Active vs passive assets and the small business CGT concession

The small business capital gains tax concessions are extremely valuable. For small business owners who need to dispose of assets that have risen in value during the time they have owned them, accessing these concessions can mean greatly reducing any consequent tax liability, even to zero.

But to access the CGT concessions some conditions must first be satisfied, such as having an aggregated annual turnover of less then $2 million, or net assets not exceeding $6 million. One of the other conditions requires that the CGT asset satisfies the "active asset" test.

A CGT asset is an "active asset" if it is used, or held ready for use, in the course of carrying on a business by the taxpayer (or their affiliate or an entity connected with them, known as relevant entities).

For example, a bricks-and-mortar shop held and used by a green grocer to sell fruit and vegetables is an example of an active asset.

About this newsletter

Welcome to our monthly newsletter. Should you require professional advice on any matters contained in this newsletter, our team of Accountants are here to assist.

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Active vs passive assets and the small business CGT concession *cont*

Another condition to satisfy this test is that the asset must be an active asset of the taxpayer for the lesser of 7.5 years or half of the relevant ownership period.

However, certain assets are specifically excluded from being an active asset, with one such exclusion applying to assets where the **main use** by the taxpayer is to derive rent (unless the main use for deriving rent was only temporary).

When determining the main use of the asset to derive rent, the taxpayer is instructed to disregard any personal use or enjoyment of the asset by them (which includes use by affiliates and connected entities).

Carrying on a business

To qualify as an active asset, a tangible CGT asset must be used or held ready for use in the course of carrying on a business, but there is no black-and-white test for determining whether a business is being carried on. However the ATO has enumerated several indicators that may be relevant, including;

- the size, scale and permanency of the activity
- repetition and regularity of the activity
- whether the activity is planned, organised and carried on in a systematic and businesslike manner, and
- the expectation, and likelihood, of a profit.

It can be assumed that the operator of a motel is conducting a business, however most residential rental activities are a form of investment, and do not amount to carrying on a business.

Notwithstanding this, it is possible to conduct a rental property business. To take a real example from the ATO's case files, it so happened that a taxpayer owned eight houses and three apartment blocks (each comprising six residential units), making a total of 26 properties.

The taxpayer actively managed the properties, devoting a significant amount of time to this (an average of 25 hours per week). The ATO concluded this taxpayer was carrying on a business.

So while an asset whose main use is "to derive rent" cannot be an active asset, it has been argued that this exception should not apply to properties where the taxpayer carries on a business of leasing properties (but rather only apply to passive investments).

There have however been legal cases where the courts rejected this argument, stating clearly that it does not matter if the taxpayer is in the business of leasing properties or not.

There is no statutory definition of the word "rent" that is relevant in this context, so the term takes on its common law meaning.

Where there is a question of whether the amount paid constitutes "rent", a key factor to consider is whether the occupier has a right to "exclusive possession" of the property. If such a right exists, the payments involved are likely to be rent.

Conversely, if the arrangement allows the occupier only to enter and use the premises for certain purposes, and does not amount to a lease granting exclusive possession, the payments involved are unlikely to be rent.

Other relevant factors include the degree of control retained by the owner, the extent of any services performed by the owner (such as room cleaning, provision of meals, supply of linen and shared amenities) and the length of the arrangement.

By way of example, the ATO looked at the operator of an eight-bedroom boarding house. The average length of stay was four to six weeks. Visitors were required to leave the premises by a certain time and the proprietor retains the right to enter the rooms.

He pays for all utilities and provides cleaning and maintenance, linen and towels, and the house has common areas such as a lounge room, kitchen and recreation area. The ATO concluded that the amounts received were not rent.

What is main use?

The term "main use" is not defined in the relevant laws. Therefore resolving the matter in regard to the mixed use of assets is likely to involve a consideration of various factors, however most important will be the comparative level of income derived from the different uses of the asset.

By way of example, consider a taxpayer who owns land on which there are several industrial sheds. He uses one shed (45% of the land area) to conduct a motorcycle repair business and leases the other sheds (55% of the land by area) to unrelated third parties.

The income derived from the repair business is 80% of total income, with the rest derived from leasing the other sheds. Having regard to all the circumstances, the ATO considered that the "main use" of the taxpayer's land is not to derive rent.

If you need assistance in working out whether your asset qualifies, contact this office. ■

Deceased estates: A brief guide to tying up the loose ends

After a person dies, and the usual arrangements are completed, there will come a time when other matters, such as tax and superannuation issues, must be looked after. The person who takes on the responsibility for administering a deceased estate is commonly referred to as the executor, but could also be known as an administrator or a legal personal representative.

One of the necessary steps in the process, and generally the first action to take, is to obtain probate. Basically, this is a court-issued document that confirms that the person whose affairs are being looked at is in fact deceased — and therefore cannot hold bank accounts, shares, property and so on — and that the person appointed executor in their will is legally entitled to wind up said affairs.

