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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

NEW BUSINESS TAX SYSTEM (CAPITAL GAINS TAX) BILL 1999

EXPLANATORY MEMORANDUM

(Circulated by authority of the

Treasurer, the Hon Peter Costello, MP)

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Glossary

The following abbreviations and acronyms are used throughout this Explanatory Memorandum.

Abbreviation	*Definition*
11.45 am AEST on 21 September 1999	11.45 am, by legal time in the Australian Capital Territory, on 21 September 1999
A Platform for Consultation	*Review of Business Taxation: A Platform for Consultation*
A Tax System Redesigned	*Review of Business Taxation: A Tax System Redesigned*
AEST	Australian Eastern Standard Time
ANTS	Government's Tax Reform Document: *Tax Reform: not a new tax, a new tax system*
CGT	capital gains tax
CGT discount	CGT discount introduced in Division 115-A in the Integrity and Other Measures Bill
Commissioner	Commissioner of Taxation
ETP	eligible termination payment
Integrity and Other Measures Bill	New Business Tax System (Integrity and Other Measures) Bill 1999
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
PDF	Pooled Development Fund
PDF Board	Pooled Development Fund Registration Board
PDFA 1992	*Pooled Development Funds Act 1992*
RBL	reasonable benefit limit
the Recommendations	*Review of Business Taxation: A Tax System Redesigned*
the Review	Review of Business Taxation

General outline and financial impact

Small business relief

This Bill amends the ITAA 1997 to:

- streamline existing CGT concessions for small businesses; and
- provide a further concession for small businesses where an active asset of the business, held for at least 15 years, is disposed of because either the taxpayer is to retire on account of being at least 55 years old or is incapacitated.

Date of effect: The small business CGT concessions will apply to CGT events occurring after 11.45 am AEST on 21 September 1999.

Proposal announced: The proposal was announced in Treasurer's Press Release No. 58 of 21 September 1999 (in particular refer to Attachments E and F of that Press Release) and Treasurer's Press Release No. 59 of the same date.

Financial impact: There is no data available to prepare a reliable revenue estimate for this measure. There is expected to be a small cost to revenue.

Compliance cost impact: This measure will reduce compliance costs, particularly through the streamlining of the current small business concessions. These concessions are complex to apply. As a result of the amendments, small business taxpayers will no longer need to choose which of the concessions they will apply.

Scrip for scrip roll-over

This Bill amends the ITAA 1997 to provide for a CGT roll-over (meaning that any capital gain will be deferred) where shareholders in companies, unitholders in unit trusts or beneficiaries of fixed trusts, exchange these membership interests for comparable interests in an acquiring entity as part of a takeover.

Date of effect: CGT events that happen on or after the date of Royal Assent of this Bill.

Proposal announced: The proposal was announced in Treasurer's Press Release No. 58 of 21 September 1999 (in particular refer to Attachment G of that Press Release) and Treasurer's Press Release No. 59 of the same date.

Financial impact: The financial impact of this measure is set out in the following table:

2000-2001	2001-2002	2002-2003	2003-2004	2004-2005
$2m	–$19m	–$5m	$11m	$29m

Compliance cost impact: The measure will reduce compliance costs, as relevant shareholders, unitholders and beneficiaries will not need to work out a capital gain or a capital loss when they exchange their membership interests in the course of a takeover.

Venture capital exemption

This Bill amends the ITAA 1997 and the PDFA 1992 to:

- allow certain non-resident tax exempt superannuation funds (venture capital entities) an exemption on gains made on the disposal of particular Australian venture capital investments; and
- provide that venture capital entities register with, and lodge information with, the PDF Board in order to be entitled to the exemption.

Date of effect: The issue or allotment of venture capital equity in a resident investment vehicle on or after the date of Royal Assent of this Bill.

Proposal announced: The proposal was announced in Treasurer's Press Release No. 58 of 21 September 1999 (in particular refer to Attachment H of that Press Release) and Treasurer's Press Release No. 59 of the same date.

Financial impact: The measure will have no impact between the 1999-2000 and 2003-2004 financial years inclusive, with a revenue cost of $5 million in the 2004-2005 financial year.

Compliance cost impact: The measure will reduce compliance costs, as venture capital entities will not be required to work out gains on the eligible venture capital investments for Australian tax purposes.

In order to be eligible for the exemption, certain information will need to be provided to the PDF Board. However, the information required would be collected in the ordinary course of business and will assist in evaluating the overall effectiveness of the measure in 5 years time.

Summary of Regulation Impact Statement

Regulation Impact on Business

Impact: The measures in this Bill are part of the Government's broad ranging reforms which will give Australia a New *Business* Tax System. These reforms are based on the Recommendations of the Review that the Government established to consider reforms to Australia's business tax system.

The New *Business* Tax System is designed to provide Australia with an internationally competitive business tax system that will create the environment for achieving higher economic growth, more jobs and improved savings, as well as providing a sustainable revenue base so the Government can continue to deliver services for the community.

The CGT reforms contained in this Bill are a critical component of the New *Business* Tax System. These reforms will remove impediments to efficient asset management, improve capital mobility, reduce complexity and compliance costs and make Australia's CGT regime internationally competitive.

Main points:

- The potential compliance, administrative and economic impacts of the measures contained in this Bill have been carefully considered, by both the Review and the business sector. The Review focused on the economy as a whole and concluded that there would be net gains to business, Government and the community generally from business tax reform.
- The measures in this Bill will reduce compliance costs as part of providing a more consistent and easily understood business tax system.
- The measures relating to venture capital relief and scrip for scrip roll-over relief will be evaluated 5 years after their commencement in order to assess their effectiveness.
- There will be some reporting requirements imposed on entities seeking venture capital relief. However, the information required is collected in the ordinary course of business and will be important in assessing the overall effectiveness of the measure.
- Administration costs are not expected to significantly increase as a result of the implementation of the measure in this Bill.

Chapter 1
Small business relief

Outline of Chapter

1.1 Schedule 1 to this Bill amends the ITAA 1997 to streamline and simplify the current small business CGT concessions and to provide further concessions in relation to retirement from carrying on business by disregarding certain capital gains made by small business entities from the disposal of active assets.

Context of Reform

1.2 These amendments to the ITAA 1997 will significantly improve the way in which CGT concessions are delivered to small business entities by:

- increasing the range of CGT concessions available;
- rationalising and improving the current law; and
- providing greater flexibility in accessing the various CGT concessions.

1.3 The interaction between the current roll-over relief, retirement exemption and goodwill exemption provisions is unnecessarily complex and, as a consequence, the law does not operate effectively. These amendments will allow small businesses to benefit successively from all of the CGT concessions for any single eligible capital gain. This will reduce unnecessary compliance costs for small business entities in determining which concession provides the most benefit.

1.4 These amendments give effect to Treasurer's Press Release No. 58 of 21 September 1999 (Attachments E and F) and recommendations 17.5 and 17.6 of the *A Tax System Redesigned.*

Summary of new law

1.5 The new law:

- disregards a capital gain made by a small business entity from a CGT event that happens to an active asset that has been continuously owned by the taxpayer for at least 15 years, and the disposal is related to a person retiring or becoming permanently incapacitated;

- replaces the current 50% goodwill exemption that applies to business entities with net assets of under $2.3 million with a 50% active asset exemption for all businesses with net assets of $5 million or less; and
- replaces the existing small business retirement exemption and roll-over relief with more streamlined rules.

1.6 The new law will also reduce compliance costs by rationalising and standardising the eligibility criteria for small business CGT concessions.

Comparison of key features of new law and current law

New law	*Current law*
Key features The conditions for obtaining the small business CGT concessions are standard for all of the concessions, with minor modifications for specific measures. Each concession can apply successively to each small business capital gain, if the particular conditions for the concession are satisfied.	*Key features* The conditions for small business CGT concessions vary in the current law. Only one concession can apply to each small business capital gain.
Small business 50% active asset reduction The goodwill exemption has been replaced with a broader exemption for half of the capital gain on the disposal of all active assets of the business.	*Goodwill exemption* A small business operator disposing of post-CGT goodwill qualifies for an exemption for half of the capital gain. This exemption does not apply to created assets such as restrictive covenants, which relate to and protect goodwill, that may arise out of the goodwill disposal.
Small business retirement exemption The existing law has been replaced with streamlined provisions that allow better access to the concession.	*Small business retirement exemption* There are a number of unintended results from applying the current law. The rules are complex, and difficult to apply.
Small business roll-over relief The existing law has been replaced with streamlined provisions that allow better access to the concession.	*Small business roll-over relief* There are a number of unintended results from applying the current law. The rules are complex, and difficult to apply.

New law	*Current law*
Small business 15-year exemption This is a new exemption for capital gains arising from the disposal of assets held for at least 15 years by a small business entity and the disposal is related to a person retiring, or becoming permanently incapacitated.	

Detailed explanation of new law

What are the small business CGT concessions?

1.7 There are 4 small business CGT concessions. These are:

- the small business 15-year exemption;
- the small business 50% active asset reduction;
- the small business retirement exemption; and
- the small business roll-over relief.

[Item 1, Division 152]

1.8 A small business entity may also be able to apply the CGT discount[1] to the capital gain before claiming any of the small business CGT concessions.

What are the basic conditions that must be satisfied to qualify for the small business CGT concessions?

1.9 If a CGT event happens to an asset owned by a small business entity and the CGT event results in the entity making a capital gain, the entity can apply the small business CGT concessions if it satisfies:

- the maximum net asset value test[2]; and
- the active asset test[3].

[Item 1, subsection 152-10(1)]

1.10 If the CGT asset is a share in a company or an interest in a trust:

- the company or trust must have a controlling individual[4]; and

[1] Inserted by the Integrity and Other Measures Bill, introduced into the House of Representatives on 21 October 1999.
[2] See paragraphs 1.11 to 1.16
[3] See paragraphs 1.29 to 1.33

- the asset must be owned by a 'CGT concession stakeholder'[5] of that company or trust.

[Item 1, subsection 152-10(2)]

The maximum net asset value test

1.11 A small business entity satisfies the maximum net asset value test if the total net value of CGT assets owned by:

- the small business entity;
- an entity that is the taxpayer's 'small business CGT affiliate'[6]; and
- an entity 'connected with'[7] the small business entity or a small business affiliate,

does not exceed $5 million just before the CGT event happens to a CGT asset of the small business entity. ***[Item 1, section 152-15]***

1.12 The purpose of the maximum net asset value test is to treat the small business and all of its related entities as a single economic unit. That unit's CGT assets must not exceed the $5 million net asset threshold just before the CGT event happens. If the unit's net assets exceed $5 million, the unit is not a small business and is not eligible for the small business CGT concessions.

