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Super contributions for small business owners

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TAXATION

Includes
- Small business CGT concessions
- Specific conditions for using the tax concessions
- 15-year exemption
- 50 per cent active asset reduction

The new super reform changes are significantly reducing the amount an individual can invest through super under both non-concessional contributions (NCC) and concessional contributions (CC) caps. People with a total super balance of $1.6 million or more may never be able to make any NCCs unless their super balance once again falls under the threshold.

On a positive note, the small business CGT contributions are not affected by the total super balance. An eligible small business owner, upon selling an active business asset, can still contribute up to $1.445 million into their super under the CGT cap. However, the rules surrounding this area are complicated.

This article explains how and when a small business CGT contribution can be made. The following are definitions of key terms used in this article:

CGT cap
The CGT cap is a lifetime cap, currently $1.445 million and is indexed annually. The CGT cap is in addition to the individual's CCs and NCCs caps. Contributions that can be made under the lifetime CGT cap are:

- The proceeds from selling a business asset under the 15-year exemption; and/or
- The capital gains exempt amount under the retirement exemption.

The amount contributed under the CGT cap forms part of the tax-free component of a member's super interest.

Small Business participation percentage
This refers to the percentage of an individual's voting power in a company or their entitlement to the trust distribution.

Significant individual
Very broadly, a significant individual is someone who has at least 20 per cent business participation percentage.

CGT concession stakeholder
A CGT concession stakeholder of an entity (i.e. a company or trust) is a significant individual or a spouse of a significant individual if the spouse has greater than a 0 per cent business participation percentage in the relevant entity.

Small business CGT concessions

When a business owner plans to sell their business assets, they will want to know the answers to two questions:

1. Are there any tax concessions available to reduce the tax liabilities?
2. How much of the sales proceeds can they invest in a tax-effective environment?

Let's have a look at the answers to these two questions.

The four small business CGT concessions

Four small business CGT concessions are available to eliminate, reduce or defer the capital gains on disposing of an eligible business CGT asset:

1. 15-year exemption;
2. 50 per cent active asset reduction;
3. CGT retirement exemption; and
4. CGT rollover relief.

In order to use one or more of the concessions, the basic conditions must be met. The details of the basic conditions are very complex and outside the scope of this article, but for general guidance, the basic conditions are:

- The $6 million maximum net asset value test, or the $2 million aggregated turnover test; and
- The active asset test which broadly requires that a CGT asset is being used in the course of carrying on a business by the disposer, the disposer's affiliate, or a connected entity of the disposer for the lesser of 7.5 years or half of the ownership period.
- The CGT concession stakeholder test or 90 per cent small business participation test is required when selling shares in a company or units in a unit trust.

Specific conditions

Each of the four CGT concessions has its own specific conditions.

The 15-year and retirement exemptions are relevant to super contributions made under the CGT caps, and the 50 per cent active asset reduction concession can affect the amount contributed. We will look at these three CGT concessions in detail.

The small business rollover relief concession is more relevant to replacing the CGT asset being sold with a replacement CGT asset(s) and is not discussed in this article.

15-year exemption

The 15-year exemption is the most powerful CGT concession. If this exemption applies, the taxpayer can disregard the entire capital gain and there is no need to apply any other concessions.

In order to use this tax exemption, on top of the basic conditions explained previously, specific conditions must be met. These are:

- The CGT asset must be owned continuously for at least 15 years;
- An individual disposer must be at least 55-years-old and retiring, unless permanently incapacitated;
- An entity disposer must have had a significant individual for a total of at least 15 years during the ownership period (does not need to be the same person) and the significant individual just before the disposal is at least 55-years-old and retiring, unless permanently incapacitated.

Will the sales proceeds be trapped in the company or trust?
A company or trust, when disposing of its CGT asset, will receive the entire sale proceeds CGT-free under the 15-year exemption, as any capital gain is disregarded.

However, for distributing these proceeds tax-free out of the entity into the hands of a relevant individual, the below conditions must be met:

- Only the amount exempt under the 15-year exemption (i.e. proceeds less cost base) is allowed to be distributed tax-free to the CGT concession stakeholders in accordance with their stakeholder participation percentage.
- The exempt amount must be distributed by the entity to the relevant individual(s) within two years[1] of the CGT event.

Planning point: Tax law only allows the exempt amount (sale proceeds less the cost base) to be paid out of the entity tax-free, not the entire sales proceeds. Accessing the cost base amount is generally not a problem from a trust structure and capital distribution can be made without a tax consequence.

Unlike a trust, a company is a separate legal entity, which means their assets are separated from the relevant individual's personal assets. Depending on how the asset was originally purchased (borrowed from shareholders or using retained profit), distributing the cost base amount out of the company to an individual could cause significant tax issues for the individual.