One of the central matters to take care of is the final tax return. The ATO refers to this return as a "date of death tax return", which is lodged on behalf of the deceased. The ATO insists that these must be lodged on a paper return, but otherwise all the other assessment conditions apply — that is, the same tax rates, income thresholds, withholding conditions, lodging requirements and so on.

The date of death tax return will be the last document to require the deceased's particular individual tax file number (TFN). Upon completion, this TFN will not be used again.

There are a few other differences to remember when completing this return. The executor will need to print the words "Deceased estate" on the top of the first page of the return, sign the tax return on behalf of the deceased, and show the name of the taxpayer as "The legal representative of <their name>, deceased". Also, at the question "Will you need to lodge an Australian tax return in the future?", answer with an "X" or the word "No".

Assessable income earned or derived, and deductible expenses incurred, up to the date of death should be included in the return. But income earned and deductible expenses incurred after the date of death (for example from investments and such) will need to be dealt with in the deceased estate's trust return — not in this final individual tax return. The treatment of capital gains or losses would be dealt with in a similar way. Generally it will be advisable to seek guidance if required to complete a deceased estate trust return, which we can help you with.

If the deceased person had accumulated losses, these can be offset against income in the final tax return (capital losses may be offset against capital gains) but can't be carried forward into the deceased estate. Ordinary losses, as well as capital losses, that can't be offset in this final tax return will lapse.

The ATO will usually send the ensuing notice of assessment to the executor, which should show any refund owing, or any tax liabilities. There may in some cases be a requirement to withhold amounts from the assets or income of the deceased estate to pay any tax liabilities.

To ensure everything is taken care of, an ATO checklist follows to help gather all the loose ends that can crop up with a deceased estate. If the deceased person also carried on a business, further advice should be sought.

cont ⇨

Deceased estates: A brief guide to tying up the loose ends *cont*

7 point checklist for deceased estates

1. DID THE PERSON HAVE A WILL?

Yes. Determine who is the executor or administrator of the will. See next point.	**No.** Contact the public trustee in your state or territory to determine if they will act on behalf of the deceased person. If so, they will take the action required.

2. HAS PROBATE BEEN OBTAINED BY THE EXECUTOR?

Yes. See next point.	**No.** You may need to provide further information if you wish to establish authority to deal with the tax affairs of the deceased person. See next point.

3. OFFICIALLY NOTIFY THE ATO OF THE PERSON'S DEATH

Complete the "Notification of a deceased person" form (ask us for a copy if you need one).

This form:

- officially notifies the ATO of the person's death
- can be used to establish authority to deal with their tax affairs.

You will need to provide the death certificate and supporting documents required at an Australia Post outlet for an interview, or certified copies to the ATO by mail. The ATO may also attempt to match individual records to Births, Deaths and Marriages data. Ask us for assistance if need be. See next point.

4. DO YOU NEED TO LODGE A FINAL INDIVIDUAL TAX RETURN?

While this article may help if you need to lodge a "date of death" tax return, see this office if you need guidance.

It is also wise to check for outstanding income tax returns for previous years.

Yes. This return should cover the period from the previous July 1 to the date of death. See next point.	**No.** Complete a "Non-lodgment advice form" (ask us for a copy) and send it to the ATO. On the form, where it asks for "Reason for not lodging a tax return" write "Deceased" and the date of death. See next point.

5. DO YOU NEED TO LODGE A DECEASED ESTATE TAX RETURN?

Yes. Generally it will be best to seek advice. See next point.	**No.** If all of the above has been completed, no further information is required by the ATO.

6. OBTAIN A TAX FILE NUMBER (TFN) FOR THE DECEASED ESTATE

As a deceased estate is considered a trust, a "TFN application for a deceased estate" form will be required. We can help with this. See next point.

7. LODGE THE DECEASED ESTATE TAX RETURN(S)

A trust tax return will need to be completed. Each financial year will require another such return to be lodged until the deceased estate has been fully administered and no longer has a tax liability.

The process (and pros and cons) of "electing" to be a **family trust**

Trusts are an important and very useful concept for managing one's financial affairs, as well as estate planning.

A trust is established whenever there is a separation of the legal ownership (for example, the name appearing on a land title) from the beneficial (equitable) owner of an asset (in other words, the person that a court would deem to be the true owner).

Legislation specifies the rules by which trust income should be calculated for tax purposes and how that income should be taxed — that is, whether in the hands of the trust or the beneficiaries. Therefore trusts, if set up in the right way, can help you legally minimise some tax liabilities.

One important feature in this regard is where a formal decision is made (termed an "election") to be deemed a "family trust" for tax purposes.

THE UPSIDE

Being a family trust has specific taxation consequences, as electing to be a family trust restricts and specifies the trust beneficiaries, which in turn can secure or simplify the claiming of tax losses, debt deductions, franking credits and negate certain trust beneficiary reporting rules.

Some of the key taxation differences includes the fact that beneficiaries of, for example, discretionary trusts may not otherwise be able to take advantage of franking credits attached to share dividends or indeed franked non-share dividends received by the trust and passed on to the beneficiaries.