1.13 To avoid double counting in calculating the net asset value for a small business entity, shares, units or other interests (apart from debt) held in an entity connected with the small business are disregarded in working out whether the entity satisfies the maximum net asset value test. ***[Item 1, paragraph 152-20(2)(a)]***

1.14 Assets of a private or personal nature are also not included in the maximum net asset value test for a small business entity that is not a company or trust. The type of assets that are excluded are those that are:

- solely for the personal use and enjoyment of the individual or a small business CGT affiliate;
- 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

4 See paragraphs 1.34 to 1.38

5 See paragraph 1.28 for discussion on 'CGT concession stakeholder'.

6 See paragraphs 1.17 and 1.18 for discussion on 'small business CGT affiliate'.

7 See paragraphs 1.19 to 1.27 for discussion on 'connected with'.

- life insurance policies.

[Item 1, paragraph 152-20(2)(b)]

1.15 The assets of a small business CGT affiliate are not included in the maximum net asset value test if those assets are not used, or held ready for use, in a business carried on by the small business entity, either alone or together with others, or in a business carried on by an entity connected with the small business entity, either alone or together with others. ***[Item 1, section 152-20(3)]***

1.16 In considering whether a dwelling is used solely for personal use and enjoyment, the rule is relaxed if the dwelling is used incidentally for non-private purposes. It is inappropriate to include the dwelling in the maximum net asset value test merely because of that incidental usage. However, if the taxpayer had incurred interest on purchasing that dwelling and some or all of that interest would be deducted from their assessable income, that dwelling is included in the maximum net asset value test, even if its predominant use is for private purposes. ***[Item 1, subparagraph 152-20(2)(b)(ii)]***

Who is a small business CGT affiliate?

1.17 A taxpayer's spouse, or child under 18 years is a ***small business CGT affiliate***. A taxpayer's small business CGT affiliate may also be an entity that:

- acts, or could reasonably be expected to act, in accordance with the taxpayer's directions or wishes; or
- acts, or could be reasonably be expected to act, in concert with the taxpayer.

[Item 1, subsection 152-25(1)]

1.18 A partner in a partnership in which the taxpayer is also a partner is not a small business CGT affiliate of the taxpayer merely because the partner acts, or could reasonably be expected to act, in concert with the taxpayer. ***[Item 1, subsection 152-25(2)]***

When is an entity connected with a small business entity?

Connected with – control of a company or trust

1.19 A company or trust is ***connected with*** a small business entity if:

- the small business entity controls the company or trust;
- the company or trust controls the small business entity; or

- both the company or trust and the small business entity are controlled by a third entity.

[Item 1, subsection 152-30(1)]

1.20 An entity will be ***connected with*** another entity if the first entity or its small business CGT affiliate, or the entity and the affiliate:

- beneficially own, or have the right to acquire beneficial ownership of, interests in another entity that give the right to receive at least 40% (the control percentage) of any distribution of income or capital by the other entity; or

- if the other entity is a company – beneficially own, or have the right to acquire beneficial ownership of, shares in the company that give at least 40% (the control percentage) voting power in the company.

[Item 1, paragraphs 152-30(2)(a) and (b)]

1.21 Where an entity's control percentage in another entity is at least 40% but less than 50%, the Commissioner can ignore the interest or shares of that entity in the other entity if the first entity can satisfy the Commissioner that a third entity actually controls the other entity. ***[Item 1, subsection 152-30(3)]***

Connected with – control of a discretionary trust

1.22 There are special rules for identifying control of a discretionary trust for the purposes of the 'connected with' test. The small business entity controls a discretionary trust if the entity or its small business CGT affiliate or both:

- are trustees of the discretionary trust (other than a Public Trustee of a State or Territory); or

- have the power to determine how the trustee makes any payments of income or capital.

[Item 1, paragraph 152-30(2)(c)]

1.23 A beneficiary is taken to have an interest in any distribution of income or capital of the discretionary trust, up to the maximum percentage of the income or capital that the trustee could distribute to that beneficiary.

[Item 1, subsection 152-30(5)]

Example 1.1

A discretionary trust deed has the effect that a beneficiary may receive up to 100% of the income or capital of the trust. That beneficiary is taken to have a 100% interest in the discretionary trust for the purpose of the net assets test, with the result that the beneficiary is treated as 'connected with' the trust. The assets of the beneficiary will be included in the net assets test for the trust.

1.24 An entity will not be ***connected with*** a discretionary trust if all of the following conditions are met:

- the discretionary trust is the entity making the capital gain;
- there is another entity that is the trustee or has the power to determine how the trustee decides to make any payments of income or capital to beneficiaries of the trust; and
- the beneficiary is not a small business CGT affiliate of the trustee of the trust or of an entity that has the power to determine how the trustee decides to make any payments of income or capital of the trust.

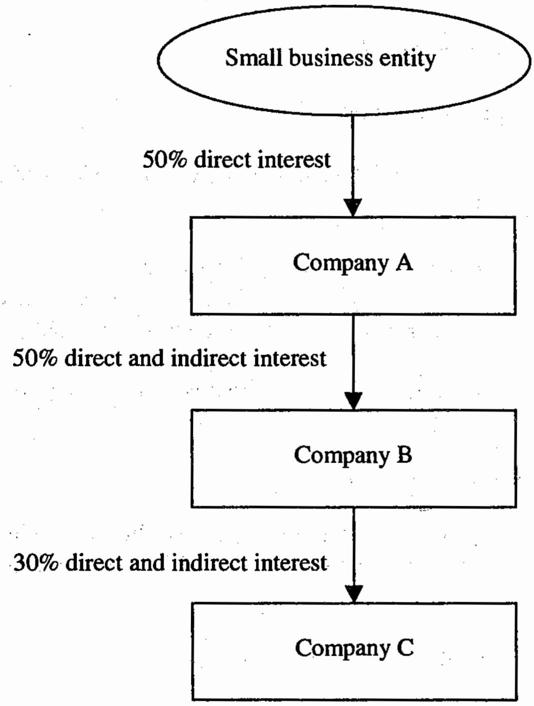
[Item 1, subsection 152-30(4)]

1.25 It is common for trust deeds of discretionary trusts to prescribe as beneficiaries any public entity in which a beneficiary of the trust has an interest. For example, if a beneficiary holds an interest in a listed public company, that company is treated as a potential beneficiary of that discretionary trust. As a result, in working out whether the discretionary trust satisfies the 'maximum net asset value test', it is possible that all of the assets of the listed public company would inappropriately be taken into account. To avoid this result, a beneficiary of a discretionary trust that is a company, trust or mutual insurance organisation whose shares or units are publicly traded (a ***public entity***) is *not* treated as connected with the trust. ***[Item 1, subsection 152-30(6)]***

Connected with – indirect control of an entity

1.26 The control tests for the 'connected with' rules are designed to look through business structures that include interposed entities. However, only controlled entities are taken into account in tracing interests. The indirect control rule has been adopted to avoid complex tracing requirements for a small business entity. If an entity (the first entity) directly controls a second entity, and the second entity controls (whether directly or indirectly) a third entity, the first entity is also taken to control the third entity. ***[Item 1, subsection 152-30(7)]***

Example 1.2



The small business entity controls companies A and B but not C.

1.27 The indirect control test in subsection 152-30(7) does not apply if a small business entity controls a public entity and that public entity controls a third entity, unless the small business entity actually controls the third entity (e.g. because it holds 50% of the voting shares of the third entity). ***[Item 1, subsection 152-30(8)]***

Example 1.3

If an entity (E1) controls a public entity (E2) that in turn controls another entity (E3), E1 will not be deemed to control E3 merely because it controls E2. However, E1 will control E3 if, for example, E1 beneficially owns shares that carry a right to 50% of the voting rights in E3.

Who is a CGT concession stakeholder?

1.28 An individual is a ***CGT concession stakeholder*** of a company or trust if the individual is:

- a 'controlling individual' of that company or trust; or
- a controlling individual's spouse who holds legal and equitable interests in the company, or is beneficially entitled to

the income or capital of the trust, or may be entitled to receive any of the income or capital of the trust.

[Item 1, section 152-60]

What is the active asset test?

1.29 A CGT asset is an ***active asset*** if it is owned by a small business entity and it is:

- used or held ready for use by the small business entity, a small business CGT affiliate, or an entity connected with the small business entity, in the course of carrying on a business; or
- an intangible asset that is connected with a business carried on by the small business entity.

[Item 1, subsection 152-40(1)]

1.30 To satisfy the active asset test, the CGT asset must have been an active asset of the small business entity seeking the concession just before the earlier of:

- the CGT event; and
- if the small business ceases and the CGT event happens within 12 months (or any longer period that the Commissioner allows) of the business ceasing – when the small business ceased, and

for at least half of the period beginning at the later of:

- acquisition of the CGT asset; and
- 15 years before the CGT event

and ending at the time of the CGT event or the small business ceasing.
[Item 1, section 152-35]

1.31 A share in a company or an interest in a trust may also be an active asset if:

- the company or trust is an Australian resident; and
- the total of the market values of the active assets of the company or trust is 80% or more of the total of the market values of all of the assets of the company or trust for at least half of the time the small business entity owns the share or interest.

[Item 1, paragraphs 152-40(3)(a) and (b)(i)]

1.32 Cash or a debt asset of a company or trust that is attributable to the sale proceeds of an active asset are not included for the purposes of the 80% active asset test if that cash or debt asset is held for less than 2 years from the time of the CGT event that generated the relevant sales proceeds. The cash or debt asset must have been held with a view to acquiring active assets. ***[Item 1, subparagraph 152-40(3)(b)(ii)]***

Certain assets cannot be active assets

1.33 The definition of active asset specifically excludes those assets that are held to produce passive investment income. Examples of such assets are loans, debentures, bonds and assets whose main use is to derive interest and rental income. ***[Item 1, subsection 152-40(4)]***

What is the controlling individual test?

1.34 A company or trust will satisfy the controlling individual test if there is at least one controlling individual of the company or trust just before the CGT event happens to the active asset. ***[Item 1, section 152-50]***

1.35 An individual is a ***controlling individual*** of a company if the individual holds legal and equitable interests in shares (apart from redeemable shares) that carry between them:

- the right to exercise at least 50% of the voting power in the company; and
- the right to receive at least 50% of any distribution of income and capital that the company may make.

[Item 1, subsection 152-55(1)]

1.36 An individual is a ***controlling individual*** of a trust if the individual is beneficially entitled to at least 50% of the income and capital of the trust. ***[Item 1, subsection 152-55(2)]***

1.37 An individual is a ***controlling individual*** of a discretionary trust if:

- the trust made a distribution of income or capital or both during the year of income; and
- the individual was beneficially entitled to at least 50% of the total of the distributions of income and the total of the distributions of capital made by the trust in that year.

[Item 1, subsection 152-55(3)]

1.38 This controlling individual test is modified for the small business 15-year exemption. ***[Item 1, section 152-120]***

How does the CGT discount interact with the small business CGT concessions?