Advisers should work with the client's tax accountant to work out how best to distribute the cost base amount out of the company (e.g. a division 7A loan agreement could be used to avoid having this amount treated as dividends).

How and when the proceeds can be contributed to super
It's not compulsory to contribute any part of the sale proceeds to super under the 15-year exemption. However, an eligible individual (i.e. under 65 or between 65 and 75 and who satisfies the work test) can contribute the entire sale proceeds up to the lifetime CGT cap amount ($1.445 million in 2017/18) to their super, in addition to their standard NCCs.

In order to use the CGT cap:

- If the disposer is an individual, the contribution must be made before the later of the day the individual's tax return is due or 30 days from receiving the capital proceeds; or
- If the disposer is an entity, the entity must make a distribution within two years[1] after the CGT event to the relevant individual, and the contribution must be made by the individual within 30 days of receiving their share of the distribution from the entity; and
- In both cases, the ATO CGT cap election form must be submitted to the super fund before or when the contribution is made.

Planning point: Sale proceeds from selling a pre-CGT asset could also be contributed under the CGT cap, if the basic conditions and specific conditions for applying the 15-year exemption are satisfied.

Example 1
Paul (age 69) and Nigel (age 50) are shareholders of a private company. They are unrelated business partners. Paul has always owned 80 per cent and Nigel 20 per cent of the shares in this company, since they started the company.

The company bought the factory for $500,000 over 15 years ago and the factory has always been used by the company to carry on its business. The company is selling the factory for $2 million.

After the sale, Paul will retire but Nigel will continue to work. They are both hoping to contribute as much as possible to super.

Assume the company meets the basic

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conditions of the small business CGT concessions. The company also meets the specific conditions to use the 15-year exemption, because:

- the company has a significant individual totalling at least 15 years;
- a significant individual at the time of the CGT event is over 55 and retiring (Paul). The fact Nigel is not retiring will not fail this condition.

The company receives the $2 million CGT-free by applying the 15-year exemption, however, only the $1.5 million exempt amount (sales proceeds less cost base) can be distributed tax-free in accordance with the CGT concession stakeholders' business participation percentage:

– Paul: $1.5 million x 80% = $1.2 million
– Nigel: $1.5 million x 20% = $300,000

The company may not be able to distribute the $500,000 cost base amount tax-effectively and the amount they can contribute under the CGT cap will be limited by the actual distribution made by the company.

If the company makes the distribution in the 2017/18 financial year, Paul (meeting the work test in 2017/18) and Nigel can both contribute under the CGT cap within 30 days from receiving the distribution.

If the company makes the distribution in the 2018/19 financial year, Paul cannot contribute if he fails the work test.

Note: The disposer cannot apply the 15-year exemption if they fail any of the specific conditions stated previously. The disposer can look at applying other small business CGT concession(s) to reduce or eliminate their taxable capital gains.

50 per cent active asset reduction and the retirement exemption

As long as the basic conditions of the small business CGT concessions are met, the 50 per cent active asset reduction is available after the application of the 50 per cent general CGT discount where the assets are held for at least 12 months, unless the cost base is indexed for a CGT asset purchased before September 1999.

The taxpayer, however, can choose not to apply the 50 per cent active asset reduction before applying the retirement exemption. By doing so, the relevant individual could optimise the amount contributed to super under the CGT cap. This is explained below.

Specific conditions for applying the retirement exemption for tax purposes

For tax purposes, the small business retirement exemption could reduce the taxable capital gains by a lifetime limit of $500,000 for each eligible individual. Unlike the 15-year exemption, the retirement exemption can be used by an individual at any age and it does not require the individual to retire. However, in order to use this tax exemption, the retirement exemption amount must be contributed to super if the relevant individual is under age 55.

If the disposer is an entity, the entity must have a significant individual at the time of the disposal and the entity must distribute the CGT exempt amount to one or more CGT concession stakeholders tax-free by the later of seven days after the entity makes the choice to use the retirement exemption (usually tax time) and seven days after the entity receives the sale proceeds.

In contrast with the 15-year exemption, the distribution is not required to be linked to the CGT stakeholders' business participation percentage.

Contributing the CGT exempt amount to super using the CGT cap

By applying the retirement exemption, the CGT exempt amount can be contributed to super under the lifetime CGT cap.

The maximum capital gains that can be exempt under the retirement exemption is limited by the lifetime tax cap of $500,000 per relevant individual. This means an eligible individual (i.e. under 65 or between 65 and 75 and who satisfies the work test), can only contribute up to $500,000 using the CGT cap under the retirement exemption, despite the lifetime CGT cap being $1.445 million (2017/18).

