ryan Gruenthal.

Division 7A relaxed? Changes to the deemed dividend rules

The ATO recently released PS LA 2007/20 which sets out the Commissioner's approach during the initial transitional period (which ends on 30 June 2008)

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where taxpayers take specific "corrective action" to put themselves in a position that complies with the present Division 7A requirements and avoid penalties under Division 7A. Up until 30 June 2008, taxpayers will not be required to make a written request for the Commissioner to exercise his discretion, thereby making it easier and cheaper to comply. The 'offer' as set out in PS LA 2007/20 applies to mistakes made between 2001/02 and 2006/07.

The release of PS LA 2007/20 is a recent development following the enactment of the *Tax Laws Amendment (2007 Measures No. 3) Act 2007* which Royal Assent on 21 June 2007. That Act gave the Commissioner power to disregard the operation of Division 7A or to allow a Division 7A deemed dividend to be frankable.

Under new section 109RB the Commissioner will have power to disregard the operation of Division 7A in relation to the 2001-02 income year and later years, and the power to allow a dividend to be frankable applies from 1 July 2002 (and is therefore relevant for the 2003 income year and later years).

The discretion may be exercised by the Commissioner where Division 7A would otherwise deem a dividend to have been paid, and the taxpayer can demonstrate that a deemed dividend has arisen because of an honest mistake or inadvertent omission by:

- the recipient of the deemed dividend;
- the private company; or
- any other entity whose conduct contributed to that result.

Our comments

Whilst PS LA 2007/20 sets out the ability of taxpayers to "self-assess" compliance with the discretion in section 109RB without the need to apply to the Commissioner in writing to exercise his discretion to disregard each deemed dividend that has arisen from the application of Division 7A, in our view taxpayers should proceed with some caution before placing great reliance on the "self assessment" process given the range of factors to which the Commissioner may have regard in exercising his discretion.

Contact: Richard Norton or Rachael Delamare.

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