1.39 The assessable income of a small business entity, like any other taxpayer, includes any net capital gains the entity has made during the income year. A small business entity applies the method statement in section 102-5 of the ITAA 1997 to work out their net capital gain (if any) for an income year. This method statement incorporates the effect of the small business CGT concessions introduced by this Bill. ***[Item 7, subsection 102-5(1)]***

1.40 A capital gain is disregarded if a small business entity qualifies for the small business 15-year exemption, and the method statement in subsection 102-5(1) does not apply to that gain. ***[Item 7, subsection 102-5(1)]***

1.41 If the small business 15-year exemption *does not* apply to a capital gain made by a small business entity, step 1 and step 2 of the method statement in subsection 102-5(1) apply to that capital gain. These steps require the taxpayer to apply any current year capital losses and any unapplied net capital losses against any capital gains the taxpayer has made during the current year. ***[Item 7, subsection 102-5(1)]***

1.42 Any capital gains that remain after the small business entity has applied:

- the small business 15-year exemption;
- current year capital losses; and
- prior year unapplied net capital losses,

are subject to step 3 in the method statement in subsection 102-5(1). This step reduces any remaining discount capital gains by the taxpayer's discount percentage as set out in Division 115 of the ITAA 1997[8]. ***[Item 7, subsection 102-5(1)]***

1.43 If a small business entity has any capital gains remaining after having applied:

- the small business 15-year exemption; and
- step 1 and step 2 (about applying capital losses) and step 3 (about applying any CGT discount) of the method statement in subsection 102-5(1).

Step 4 requires the taxpayer to consider whether they qualify for any of the small business CGT concessions in Division 152 of the ITAA 1997.

8 Inserted by the Integrity and Other Measures Bill, introduced into the House of Representatives on 21 October 1999.

1.44 These small business CGT concessions are:

- the small business 50% active asset reduction;
- the small business retirement exemption; and
- the small business roll-over.

[Item 7, section 102-5]

1.45 The small business CGT concessions can apply to both 'discount capital gains'[9] and other capital gains. The method statement in section 102-5 requires the small business entity to apply the CGT discount to any discount capital gains before applying the small business CGT concessions (except for the small business 15-year exemption). After applying the concessions, any amount of capital gain remaining is the net capital gain for the income year. ***[Item 7, section 102-5]***

Example 1.4

Fred is a small business operator who decides to sell an active asset of the business that he has owned for more than 12 months. The CGT event happens in November 1999, and Fred qualifies for both the CGT discount and the small business 50% active asset exemption in respect of the capital gain of $20,000. Fred also has a capital loss of $3,000 from another CGT event in the income year. Fred calculates his net capital gain for the year as follows:

$20,000	–	$3,000	=	$17,000 (under step 1of the method statement in section 102-5)
$17,000	–	(50% × $17,000)	=	$8,500 (under step 3 of the method statement in section 102-5)
$8,500	–	(50% × $8,500)	=	$4,250 (under step 4 of the method statement in section 102-5)

Fred's net capital gain for the year is $4,250. This amount could also qualify for further relief under the small business retirement exemption or small business roll-over relief.

Capital gains, trusts and the small business CGT concessions

1.46 Capital gains made by trusts are eligible for the full range of CGT concessions available for capital gains. However, a beneficiary of a trust may not be eligible for all of the CGT concessions. For example, a trust

9 A 'discount capital gain' is one that qualifies for reduction under Division 115-A (inserted by the Integrity and Other Measures Bill, introduced into the House of Representatives on 21 October 1999).

may apply the CGT discount to a capital gain, but a company is ineligible for this discount. Rules are required to ensure that a beneficiary who is presently entitled to a share of the net income of a trust that is attributable to a discounted capital gain made by the trust is able to:

- treat that part of the net income of the trust as a capital gain of the beneficiary;
- apply any capital losses appropriately; and
- claim any relevant CGT discount.

[Item 42, Subdivision 115-C]

1.47 Similar rules are required for certain trustee assessments. This result is achieved by effectively excluding the capital gain amount from the share of the net income to which a beneficiary is presently entitled, treating this amount as capital gains made by the beneficiary and applying the CGT discount to the capital gains as if the gains were made directly by the beneficiary. ***[Item 42, section 115-215]***

Assessing presently entitled beneficiaries

1.48 If a beneficiary is presently entitled to a share of the net income of the trust (the ***trust amount***) that is attributable to a discounted capital gain or a capital gain which has been reduced because of the application of the small business 50% active asset reduction by the trustee, the beneficiary must treat that amount as a capital gain, and increase that amount before applying the method statement in subsection 102-5(1).

1.49 The amount by which the capital gain is to be increased depends on the trust's treatment of the original gain.

1.50 If a beneficiary is presently entitled to a share of the net income of the trust that is attributable to a capital gain which has *not* been reduced by the CGT discount or the small business 50% active asset reduction, no increase is required to the capital gain. ***[Item 42, paragraph 115-215(3)(a)]***

1.51 If a beneficiary is presently entitled to a share of the net income of the trust that is attributable to a capital gain that has been reduced by 50% under either the CGT discount or the small business 50% active asset reduction but not both, the beneficiary must *double* the capital gain amount. ***[Item 42, paragraph 115-215(3)(b)]***

1.52 If a beneficiary is presently entitled to a share of the net income of the trust that is attributable to a capital gain that has been reduced by 50% under both the CGT discount and the small business 50% active asset reduction, the beneficiary is to *multiply* the capital gain amount of the distribution *by 4*. ***[Item 42, paragraph 115-215(3)(c)]***

1.53 After multiplying the capital gain amount of the distribution, the beneficiary applies the method statement in subsection 102-5(1) to the increased amount of capital gain. ***[Item 42, subsection 115-215(4)]***

1.54 The trust amount applicable to either the discounted capital gain or the small business 50% active asset reduction or both can be deducted from the beneficiary's assessable income. ***[Item 42, subsection 115-215(6)]***

Example 1.5

Martin is a beneficiary in the Shadows Unit Trust. He receives a distribution of $2,000 from the trust. This distribution includes $250 of net income remaining after a $1,000 capital gain made by the trustee was reduced by the CGT discount and the small business 50% active asset reduction.

Martin must work out his net capital gain for the year of income. He reduces his assessable income by $250. As the trustee claimed both the CGT discount and small business 50% active asset reduction, Martin must multiply the $250 by 4. This results in a capital gain of $1,000 with which Martin calculates his net capital gain for the year of income.

If Martin also had a capital loss of $100 from the sale of shares in the income year he would calculate his net capital gain, using the steps in subsection 102-5(1), as follows:

Step 1:	$1,000	–	$100	= $900
Step 2:	$900	–	nil	= $900
Step 3:	$900	–	(50% × $900)	= $450
Step 4:	$450	–	(50% × $450)	= $225

Martin's net capital gain is $225. Martin must also include the net trust amount of $1,750.

Trustee assessments

1.55 Special rules apply for assessing trustees under subsection 98(3) and section 99A of the ITAA 1936.

1.56 Trustee assessments made under subsection 98(3) of the ITAA 1936 are based on net income of a trust to which a non-resident company beneficiary is presently entitled. To the extent this net income includes a capital gain to which the CGT discount has been applied, that amount is doubled. ***[Item 42, section 115-220]***

1.57 Capital gains included in that part of the net income of a trust that is assessed under section 99A of the ITAA 1936 are ineligible for the CGT discount and the small business active asset reduction. To the extent this net income includes a capital gain to which:

- *either* the CGT discount or the small business 50% active asset reduction has applied, that amount is *doubled*; or
- *both* the CGT discount and the small business 50% active asset reduction, that amount is multiplied *by 4*.

[Item 42, section 115-225]

Small business 15-year exemption

1.58 A capital gain made by a small business entity from a CGT asset it has owned for at least 15 years will be disregarded if the small business entity:

- satisfies the basic conditions for the small business CGT concessions in Subdivision 152-A, with a modified active asset test[10];
- continuously owned the CGT asset for at least 15 years just before the CGT event;
- is an individual, and is either 55 years old or more and retires, or is permanently incapacitated; and
- is a company or trust, and had a controlling individual for the entire time it owned the CGT asset, and that controlling individual is either 55 years old or more and retires, or is permanently incapacitated.

[Item 1, sections 152-105 and 152-110]

1.59 If the conditions in 1.58 are satisfied and a capital loss is made from the CGT event, the capital loss may be used to reduce other capital gains.

1.60 The active asset test normally requires the CGT asset to be active for at least half of the period of ownership. This rule is modified for the small business 15-year exemption. The CGT asset needs to have been an active asset for at least half of the 15 year period ending at the time of the CGT event or when the business ceased. ***[Item 1, subparagraph 152-35(b)(ii)]***

10 The general rules for active assets are discussed in paragraphs 1.29 to 1.33. The modified active assets test is discussed in paragraph 1.60.

Example 1.6

Ruth and Geoff are partners in a partnership that conducts a farming business on land they purchased in 1986, and have owned continuously since that time. The net value of the CGT assets of the partnership is less than $5 million. Ruth and Geoff wish to retire as they are both over 60 years of age. As they have no children, they decide to sell the farming business, and do so in 2002, for a total capital gain of $100,000. Both Ruth and Geoff qualify for the small business 15-year exemption in relation to the capital gain.

Distributions of the small business 15-year exemption amount

1.61 A capital gain made by a company or trust that qualifies for the small business 15-year exemption and is disregarded for the company or trust may be distributed to a CGT concession stakeholder of the company or trust as an exempt amount if certain conditions are satisfied. These conditions are:

- the company or trust must make the payment within 2 years of the CGT event that resulted in the capital gain;
- the payment must be made to a person who was a CGT concession stakeholder of the company or trust just before the CGT event; and
- the payment must not exceed an amount determined by multiplying the CGT concession stakeholder's control percentage by the exempt capital gain.

[Item 1, section 152-125]

1.62 The ***exempt amount*** is calculated as a percentage (the stakeholder's control percentage) of the total capital gain disregarded for the company or trust under the small business 15-year exemption. The ***stakeholder's control percentage*** is:

- for a company – the percentage of the legal and equitable interests in shares in the company that satisfy the controlling individual test;
- for a trust in which entities have entitlements to all of the income and capital of the trust, the percentage of the capital of the trust to which the beneficiary is entitled; or
- for any other trust – 100% if there is one CGT concession stakeholder or 50% each if there are 2 CGT concession stakeholders.

[Item 1, paragraphs 152-125(3)(a) and (b)]

Example 1.7

Joe is a controlling individual of Company X, owning 60% of the shares in the company. Joe's wife, Anne, owns the remaining 40% of the shares in the company. The company makes a capital gain of $10,000 and is able to disregard that capital gain under the small business 15-year exemption as both Joe and Anne are planning to retire. Six months after the CGT event, the company distributes the amount of the exempt capital gain to the shareholders. As CGT concession stakeholders, Joe and Anne both qualify for the small business 15-year distribution exemption. The amount that is exempt is calculated as follows:

For Joe: 60% of $10,000 = $6,000

For Anne: 40% of $10,000 = $4,000

If it is decided to distribute $8,000 each to Joe and Anne, they can exclude from their assessable incomes for the income year an amount of $6,000 and $4,000 respectively.