In order to use the CGT cap:

- If the disposer is an individual, the contribution must be made before the later of the day the individual's tax return is due or 30 days from receiving the capital proceeds; or
- If the disposer is an entity, the contribution must be made by the relevant individual within 30 days of receiving the distribution from the entity. If the relevant individual is under age 55 at the time of the distribution, the exempt gain must be contributed directly to the individual's super fund by the entity; and
- In both cases, the ATO CGT cap election form must be submitted to the super fund before or when the contribution is made.

Planning point: These strategies could be useful to optimise contributions using the CGT cap:

– Elect not to apply the 50 per cent active asset reduction, if the capital gain amount after applying the applicable 50 per cent general CGT discount is $500,000 or less for the relevant individual. This will increase the *amount exempted under the retirement exemption, and therefore optimise super contributions using the CGT cap.*

– *For an asset purchased before September 1999 with $500,000 or less gross capital gain, the cost base indexation method can be more favourable than the 50 per cent general CGT discount method to maximise the CGT exempt amount.*

– *An entity disposer is not require to distribute the CGT exempt amount in accordance with its CGT stakeholders' business participation percentages. Where possible, an entity disposer can avoid distributing the CGT exempt amount to a CGT stakeholder who is not eligible to contribute.*

Example 2

Zoe has been operating her sole trader florist business for 10 years. She bought the business for $50,000 and is selling it for $350,000. Zoe does not qualify for the 15-year exemption. Zoe has $30,000 brought forward capital losses from previous years, and assuming she meets the basic conditions of the small business CGT concessions and the specific conditions of the retirement exemption, she can apply the available CGT concessions as following:

1. Apply carried forward capital losses to the gross gain: $350,000 - $50,000 - $30,000 = $270,000
2. Apply 50% CGT discount: $270,000 - $270,000 x 50% = $135,000
3. Apply the optional 50% active asset reduction: $135,000 - $135,000 x 50% = $67,500
4. Apply the retirement exemption: $67,500
5. Taxable capital gain from the disposal: $67,500 - $67,500 = $0

If Zoe is under age 55, she must contribute the $67,500 retirement exemption amount to her super to be able to use this CGT exemption. If she is 55 or over, she can voluntarily make the contribution, provided she's eligible to contribute. This $67,500 can be contributed using the CGT cap. Alternatively, Zoe can choose not to apply the 50 per cent active asset reduction. The amount that can be contributed under the CGT cap will be doubled to $135,000.

Interaction with the super reform changes

NCCs and catch-up CCs

Although the small business CGT contributions are not limited by an individual's total super balance, once the contribution is made, it does count towards the individual's total super balance. If not planned properly, the CGT contributions could affect future NCCs and the member's ability to make catch-up CCs[2].

Pension transfer balance cap

Unfortunately, the amount contributed under the CGT cap will count against the member's transfer balance cap when moved to the retirement pension phase.

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Footnotes

1. A longer period may apply to payments received under an earnout right arrangement.

2. A total super balance of less than $500,000 on 30 June of the prior financial year is required to make catch-up CCs.

QUESTIONS

1. From 1 July 2017, which type(s) of contributions could be affected by an individual's total super balance at the previous 30 June?

a. NCCs, CCs and small business CGT contributions.

b. NCCs and catch-up CCs.

c. NCCs only.

d. CCs only.

2. Which of the below would not fail the specific conditions to apply the small business CGT 15-year exemption?

a. An individual disposer is over age 55 and retiring.

b. An individual disposer is over age 55 and will cut back working hours from 40 hours to 35 hours per week.

c. An individual disposer is under age 55 and retiring.

d. An individual disposer is under age 55 and will cut back working hours from 40 hours to 35 hours per week.

3. To apply the retirement exemption, which statement is correct?

a. An individual disposer must contribute the CGT exempt amount to their super, regardless of their age.

b. Only individuals over age 55 must contribute the CGT exempt amount to their super.

c. Only individuals under age 55 must contribute the CGT exempt amount to their super.

d. An individual disposer does not need to contribute the CGT exempt amount to their super, regardless of their age.

4. Which statement is correct when contributing under the CGT cap?

a. An individual aged over 65 but under age 75 does not need to satisfy the work test to make small business CGT contributions under the CGT cap.

b. An individual over age 75, meeting the work test, can make small business CGT contributions under the CGT cap.

c. An individual can contribute up to $1.445 million to their super under the CGT cap when using the retirement exemption.

d. An individual can contribute up to $500,000 to their super under the CGT cap when using the retirement exemption.

5. Which statement is incorrect?

a. The CGT cap is in addition to an individual's CCs and NCCs cap.

b. The amount contributed under the CGT cap forms part of the tax-free component of a member's super interest.

c. Amounts contributed under the CGT cap are excluded from an individual's total super balance.

d. Capital gains exempt by applying the 50 per cent active asset reduction cannot be contributed to super using the CGT cap.

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