Example 1.8

The M family discretionary trust has as its beneficiaries the members of the M family and 2 employees of the family business carried on by the trustee of the trust. Mrs M and Mr M are the controlling individuals of the discretionary trust, and are therefore CGT concession stakeholders. Their 3 children are treated as small business affiliates. The trustee of the trust sells a CGT asset of the business and makes a capital gain of $50,000 that qualifies for the small business 15-year exemption, as Mr M plans to retire from the family business. The trustee distributes that amount equally to Mrs M and Mr M and to the 3 children.

As CGT concession stakeholders, Mrs M and Mr M are each able to treat the distribution of $10,000 as an exempt amount. Their 3 children must include the distribution in their assessable incomes for the year.

Involuntary disposals

1.63 A requirement of the small business 15-year exemption is that the CGT asset must have been continuously owned for at least 15 years and must satisfy the modified active asset test. However, CGT assets acquired under roll-over relief in terms of Subdivision 124-B (assets compulsorily acquired, lost or destroyed) or Subdivision 126-A (marriage breakdown) will receive special treatment in determining whether the small business 15 year test and the active asset test have been satisfied. ***[Item 1, section 152-45]***

1.64 For the purposes of the 15-year exemption, the replacement asset will be treated as if it had been:

- acquired when the original asset was acquired; and
- used in the same way as the original asset was used from the time the original asset was acquired.

[Item 1, subsection 152-115(1)]

1.65 A small business individual who has a CGT asset transferred to them because of a marriage breakdown, and the capital gain arising from that transfer was rolled over under Subdivision 126-A, will be able to choose whether:

- to include the ownership and active asset periods of their former spouse; or
- to commence the ownership and active asset periods from the time the asset was transferred to them.

1.66 If a small business individual chooses to include their former spouse's ownership and active asset periods of the CGT asset, that asset will be treated as if the entity:

- had always owned the CGT asset; and
- used it in the same manner as the person's former spouse used it.

[Item 1, subsection 152-115(2)]

Example 1.9

Cameron and Therese were married. During the 10 years they were married, Cameron owned a farm on which he operated a dairy business. Since their divorce Therese has owned the farm and operated the dairy business for the past 5 years. Therese is able to sell the farm and obtain the 15-year exemption if she chooses to adopt Cameron's ownership and active asset periods.

Impact on superannuation benefits

1.67 Many small business entities provide for their retirement by selling their business assets. This concession will allow individuals operating small businesses to dispose of their eligible active assets and retire without affecting their superannuation reasonable benefit limit. ***[Item 1, subsection 152-110(2)]***

Requirement to be permanently incapacitated or retiring

1.68 One of the requirements of this concession for an individual small business taxpayer is that they must be either permanently incapacitated at the time of the CGT event, or at least 55 years old and using the capital proceeds for their retirement.

Small business 50% active asset reduction

1.69 A small business entity that makes a capital gain that does not qualify for the small business 15-year exemption will be directed by the method statement in section 102-5 of Division 152 after the calculation of their discounted and non-discounted capital gain amounts.

1.70 If the remaining capital gains, both discounted and non-discounted, satisfy the basic conditions of the small business concessions in Subdivision 152-A they can be reduced by 50%. That is, an individual who makes a capital gain that satisfies the basic conditions may reduce the capital gain amount remaining after capital losses and net capital losses have been applied by 75%. ***[Item 1, section 152-205]***

1.71 After applying the small business 50% reduction, the remaining capital gain may also qualify for the small business retirement exemption, or the small business roll-over relief or for both. If it qualifies for both the taxpayer can choose the order in which those concessions are to be applied. ***[Item 1, section 152-210]***

Example 1.10

Mary operates a small manufacturing business and disposes of a CGT asset that she has owned for 3 years, and has used as an active asset of the business. Mary makes a capital gain of $17,000 from the CGT event, and qualifies for the CGT discount and for the small business 50% reduction. Mary also has a capital loss in the income year of $3,000 from the sale of another asset. Mary calculates her net capital gain for the year as follows:

$17,000	–	$3,000	=	$14,000 (under step 1 of the method statement in section 102-5)
$14,000	–	(50% × $14,000)	=	$7,000 (under step 3 of the method statement in section 102-5)
$7,000	–	(50% × $7,000)	=	$3,500 (under step 4 of the method statement in section 102-5)

Her net capital gain for the year is $3,500.

Small business retirement exemption

1.72 The new small business retirement exemption provisions are largely the same as the small business retirement exemption provisions in Subdivision 118-F of the ITAA 1997. The changes reflect the standardised and rationalised basic conditions for all of the small business CGT concessions.

1.73 In qualifying situations, a capital gain made by an individual, company or trust from a CGT event happening to an active asset is disregarded. ***[Item 1, Subdivision 152-D]***

Choosing the exemption

1.74 A small business individual can choose to disregard a capital gain if the basic conditions in Subdivision 152-A are satisfied. If an individual who is under 55 years of age receives an ETP up to the amount of the excluded gain, the ETP must be rolled over. ***[Item 1, subsection 152-305(1)]***

1.75 For a company or trust, the exemption is also available if the above conditions are satisfied, the entity has a controlling individual, and the CGT concession stakeholders are paid their proportion of the capital proceeds as an ETP by the later of:

- 7 days after the choice is made by the company or trust to disregard the capital gain; or
- 7 days after an amount of capital proceeds is received by the CGT concession stakeholder.

[Item 1, subsection 152-305(2) and section 152-325]

Choosing the amount to disregard

1.76 The capital gain that the taxpayer can choose to treat as exempt is a ***CGT exempt amount***. That amount must not exceed the retirement exemption limit of the individual receiving the ETP. ***[Item 1, section 152-315]***

Consequences of the exemption

1.77 The amount of the capital gain equal to the small business entity's CGT exempt amount is disregarded and the amount is to be paid in form of an ETP. Any capital gain made that exceeds the CGT exempt amount does not qualify for this exemption. ***[Item 1, section 152-310]***

CGT retirement exemption limit

1.78 An individual's CGT ***retirement exemption limit*** is $500,000 reduced by any previous exemptions the individual has received under these rules or the earlier rules[11]. ***[Item 1, section 152-320]***

Superannuation reasonable benefit limit consequences

1.79 The ETP amounts will be assessed against the individual's RBL. Any amounts received in excess of their RBL will be taxed at the top marginal rate of tax.

Small business roll-over relief

1.80 The new small business roll-over provisions are largely the same as the small business roll-over in Division 123 of the ITAA 1997. The changes reflect the standardised and rationalised basic conditions for all of the small business CGT concessions. To qualify for the roll-over a small business entity must satisfy all of the basic conditions in Subdivision 152-A. ***[Item 1, paragraph 152-410(a)]***

1.81 The small business entity must also satisfy additional conditions to obtain the roll-over relief. These conditions are:

- the small business entity must acquire a replacement asset within one year before and 2 years after a CGT event happens to the active asset for which a roll-over is sought; and
- the replacement asset must satisfy the conditions in section 152-475.

[Item 1, paragraphs 152-410(b) and (c)]

1.82 If these conditions are satisfied, the capital gain can be rolled over to the extent it does not exceed:

- the acquisition consideration of the replacement asset (i.e. the first element of the cost base of the replacement asset); and
- any incidental costs associated with that acquisition (i.e. the second element of the cost base of the replacement asset).

[Item 1, section 152-415]

[11] Division 17B of the ITAA 1936, or Division 118-F of the ITAA 1997

What is a replacement asset?

1.83 A replacement asset is an active asset, as defined in section 152-45, acquired by the small business entity to replace an active asset (the original asset) to which a CGT event has happened. The replacement asset must be an active asset acquired within the period of one year before and 2 years after the CGT event happened to the original asset. The Commissioner may allow further time. ***[Item 1, subsections 152-420(1), (3) and (4)]***

1.84 If the replacement asset is a share in a company or an interest in a trust, the small business entity or an entity connected with that small business entity must be a controlling individual of that company or trust while they own the share or interest. ***[Item 1, subsection 152-420(5)]***

What happens if an individual dies and that person obtained a small business roll-over for a gain made on an active asset they owned?

1.85 If:

- a person dies after they have acquired a replacement asset under the small business roll-over;
- that asset forms part of the person's deceased estate; and
- that asset passes to the legal personal representative of the deceased person,

the legal personal representative is treated, for the purposes of this roll-over, as if they had undertaken any actions taken by the person before they passed away. ***[Item 1, section 152-425]***

1.86 However, this rule does not apply if the person before they died had done anything that would have triggered CGT events J2 or J3[12]. ***[Item 1, subsection 152-425(1)]***

1.87 The same concept applies to a beneficiary of a deceased estate where the replacement asset passes to the beneficiary. ***[Item 1, subsection 152-425(2)***

[12] CGT event J2 applies if an asset changes its status as an active asset. CGT event J3 applies if the active asset is a share or interest in a trust, and the company or trust in which the share or interest is held ceases to have a controlling individual or if less than 80% of the market value of its assets are active assets.

Can a capital gain that has been rolled over be rolled over again when CGT events J2 or J3 crystallise that gain?

1.88 If a rolled over capital gain is crystallised because the replacement asset:

- loses its status (CGT event J2); or
- if it is a share or interest in a trust, the company or trust ceases to satisfy the controlling individual test or the 80% active asset test (CGT event J3),

the capital gain may be eligible for further roll-over relief under Subdivision 152-E.

1.89 If a CGT event happens to a replacement asset that results in a taxpayer making a capital gain, that capital gain can be rolled over under the small business roll-over relief. Any capital gain made on a CGT event happening to the replacement asset that has been crystallised by either CGT event J2 or J3 may also be rolled over.

Example 1.11

Peter disposes of an active asset for $10,000, making a capital gain of $2,000. He buys 2 replacement assets for $5,000 each and obtains a roll-over under Subdivision 152-E.

$1,000 of the capital gain is disregarded for each replacement asset.

One of the replacement assets is later sold for $7,500 (CGT event A1) resulting in Peter making a capital gain of $2,500.

He will also make a capital gain of $1,000 as the sale of the replacement asset has triggered CGT event J2. The $1,000 capital gain represents the capital gain made on the disposal of the active asset that was rolled over in respect of this replacement asset under Subdivision 152-E.

Both capital gains ($2,500 made under CGT event A1 and $1,000 made under CGT event J2) may be eligible for further roll-over relief under Subdivision 152-E.

Application and transitional provisions

1.90 These amendments, including the consequential amendments, apply to assessments for the income year including 21 September 1999 and later years for CGT events happening at or after 11.45 am AEST on 21 September 1999. ***[Item 61]***

1.91 Taxpayers who have claimed the small business retirement exemption in income years before 1999-2000 have reduced their retirement exemption limit under the provisions in force at the time of the CGT disposal or event. A transitional measure will ensure that this reduction in the retirement exemption limit is also relevant for the new provisions. ***[Item 62]***

Consequential amendments

1.92 Consequential amendments to a number of provisions in Parts 3-1 and 3-3 of the ITAA 1997 are being made to reflect the repeal of the small business roll-over relief in Division 123 and the small business retirement exemption in Division 118-F, and their replacement with Subdivisions 152-D and 152-E. ***[Items 8, 12, 13, 15 to 20, 22 to 25, 27, 29 to 32, 34, 36 to 38, 40 to 41, 43 to 48 and 50 to 53]***

1.93 Consequential amendments are also being made to the ITAA 1936 to reflect these changes. ***[Items 54 to 60]***

1.94 Certain other amendments are being made to reflect the effect of streamlining the basic conditions for the small business CGT concessions. ***[Items 9, 10, 11, 14, 21, 26, 28, 33, 35, 39 and 49]***

1.95 The interaction between the CGT discount provisions and the small business CGT concessions have also led to certain changes to Subdivision 115-C, the method statement in section 102-5, and to the guide material in Division 100. ***[Items 2 to 7 and 42]***

1.96 Other consequential amendments are required to the cost base adjustment provisions in section 104-70 of the ITAA 1997 because of these changes to the small business CGT concessions. These amendments will be made in conjunction with other proposed changes arising from the Review.

Chapter 2
Scrip for scrip roll-over

Outline of Chapter

2.1 Schedule 2 to this Bill amends the ITAA 1997 to insert Subdivision 124-M. It allows CGT roll-over when original interests in one entity are exchanged for interests in another entity, typically because of a takeover.

2.2 This roll-over allows a capital gain made on the disposal of the original interests to be deferred until the disposal of the replacement interests.

Context of Reform

2.3 The existing CGT provisions are an impediment to corporate acquisition activity in Australia. Acquiring an interest in an entity may crystallise a capital gain in the hands of the existing equity holder. Entities seeking to acquire interests often find it necessary to pay a premium to compensate the equity holder for the potential CGT liability. Also, the offer may have to include cash so that the equity holder has funds to pay its tax.

2.4 New Subdivision 124-M will enable an equity holder in a scrip for scrip exchange to choose to obtain a CGT roll-over to defer any CGT liability.

2.5 The roll-over will enhance the functioning of, and value creation by, the corporate sector in Australia.

Summary of new law

2.6 Subdivision 124-M will provide for a CGT roll-over when certain interests in companies and trusts are exchanged for interests in another entity, typically as the result of a takeover.

2.7 Broadly, the effect of the roll-over is to defer the making of a capital gain. Roll-over is not available under this Subdivision if the exchange results in a capital loss.

2.8 Roll-over is available for shares in a company, interests that entitle the holder to fixed income and capital entitlements in fixed trusts and other interests (such as convertible notes) that confer an entitlement to acquire those interests in the future. Roll-over is only available for interests acquired on or after 20 September 1985.

2.9 Roll-over is available if:

- interests are exchanged for similar interests in another entity;
- the exchange is in consequence of an offer made by the other entity to all of the holders of interests in the original entity to acquire:
  - voting shares in a company; or
  - trust voting interests or, if none, units or fixed interests in the fixed trust; and
- the other entity becomes the owner, because of the offer, of at least 80% of the interests.

2.10 A capital gain or loss may arise if the proceeds received for the original interests include cash or something other than an interest in the acquiring entity. The cost base of the original interest is apportioned in such a case in working out the amount of the gain or loss.

2.11 Special capital proceeds rules apply in some cases where the original and acquiring entities:

- have fewer than 300 members; or
- are members of the same linked group.

An entity will be treated in the same way as an entity with fewer than 300 members if interests in it are concentrated in the hands of 20 or fewer individuals.

2.12 The cost base of a replacement interest is determined by reference to the cost base of the original interest.

2.13 The cost base of an interest acquired in exchange for a pre-CGT interest is its market value just after it is acquired.

2.14 Roll-over is not available in certain circumstances, for example, where replacement interests are trading stock.

Comparison of key features of new law and current law

2.15 There is no current law in relation to CGT roll-over for scrip for scrip exchanges.

Detailed explanation of new law

2.16 Scrip for scrip roll-over is available for the exchange of an original interest in an original entity for a replacement interest in an acquiring entity.

What interests does the roll-over apply to?

2.17 Roll-over is available for:

- a share in a company ***[subparagraph 124-780(1)(a)(i)]***;
- a unit or other interest in a fixed trust that entitles the holder to a fixed entitlement to income and capital of the trust ***[subparagraph 124-780(1)(a)(ii)]***; or
- other interests, such as a convertible note or option, that gives the holder a right to acquire any of those shares or trust interests ***[subsection 124-780(3)].***

2.18 There is no roll-over for an interest acquired before 20 September 1985 ***[paragraph 124-780(1)(a)].*** Scrip for scrip roll-over is intended to alleviate cash flow problems associated with meeting a CGT liability arising from an equity exchange. No such liability arises where a pre-CGT interest is exchanged.

When is roll-over available?

2.19 Roll-over applies if an equity holder exchanges an original interest in one entity for a replacement interest in another entity. The exchange must be in consequence of an offer made by the acquiring entity to all the holders of interests in the original entity to acquire:

- voting shares in the original entity if it is a company; or
- 'trust voting interests', or if there are none, units or other fixed interests in the original entity if it is a fixed trust.

[Subsection 995(1), paragraphs 124-780(1)(b) and (c)]

2.20 If either the original entity or acquiring entity is a trust, the beneficiaries of the entities must have 'fixed entitlements' to all the income and capital of the trust. ***[Subsection 124-795(3)]***

2.21 A beneficiary of a trust has a ***fixed entitlement*** to a share of the income or capital of the trust in the circumstances as set out in section 272-5 of Schedule 2F of ITAA 1936[13]. ***[Subsection 995-1(1)]***

[13] The definition of 'fixed entitlement' is inserted into subsection 995-1(1) by Item 8 of Schedule 4 of this Bill.

2.22 The entity that made the offer must, as a consequence of the offer, own at least 80% of the relevant interests in the original entity. ***[Paragraph 124-780(1)(d)]***

2.23 An acquisition occurs *in consequence* of an offer if the acquisition occurs as a result of, or effect of, the offer. This means that the offer needs to occur before the acquisition *and* have a causal or other connection with it. The requirement will be satisfied if, for example, after a takeover offer expires, an entity acquires interests under powers of compulsory acquisition contained in the *Corporations Law*.

Example 2.1

Tall Ships Ltd makes a scrip for scrip takeover offer for 100% of the shares in Pacific Cruises Ltd. Tall Ships receives 92% acceptances and consequently acquires the remaining 8% of shares in Pacific Cruises under the compulsory acquisition rules in the *Corporations Law*.

The shareholders in Pacific Cruises whose shares are compulsorily acquired are eligible for scrip for scrip roll-over.

Example 2.2

Green Bottles Ltd makes a scrip for scrip offer for Tincans Ltd. Green Bottles acquires 62% of the shares in Tincans through acceptances of the offer. Roll-over is not available to the shareholders in Tincans as Green Bottles did not acquire 80% of the shares.

Green Bottles continues to acquire Tincans shares on the market increasing its shareholding to 70%. Green Bottles makes a new scrip for scrip offer to Tincans shareholders and as a consequence increases its shareholding to 85%. The shareholders in Tincans who accepted this second offer are eligible for scrip for scrip roll-over.

When is a full roll-over available?

2.24 A full roll-over is available for an equity holder who, in exchange for an interest that otherwise qualifies for roll-over, receives only a similar interest in the entity making the offer. ***[Subsection 124-780(2)]***

2.25 This requirement will be satisfied if:

- a share in a company is exchanged for a share in another company; or
- a unit or other interest in a fixed trust is exchanged for a unit or other interest in another fixed trust,

even if the rights attaching to the share, unit or other trust interest are different.

2.26 Similarly, roll-over will be available for an exchange of an option, a right or similar interest issued by the original entity that enables an equity holder to acquire a share, unit or trust interest in that entity. The equity holder must receive from the acquiring entity options, rights and similar interests of the same kind as those owned in the original entity ***[subsection 124-780(3)]***. It is not a requirement for this extension of the roll-over that the equity holder own a share, unit or other trust interest in the original entity.

Example 2.3

Julie owns 1,000 shares in Holiday Ltd. She also owns 200 options to acquire preference shares in Holiday. Travel Ltd makes an unconditional takeover offer for Holiday offering 2 Travel shares for each Holiday share and one Travel share for each Holiday option. Julie accepts the offer and receives 2,200 Travel shares.

Julie can choose roll-over in respect of the 1,000 Holiday shares she exchanged. Roll-over is not available in respect of the Holiday options as she received shares in exchange for options. If Julie had received options in Travel in exchange for her options in Holiday, roll-over would also have been available.

2.27 Roll-over will not be available if a share is exchanged for a unit or other interest in a fixed trust or a unit or other interest in a fixed trust is exchanged for a share. Other situations in which roll-over will not be available include the exchange of a convertible note for a share, a share for a convertible note, an option for a share and a share for an option.

2.28 An equity holder can determine on a reasonable basis what capital proceeds it has received for particular interests.

Example 2.4

Norman has 200 shares in Wanted Ltd; 100 were acquired pre-CGT and 100 were acquired post-CGT. Acquirer Ltd makes an offer to acquire those shares. The offer provides these alternatives:

- Offer 1: $10 for each Wanted share; and
- Offer 2: 1 share in Acquirer for 2 shares in Wanted.

If Norman accepts Offer 1 for his pre-CGT shares and Offer 2 for his post-CGT shares he can choose to obtain a full roll-over for his post-CGT shares. Although roll-over is not available for his pre-CGT shares, any gain from them is disregarded.

If Norman accepts Offer 1 for his post-CGT shares and Offer 2 for his pre-CGT shares, no roll-over is available as he has not received any replacement equity for those of his shares that otherwise qualify for roll-over.

If Norman accepts Offer 1 for some of his post-CGT shares and Offer 2 for others, he can choose to obtain a partial roll-over to the extent he has applied his Wanted shares to Offer 2 (discussed at paragraph 2.38).

2.29 Roll-over will not be available in some cases where the equity holder is not dealing at arm's length with the acquiring entity. Roll-over will not be available in these cases if:

- the original entity and the acquiring entity have fewer than 300 members or beneficiaries; or
- the equity holder, the original entity and the acquiring entity are members of a linked group[14],

unless the proceeds received for the original interest is substantially the same as its market value *and* the replacement interest received carries the same rights and obligations attached to the original interest. ***[Subsections 124-780(4) and (5)]***

2.30 Where interests in an entity are concentrated in the hands of 20 or fewer individuals, an entity is treated in the same way as an entity having fewer than 300 members or beneficiaries. ***[Subsection 124-810(1) to (4)]***

2.31 The concentrated ownership test also considers whether there is any potential for rights attaching to the shares or interests in the trust to be varied or abrogated. It does not matter whether or not the rights attaching to any of the shares or interests are actually varied or abrogated. ***[Subsections 125-810(1), (2) and (5)]***

2.32 For the purposes of the concentrated ownership test, one individual together with associates, and any nominees of the individual or their associates will be counted as one individual. ***[Subsection 125-810(6)]***

What roll-over is provided?

2.33 If an equity holder chooses to obtain a roll-over, the CGT consequences are as follows.

2.34 A capital gain made from an original interest is disregarded ***[subsection 124-785(1)]***. There is no roll-over if the exchange results in a capital loss ***[paragraph 124-780(1)(e)]***.

2.35 The first element of the cost base of a replacement interest is the cost base or a portion of the cost base of the original interest, exchanged for the replacement interest ***[subsection 124-785(2)]***. The cost base of the original interest is apportioned if an original interest is not exchanged for a

14 The definition of 'linked group' was inserted by the Integrity and Other Measures Bill, introduced into the House of Representatives on 21 October 1999.

single replacement interest, for example, one share is exchanged for 2 shares.

2.36 The cost base of an original interest is the cost base just before the interest is exchanged, reduced by the amount of the cost base that is attributable to an ineligible part. For example, the cost base is reduced if an original interest is exchanged for a replacement interest *and* cash. ***[Subsection 124-785(3)]***

2.37 The first element of the reduced cost base of a replacement interest is worked out similarly. ***[Subsection 124-785(4)]***

Example 2.5

Lila owns ordinary shares in Reef Ltd. She accepts a takeover offer from Heron Ltd under which she receives one ordinary share and one preference share for each Reef share. The market value of Heron shares just after Lila acquires them is $20 for each ordinary share and $10 for each preference share.

The cost base of each Reef share just before Lila ceased to own them was $15. This cost base is apportioned to each of Lila's Heron shares as follows:

Ordinary share: $$\frac{20 \times 15}{30} = \$10$$

Preference share: $$\frac{10 \times 15}{30} = \$5$$

When is there a partial roll-over?

2.38 Roll-over does not apply to the extent that an equity holder accepts an offer that provides for the payment of ineligible proceeds. Ineligible proceeds are something other than a replacement interest in the acquiring entity, for example, cash. To work out the amount of any capital gain or loss made on disposing of the ineligible part of the original interest, a proportion of the cost base of the original interest reduces the ineligible proceeds. The apportionment is done on a reasonable basis. ***[Section 124-790]***

Example 2.6

Patrick owns 100 shares in Windsor Ltd each with a cost base of $9. He accepts a takeover offer from Regal Ltd which provides for Patrick to receive one Regal share plus $10 cash for each share in Windsor. Patrick receives 100 shares in Regal and $1,000 cash. Just after Patrick is issued shares in Regal each is worth $20.

Patrick has received $10 cash for each of his 100 Windsor shares and so has ineligible proceeds of $1,000.

In this case it is reasonable to allocate a portion of the cost base of the original shares having regard to the proportion that the ineligible proceeds bears to the total proceeds ($3,000). That is:

$$\frac{\$1{,}000 \times \$900}{\$3{,}000} = \$300$$

Patrick makes a capital gain calculated as follows:

Ineligible proceeds	$1,000
less Cost base	$ 300
Capital gain	$ 700

The cost base of each of Patrick's Regal shares is calculated as follows:

$$\frac{\$900 - \$300}{100} = \$6$$

Example 2.7

Adventure Rail Ltd makes an offer to acquire shares in Thomas Ltd. The offer provides these alternatives:

- Offer 1: 1 Adventure Rail share plus $1 for each Thomas share; or
- Offer 2: $5 for each Thomas share.

David chooses to accept the offers as follows:

- Offer 1 in respect of 50 post-CGT shares with a cost base of $2 each; and
- Offer 2 in respect of 50 post-CGT shares with a cost base of $6 each.

At the time he accepts the offer, the market value each Adventure Rail share is $4.

David makes a capital gain on the disposal of the ineligible part of Thomas shares under *Offer 1*, (i.e. on the cash component of the offer), calculated as follows:

Ineligible proceeds	$(50 \times \$1)$	$50
less Cost base	$\left(\frac{\$1}{\$5} \times \$100\right)$	$20
Capital gain		$30

The cost base of each Adventure Rail share David receives under *Offer 1* is calculated as follows:

$$\frac{\$100 - \$20}{50} = \$1.60$$

David makes a capital loss on the disposal of Thomas shares under *Offer 2*, calculated as follows:

Capital proceeds	(50 × $5)	$250
less Reduced cost base	(50 × $6)	$300
Capital loss		$ 50

Exceptions

2.39 In certain situations roll-over is not available.

Residency status of equity holder

2.40 Roll-over is not available if a non-resident acquires a replacement interest in a company that is not a resident of Australia or a fixed trust that is a not a resident trust for CGT purposes. ***[Subsection 124-795(1)]***

2.41 If a non-resident acquires a replacement interest in an Australian resident entity in place of an interest that had the 'necessary connection with Australia', the effect of the roll-over is that the replacement interest is treated as having the 'necessary connection with Australia'. This ensures that the non-resident can make a capital gain or loss when a CGT event happens to the replacement interest. ***[Items 5 and 6, section 136-25]***

2.42 A non-resident would not need to seek roll-over for an original interest that did not have the 'necessary connection with Australia' as no capital gain or loss would arise if a CGT event happened to that interest.

Other exceptions

2.43 Roll-over is not available if, should a CGT event happen to the replacement interest, any capital gain or capital loss would be disregarded. An exception to this rule applies if roll-over is the reason for the capital gain or loss being disregarded ***[paragraph 124-795(2)(a)]***. Roll-over will not be available if a replacement interest is trading stock.

2.44 Roll-over is not available under Subdivision 124-M if the equity holder is a member of the same wholly-owned group as the entity in which it holds a replacement interest. Roll-over may be available under Subdivision 126-B. This Subdivision allows a company to obtain roll-over if it transfers a CGT asset to another company that is a member of the same wholly-owned group. ***[Paragraph 124-795(2)(b)]***

Interests acquired in exchange for pre-CGT interests

2.45 An interest acquired in exchange for a pre-CGT interest is acquired when issued. The cost base of such an interest is its market value just after acquisition. If the interest is listed on a stock exchange in Australia, the last sale price on the day of issue is an acceptable market value. If the interest is not listed, another method that gives a current reflection of the market value of the interest must be used. ***[Section 124-800]***

Cost base issues

2.46 The scrip for scrip roll-over applies to ensure that a shareholder or unitholder who exchanges their equity for new equity as part of a takeover or merger defers any capital gain on that transaction. This roll-over is achieved by ensuring that any capital gain is disregarded at the time of the exchange, and by ensuring that the new equity takes on the cost base of the original equity.

2.47 The scrip for scrip roll-over focuses on the exchanging shareholders and unitholders, and provides for cost base changes for the new equity. These measures do not apply to any other part of the takeover or merger process.

2.48 A common feature of a takeover or merger is the interposition of the acquiring entity, the takeover or merger target, or another entity as part of the process of acquiring at least 80% of the equity in the target. Existing roll-over relief under Subdivisions 124-G and 124-H ensures that the full effect of the interposition is recognised and dealt with appropriately for wholly internal reconstructions with 100% beneficial ownership of the interposed entity. The provisions do not apply to mergers or takeovers of the type contemplated by the scrip for scrip proposals.

2.49 The Government is examining options for dealing with the cost base of assets acquired by an interposed entity as part of a takeover or merger process where the scrip for scrip roll-over applies to the exchanging shareholders or unitholders, and will be consulting on this issue.

Application and transitional provisions

2.50 The changes made by Schedule 2 apply to CGT events that happen on or after the date of Royal Assent of this Bill. ***[Item 7]***

2.51 There are no transitional provisions in relation to scrip for scrip roll-over.

Consequential amendments

2.52 Amendments are made to the ITAA 1997 to reflect the availability of scrip for scrip roll-over. Scrip for scrip roll-over is added to the table in section 112-115 which list the replacement asset roll-overs that may modify a CGT asset's cost base ***[item 1]***. Subdivision 124-M is included in the references to replacement asset roll-overs in the guide material to Division 124 ***[items 2 and 3]***.

Chapter 3
Venture capital exemption

Outline of Chapter

3.1 Schedule 3 to this Bill inserts Subdivision 118-G into the ITAA 1997 and Part 7A into the PDFA 1992. It allows certain non-resident, tax exempt pension funds exemption from tax on gains made on the disposal of their Australian venture capital investments.

3.2 The exemption is available to tax exempt foreign pension funds from specified jurisdictions on the disposal of eligible venture capital investments, owned for at least 12 months, that have an element of risk.

Context of Reform

3.3 There is a shortage of venture capital funding in Australia and the current CGT regime is an impediment to the development of this market. As Australia competes with other jurisdictions for foreign venture capital investment, it is necessary to have a competitive tax regime to attract the highly mobile capital of non-resident investors. Australia's tax treatment of capital gains on venture capital investments is seen as being relatively harsh in comparison with that of other countries competing for these investments.

3.4 A significant issue for foreign investors is that they may receive no credits, or only limited credits, for Australian tax because they are tax exempt in their country of residence or generally subject to lower rates of tax.

3.5 To stimulate venture capital funding, it is necessary to make the CGT regime more competitive by targeting CGT relief for such investments.

Summary of new law

3.6 The new law will provide venture capital entities, such as United States pension funds, with an exemption from tax on the disposal of venture capital equity in resident investment vehicles in Australia.

3.7 To qualify for the exemption the venture capital entity must:

- not be a resident of Australia;
- be a foreign superannuation fund;
- be a resident of a specified jurisdiction;
- be exempt from tax in that jurisdiction;
- be registered under Part 7A of the PDFA 1992; and
- make an eligible investment.

3.8 The normal residency rules apply to a venture capital entity. A venture capital entity cannot be a dual resident with Australia but can have dual residency of 2 non-Australian specified jurisdictions.

3.9 The specified jurisdictions are Canada, France, Germany, Japan, the United Kingdom and the United States of America. The list of specified jurisdictions may be added to by regulation with the date of effect stipulated in the regulation. The countries selected need to satisfy the criterion that they exempt only bona fide retirement pension funds.

3.10 An entity is exempt from tax in its country of residence if it is effectively not liable to income tax in that country.

3.11 An eligible investment must be:

- in a resident investment vehicle;
- by way of venture capital equity;
- held at risk; and
- held for at least 12 months.

3.12 A resident investment vehicle is a company or fixed trust that:

- is an Australian resident;
- does not have total assets exceeding $50 million at the time of the new investment (including the new investment); and
- does not have property development or ownership in land as its primary activity.

3.13 Venture capital equity is a share in a company or unit or other fixed interest in a trust.

3.14 The venture capital entity must be registered with the PDF Board under the PDFA 1992. It must also lodge an annual return with the PDF Board.

Comparison of key features of new law and current law

3.15 There is no current law that provides venture capital entities with an exemption from tax on the disposal of venture capital equity.

Detailed explanation of new law

3.16 If a venture capital entity makes a profit or gain from the disposal of venture capital equity in a resident investment vehicle, owned for at least 12 months, that profit or gain is not taken into account for calculating taxable income. Correspondingly, a loss is also disregarded. The same treatment is given to a gain, profit or loss made by a limited partnership which is on revenue account. ***[ITAA 1997, sections 26-70 and 51-55, subsection 118-505(1)]***

3.17 The entity must be registered under Part 7A of the PDFA 1992 at the time the venture capital equity is disposed of or a CGT event happens to the equity. ***[Subsection 118-505(2)]***

Example 3.1

On 15 November 2000 Tokyo Municipal Workers Pension Fund (TMWPF) acquires 5 million $1 ordinary shares in Australia Innovations Pty Ltd, a resident investment vehicle. TMWPF is registered by the PDF Board as a venture capital entity.

On 20 May 2002 TMWPF sells these shares for $8 million. The $3 million gain on the sale of the shares is exempt from Australian income tax, providing TMWPF is still registered as a venture capital entity.

What is a venture capital entity?

3.18 A ***venture capital entity*** is a foreign superannuation fund that is:

- not a resident of Australia;
- a resident of a specified eligible jurisdiction:
  - Canada;
  - France;
  - Germany;

  - Japan;
  - the United Kingdom; or
  - the United States of America; and
- exempt from tax on its income in that jurisdiction.

[Subsections 995-1(1) and 118-515(1)]

3.19 A venture capital entity which is a partner in a partnership of venture capital entities is eligible for the exemption if the venture capital equity in a resident investment vehicle is provided through the partnership. ***[Paragraph 118-515(2)(a)]***

Example 3.2

On 1 May 2001 the Miami City Employees Pension Fund (MCEPF) acquired 1 million $10 ordinary shares in Great Inventions Australia Ltd (GIAL), a resident investment vehicle. MCEPF is also a partner in a partnership with 5 other tax exempt United States pension funds. Through this partnership $12 million is subscribed for ordinary shares in GIAL, each partner contributing $2 million for this investment.

When MCEPF sells any of its ordinary shares in GIAL, it applies subsection 118-515(1) to determine if it is a venture capital entity. When MCEPF sells its interest in any of the ordinary shares in GIAL, it applies subsection 118-515(2) to determine whether it is a venture capital entity.

3.20 If the partnership is a 'limited partnership', the concession is available to the partners providing:

- all the partners, other than the general partner or managing partner, are venture capital entities; and
- the general or managing partner's interests in the partnership is less than 10% of the value of the total assets of the partnership.

[Paragraph 118-515(2)(b)]

3.21 A 'limited partnership' has the meaning given in section 94B of the ITAA 1936. ***[Subsection 995-1(1)]***

3.22 Where the investment in a resident investment vehicle is made through a partnership, it is not necessary that all the partners be residents of the same jurisdiction. It is sufficient that the partners are residents of any of the specified eligible jurisdictions.

Example 3.3

The partners in the Bahamas Venture Capital Partnership are 3 United States tax exempt pension funds, 2 Canadian tax exempt pension funds and one Japanese tax exempt pension fund. If all 6 partners are venture capital entities in their own right, new venture capital equity, acquired through the partnership is eligible for the venture capital exemption.

If one of the partners is a New Zealand pension fund, the other 5 partners would not be eligible for the exemption for the equity acquired through the partnership. New Zealand is not a listed jurisdiction. However, if the 5 non-New Zealand partners separately acquire venture capital equity in a resident investment vehicle, and register with the PDF Board, they are each eligible for the exemption for these investments.

Non-resident

3.23 The venture capital entity must be a non-resident throughout the period commencing just before it acquires the venture capital equity in the resident investment vehicle and ending at the time all or part of the equity is disposed of. No apportionment of the exemption is available for venture capital entities which are non-residents for a part of the period. ***[Paragraph 118-515(1)(a)]***

3.24 The fact that a venture capital entity has a permanent establishment in Australia will not prevent it being eligible for the exemption.

Eligible non-resident countries

3.25 Eligibility for the exemption requires the venture capital entity to demonstrate that it is a resident of Canada, France, Germany, Japan, the United Kingdom or the United States of America. ***[Subparagraphs 118-515(1)(d)(i) to (vi)]***

3.26 These jurisdictions have been chosen because they have:

- potential to be significant sources of venture capital investment; and
- pension funds which are exempt from tax.

3.27 Other countries which exempt only bona fide retirement pension funds may be added by regulation to the list of eligible jurisdictions. ***[Subparagraph 118-515(1)(d)(vii)]***

Exempt from tax

3.28 The tax exempt status required of a venture capital entity means the entity's income is exempt, or is effectively exempt, from taxation in the country in which it is resident. ***[Paragraph 118- 515(1)(e)]***

3.29 An entity is effectively exempt from taxation if:

- a law of that country;
- a decree, proclamation, instrument or direction (however described) issued by a competent authority in that country; or
- an administrative arrangement in that country;

has the effect that tax is not paid on the income.

Foreign superannuation fund

3.30 A venture capital entity must be a foreign superannuation fund throughout the period commencing just before it acquires the venture capital equity in the resident investment vehicle and ending at the time all or part of the equity is disposed of.

3.31 The entity is a ***foreign superannuation fund*** at a time if:

- it is an indefinitely continuing fund, which is a provident, benefit, superannuation or retirement fund;
- it is established in a foreign country;
- it was established in that country for the benefit of individuals who are not residents of Australia or of a Territory; and
- its central management and control is carried on outside Australia by entities which are not Australian residents or residents of a Territory.

[Subsection 118-520(1)]

3.32 A fund is not a foreign superannuation fund if an amount paid to the fund is an allowable deduction or qualifies for a tax offset. ***[Subsection 118-520(2)]***

What is a resident investment vehicle?

3.33 A ***resident investment vehicle*** is an entity in which a venture capital entity acquires venture capital equity that is eligible for the exemption. ***[Subsection 995-1(1)]***

3.34 The resident investment vehicle must be either a company or a trust which is resident only in Australia. ***[Subsection 118-510(1)]***

3.35 A trust cannot be a resident investment vehicle unless the beneficiaries have 'fixed entitlements' to all of the income and capital of the trust. ***[Subsection 118-510(2)]***

3.36 A beneficiary of a trust has a ***fixed entitlement*** to a share of the income or capital of the trust in the circumstances as set out in section 272-5 of Schedule 2F of ITAA 1936[15]. ***[Subsection 995-1(1)]***

3.37 The resident investment vehicle must satisfy a $50 million value of assets test. The test is applied just before the venture capital entity acquires venture capital equity in the resident investment vehicle. The sum of following amounts must not exceed $50 million:

- the total value of the assets of the resident investment vehicle;
- the total value of the assets of any company or trust *connected with*[16] the resident investment vehicle; and
- the amount of the venture capital equity the venture capital entity proposes to acquire in the resident investment vehicle.

[Paragraph 118-510(1)(a)]

3.38 The total value of the assets is ascertained from the last audited accounts of the company or trust prepared for *Corporations Law* purposes for a period ending less than 18 months before the acquisition time. If such accounts are not prepared, a statement audited by the company's or trust's auditor and showing that value at a time not longer than 12 months before the acquisition time could be used. ***[Subsection 118-510(3)]***

3.39 The company or trust must not have as its primary activity or main business, property development or land ownership. ***[Paragraph 118-510(1)(b)]***

Example 3.4

Millennium Solar Ltd (MSL), a resident investment vehicle, is engaged in the development and marketing of solar power appliances. During the 2000-2001 income year MSL sold its business premises and acquired new premises, making a $50,000 gain. MSL also leased excess car parking spaces in its new premises.

These *land ownership* transactions are considered only incidental to MSL's primary activity or main business and would not affect MSL's status as a resident investment vehicle. Other property development and land ownership activities by MSL in previous or future years could impact on this status.

[15] The definition of 'fixed entitlement' is inserted into subsection 995-1(1) by Item 8 of Schedule 4 of this Bill.

[16] See paragraphs 1.19 to 1.27 for discussion on 'connected with'.

Meaning of venture capital equity

3.40 The venture capital exemption is only available to a venture capital entity that disposes of venture capital equity it acquired in a resident investment vehicle.

3.41 ***Venture capital equity*** is a share in a company or an interest in a trust issued or allotted to a venture capital entity on or after the date of Royal Assent of this Bill. ***[Subsection 118-525(1) and item 18]***

3.42 The venture capital entity must bear the risk of owning the share or interest. The venture capital entity must have no arrangement, either before or after the share or interest is issued or allotted, as to:

- maintaining the value of the share or interest;
- the amount of earnings made from owning it; or
- protection from all of the commercial loss of owning it.

[Paragraph 118-525(1)(c)]

3.43 In certain circumstances a share or interest in a resident investment vehicle will not be treated as being venture capital equity. If any of the following events happen and they are connected to the issue or allotment of a share or interest to a venture capital entity, or to some other arrangement between the entities concerned, the share or interest is not venture capital equity where:

- a share or interest in that vehicle acquired by another entity before that issue or allotment is cancelled or redeemed;
- there is a return of capital in that vehicle that was acquired before that issue or allotment; or
- value is shifted out of a share or interest in that vehicle acquired before that issue or allotment.

[Subsection 118-525(2)]

Example 3.5

The Chicago Pension Fund, a venture capital entity, has owned one million ordinary shares in Bright Ideas Ltd, a resident investment vehicle, since 1995. These shares are ineligible for the venture capital exemption.

On 1 August 2000, Bright Ideas buys back these one million shares and issues 500,000 ordinary shares to the Chicago Pension Fund. The new ordinary shares are not venture capital equity and are ineligible for the venture capital exemption.

Pooled Development Fund Registration Board

3.44 A non-resident tax exempt venture capitalist seeking to benefit from the venture capital exemption must be registered as a venture capital entity with the PDF Board. ***[ITAA 1997, subsection 118-505(2)]***

3.45 The current PDFA 1992 does not cover the registration and administration of venture capital entities.

3.46 The PDFA 1992 is being amended to authorise the PDF Board to register venture capital entities, receive annual returns by these entities and, in limited situations, revoke the registration.

Registration

3.47 An entity seeking venture capital tax concessions must apply for registration with the PDF Board ***[PDFA 1992, subsection 52A(1)]***. The entity must apply for registration within 30 days after the venture capital entity makes its first investment in venture capital equity ***[subsection 52A(2)]***.

3.48 An entity need only register once, that being at the time it acquires or proposes to acquire its *first* venture capital equity in a resident investment vehicle. The focus of the registration is the venture capital entity itself, rather than resident investment vehicle. If the investment is made through a partnership, each venture capital entity that is a member of the partnership, must be registered.

3.49 The application must contain the following information:

- the country in which the entity is a resident;
- details of the entity's tax exempt status in that country;
- details of the entity's status as a foreign superannuation fund;
- the address of the entity's registered office;
- the name and address of the resident investment vehicle in which the entity has acquired or proposes to acquire venture capital equity and the industry in which the resident investment vehicle operates;
- the amount of the venture capital equity acquired or proposed to be acquired in the resident investment vehicle and the date on which it was or will be acquired;
- the total value of the assets of the resident investment vehicle, immediately before the venture capital equity was or will be acquired;

- details of investments, other than venture capital equity, that the entity holds in the resident investment vehicle; and

- if the entity is a general partner or managing partner of a limited partnership referred to in subparagraph 118-515(2)(b)(ii) of the ITAA 1997, details of the partner's interests in the assets of that partnership.

[Subsection 52A(3)]

3.50 The PDF Board may require the applicant to provide additional information and documents in support of the information provided in the application. If the PDF Board is satisfied that the applicant has provided the required information it must register the applicant as a venture capital entity ***[subsection 52A(4)]***. The PDF Board must notify the applicant of its registration within 45 days of the application being lodged ***[subsection 52A(5)]***. The PDF Board must decide an application for registration within 45 days after receiving it. The PDF Board has the authority to extend the period in which it decides the application ***[section 52B]***.

Annual return

3.51 A registered venture capital entity must lodge an annual return with the PDF Board. This return must be lodged within 3 months of the end of the financial year (30 June).

3.52 The annual return must contain the following information:

- the country in which the entity is a resident;

- details of the entity's tax exempt status in that country;

- details of the entity's status as a foreign superannuation fund;

- details of:

  - venture capital equity in resident investment vehicles acquired by the entity during the year;

  - venture capital equity in resident investment vehicles disposed of by the entity during that year; and

  - venture capital equity in resident investment vehicles held by the entity at the end of that year;

- the industries in which those resident investment vehicles operate; and

- if the entity is a general partner or managing partner of a limited partnership referred to in subparagraph

118-515(2)(b)(ii) of the ITAA 1997, details of the partner's interests in the total assets of that partnership.

[Section 52C]

Revocation of registration

3.53 The PDF Board has the power to revoke the registration of an eligible venture capital entity if it fails to lodge an annual return or lodges an incomplete annual return. *[Subsection 52D(1)]*

3.54 If the PDF Board intends to revoke an entity's registration it must advise the entity of this intention in order to give the entity the opportunity to address the grounds on which the PDF Board's intention is based. The PDF Board must consider any submission made by the entity before proceeding to revoke its registration. *[Subsections 52D(2) and (3)]*

Application and transitional provisions

3.55 The amendments to Divisions 26 and 51 and Subdivision 118-G of the ITAA 1997 and the PDFA 1992 apply to the issue or allotment of venture capital equity in a resident investment vehicle on or after the day this Bill receives Royal Assent. *[Item 18]*

Consequential amendments

3.56 An amendment is made to section 11-15 to ITAA 1997 to include a gain or profit from the realisation of venture capital gains in the list of ordinary and statutory income which is exempt only if it is deemed by certain entities. *[Item 1]*

3.57 Amendments are made to the PDFA 1992 to facilitate the administration of venture capital entities. The PDF Board's decision to refuse to register or revoke the registration of a venture capital entity is added to the definition of reviewable decision *[item 5]*. Amendments to subsection 4(1) apply to include definitions of 'venture capital equity', 'resident investment vehicle' and 'venture capital entity' *[items 6 to 8)]*. The PDF Board's responsibility for registering venture capital entities is added to the list of the PDF Board's functions *[item 9]*.

3.58 The PDF Board is also authorised to seek additional information and documents for the purposes of applying the PDFA 1992 *[item 10]*. Venture capital entities will be liable to penalties for providing false or misleading information or documents in connection with either an application for registration or an annual return *[items 11 and 12]*. The PDF Board is provided with powers to delegate certain functions and powers *[items 14 to16]*. The PDF Board is required to include information relating to venture capital entities in its annual report to the Minister *[item 17]*.

Chapter 4
Regulation Impact Statement

Policy objective

The objectives of the New *Business* Tax System

4.1 The measures in this Bill are part of the Government's broad ranging reforms which will give Australia a New *Business* Tax System. These reforms are based on the Recommendations of the Review that the Government established to consider reforms to Australia's business tax system.

4.2 The Government established the Review to consult on its plan to comprehensively reform the business income tax system (as outlined in ANTS). The Review made 280 recommendations to Government designed to achieve a more simple, stable and durable business tax system.

4.3 The New *Business* Tax System is designed to provide Australia with an internationally competitive business tax system that will create the environment for achieving higher economic growth, more jobs and improved savings, as well as providing a sustainable revenue base so the Government can continue to deliver services for the community.

4.4 The New *Business* Tax System also seeks to provide a basis for more robust investment decisions. This is achieved by:

- improving simplicity and transparency;
- reducing the costs of compliance; and
- providing fairer, more equitable outcomes.

4.5 This Bill represents the second phase of legislation to implement the New *Business* Tax System. The first phase involved the following Bills, which were introduced to the House of Representatives on 21 October 1999:

- the New Business Tax System (Integrity and Other Measures) Bill 1999;
- the New Business Tax System (Capital Allowances) Bill 1999;
- the New Business Tax System (Income Tax Rates) Bill (No.1) 1999; and

- the New Business Tax System (Former Subsidiary Tax Imposition) Bill 1999.

The objectives of measures in this Bill

4.6 The New *Business* Tax System will promote investment through a fundamental reform of Australia's CGT regime.

4.7 The following CGT reforms are contained in this Bill:

- streamlining of existing CGT concessions for small businesses, with a further concession being provided where an active asset of the business, held for at least 15 years, is disposed of because the taxpayer intends to either retire on account of being at least 55 years old, or is incapacitated;
- ensuring any capital gain is deferred by allowing a 'CGT roll-over' where shareholders in a company, unitholders in a unit trust or beneficiaries of a fixed trust, exchange membership interests for comparable interests in an acquiring entity as part of a takeover; and
- providing certain non-resident tax exempt superannuation funds with an exemption on gains made on the disposal of eligible Australian venture capital investments.

4.8 Other important CGT reforms include:

- the CGT discount for individuals and superannuation funds and the phasing out of indexation on CGT asset cost bases, which are contained in the Integrity and Other Measures Bill; and
- the removal of CGT averaging for individuals, which is contained in the New Business Tax System (Income Tax Rates) Bill (No. 2) 1999, to be introduced contemporaneously with this Bill.

4.9 Together, the Government's CGT reforms will remove impediments to efficient asset management, improve capital mobility, reduce complexity and compliance costs and make Australia's CGT regime internationally competitive.

4.10 In particular, the measures in this Bill providing concessions to non-resident superannuation funds on venture capital investments are designed to remove tax impediments to invest in Australia's venture capital market. As a consequence, start-up firms participating in innovative ventures are more likely to remain and grow in Australia.

4.11 The measures contained in this Bill are also consistent with the overall objectives of the New *Business* Tax System. For example:

- the streamlining of CGT concessions for small businesses will reduce compliance costs for small business taxpayers; and
- the CGT scrip for scrip roll-over measure will defer a CGT liability arising where an equity holder of a target entity in a takeover exchanges shares and like interests. In the absence of this measure, some taxpayers may have cash flow difficulties in meeting their CGT liabilities.

Implementation options

4.12 All of the measures in this Bill arise from the Review's recommendations. Those recommendations have been the subject of extensive consultation. The implementation options for those measures are to be found in the Review's *A Platform for Consultation* (APFC) and *A Tax System Redesigned* (ATSR). Table 4.1 shows where the measures (or the principles underlying them) are discussed in those publications.

Table 4.1: Options for implementing measures in this Bill arising from the Recommendations

Measure	APFC	ATSR
Small business relief (referred to as 'Streamlining capital gains provisions for small business' in ATSR)	Chapter 11, pp. 300-301	Recommendations 17.5 and 17.6, pp. 586-589
Scrip for scrip roll-over relief	Chapter 11, pp. 294-298	Recommendations 19.3 and 19.5, pp. 615-618; 619-620
Venture capital exemption for non-resident tax exempt superannuation funds	Chapter 11, pp. 298-299	Recommendations 19.1 and 19.2, pp. 611-615

Evaluation of some measures

4.13 Consistent with the Recommendations of the Review, the effectiveness of the following measures will be evaluated 5 years after their commencement:

- scrip for scrip roll-over relief; and
- venture capital exemption for non-resident tax exempt superannuation funds.

Assessment of impacts

4.14 The potential compliance, administrative and economic impacts of the measures in this Bill have been carefully considered, by both the Review and the business sector. The Review focused on the economy as a whole in assessing the impacts of the Recommendations (including those relating to the measures in this Bill) and concluded that there would be net gains to business, Government and the community generally from business tax reform.

Impact group identification

4.15 The measures in this Bill specifically impact on taxpayers conducting a type of transaction or event as shown in Table 4.2.

Table 4.2: Taxpayers affected by the measures in this Bill

Measures	Affected taxpayer(s)
Small business relief (referred to as 'Streamlining capital gains provisions for small business' in ATSR)	Small business taxpayers disposing of certain CGT assets.
Scrip for scrip roll-over relief	Shareholders, unitholders and beneficiaries who exchange their interests in a takeover.
Venture capital exemption for non-resident tax exempt superannuation funds	Specific non-resident tax exempt superannuation funds investing in Australian venture capital.

Analysis of costs and benefits

Compliance costs

4.16 The measures in this Bill will reduce compliance costs as part of providing a more consistent and easily understood business tax system.

- Streamlining the CGT small business concessions will reduce complexity and provide small business taxpayers with greater flexibility in accessing the benefits.

- Scrip for scrip roll-over relief will mean that shareholders, unitholders and beneficiaries will not need to deal with a CGT event when they exchange their interests as part of a takeover.

- The venture capital measure will take certain foreign investors out of the Australian tax net in relation to particular investments, thereby reducing their compliance costs. There will be some registration and reporting requirements (to the PDF Board) in order to be eligible for the exemption. However, the information required is collected in the ordinary course of business and will be important in assessing the overall effectiveness of the measure (as discussed in paragraph 4.13).

4.17 Further details on how the measures in this Bill impact on affected taxpayers can be found in the specific Chapters in this Explanatory Memorandum explaining each measure.

Administration costs

4.18 The implementation of the measures in this Bill are not expected to give rise to any significant increase in administration costs.

Government revenue

4.19 The revenue impact of each measure is dealt with in the General Outline for this Explanatory Memorandum.

Economic benefits

4.20 The New *Business* Tax System will provide Australia with an internationally competitive business tax system that will create the environment for achieving higher economic growth, more jobs and improved savings. The venture capital measures in particular will place Australia's CGT treatment of venture capital investment in line with other overseas jurisdictions (such as the United States). These measures are also expected to stimulate growth in innovative industries, and therefore create more jobs.

Consultation

4.21 The consultation process commenced with the release of ANTS in August 1998. The Government established the Review in August 1998 and since that time the Review has published 4 documents on business tax reform, in particular *A Platform For Consulation* and *A Tax System Redesigned*, in which the Review canvassed options and issues, and sought public comment.

4.22 Also during this period, the Review held numerous public seminars and focus group meetings with stakeholders in the taxation system. It received and analysed 376 submissions from the public on reform options. Further details are contained in paragraphs 12 to 16 of the Overview of *A Tax System Redesigned.*

4.23 In analysing options, the published documents frequently referred to, and often were guided by, views expressed during consultation.

4.24 The measures in this Bill have therefore been subject to extensive consultation, given all the measures arose directly from the Recommendations.

Conclusion and recommended option

4.25 The measures contained in this Bill should be adopted to:

- support a more efficient, innovative and internationally competitive Australian business sector;
- reduce compliance costs; and
- establish a simpler tax system.

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