The reason for this, in very broad terms, is that unless the trustee of a non-fixed trust has elected for it to be a family trust, a beneficiary of the trust will not have a vested and indefeasible interest in so much of the capital of the trust as is comprised by the shares giving rise to the dividends.

Another spur to elect to be a family trust is that the trust would otherwise find it a lot harder to use past year tax losses against current year income, or to apply certain debt deductions. Being a family trust brings access to a concession so that only one trust loss test applies, the income injection test, and only in a modified way.

Also relevant will be the use of company losses against future income where a company shareholder is a trust. Again in broad terms, this is because the company loss provisions hold that where the relevant interests in a company are held by the trustee of a family trust, a single notional entity will be taken to own the interests, therefore making these losses available to offset. *cont* ⇨

The process of electing to be a family trust *cont*

Access to another concession is similarly achieved with regards to the small business restructure rollover relief. This is due to the requirement that when transferring active CGT assets from one entity to another (the concession being that no income tax liability will be triggered from doing so), one eligibility factor to be satisfied is that there should be no change to "ultimate economic ownership". A trust that has made a family trust election satisfies this condition.

Eligibility and conditions

Family trust elections can be made at any time, provided that from the beginning of the specified income year until June 30 of the income year immediately preceding that in which the election is made:

- the entity passes the family control test, and
- any conferrals of present entitlement or any actual distributions have been made within the designated family group.

The family control test looks at who can control the application of income or capital of the trust, which should include some or all of:

- the individual specified in the family trust election (also referred to as the "test individual")
- members of the specified individual's "family group" (which is defined in legislation; ask us for details)
- a professional legal or financial adviser to that family group.

While any kind of trust can elect to be a family trust, the need to pass the family control test restricts the choice to a trust that is not widely held and where a specific family effectively controls the trust.

The election does not have to be made on an approved form, however use of the form published by the ATO (which is updated annually) can help to ensure that all the relevant information for a valid election is provided. We can provide you with this document.

An election is only required to be made once, but the trustee is required to include the income year specified in the family trust election on the trust tax return each year while the election remains in force.

THE DOWNSIDE

A family trust may be less flexible as a result of making an election, and it is also potentially exposed to another tax, the family trust distribution tax.

Family trust distribution tax is applicable when a distribution is made outside the "family group" (which is designated by making the election). Therefore making a family trust election is an important step for the trustee to take. We can assist you to choose the appropriate "test individual" for the family group. Note that the term "distribution" has an expanded meaning for the purposes of family trusts, and includes both income and capital.

A reasonable salary, wage or other benefit (such as superannuation contributions or fringe benefits) provided to, or for the benefit of, an employee for work performed is not considered to be a distribution.

The rate of family trust distribution tax is set at the top marginal rate plus Medicare levy, which is temporarily 49% for the period from July 1, 2014 to June 30, 2017, after which it will revert to 47%.

A separate payment advice is required for each distribution of income or capital which attracts a family trust distribution tax liability, and remittance of the tax to the ATO is required to be accompanied by a *Family trust distribution tax payment advice* form.

Payment is generally required within 21 days after the distribution is made, or if the distribution was made before an election form was lodged, 21 days after the election. ■

Recent changes to the assets test for pensioners

From January 1, 2017, the assets test free area and taper rate for pensions increased.

The assets test works by reducing a person's age pension payment for every dollar of assets owned over a certain value. The test takes into account most assets, including any property (except your primary home) or possessions owned, or partly owned, in or outside Australia.

The assets test is one of two means tests used by the Department of Human Services (Centrelink) to determine your age pension eligibility, the second being an income test. The results of these tests that produces the lowest pension payment (or zero) is then applied.

The asset test free area is the amount of assets you can have without affecting your pension. Centrelink will reduce your pension by $3 each fortnight for every $1,000 of assets you own over the assets test free area. This is the taper rate. Before January 1, this rate was set at $1.50 (so it has therefore doubled).

Some people will have received more or have no change to their pension, but there is also the possibility that people may have their pensions reduced or cancelled. Centrelink states that if you lose your pension due to the January 1 changes, you will automatically get a non-income tested Low Income Health Care Card, and Commonwealth Seniors Health Card if you are age pension age. The former provides concessions on water rates and energy bills, among other discounts, and the latter provides discounts on prescription medicines and bulk-billed doctors' appointments.

See tables below to compare the old and new limits. ■

Table 1: Before and after assets test thresholds, or disqualifying limits, for the full age pension

	2016 rules	**2017 rules**
Single homeowners full pension assets must be less than	$209,000	$250,000
Single non-homeowners full pension assets must be less than	$360,500	$450,000
Couple homeowners full pension assets must be less than	$296,500	$375,000
Couple non-homeowners full pension assets must be less than	$448,000	$575,000

Table 2: Thresholds for a part age pension

	2016 rules	**2017 rules**
Single homeowners part pension assets must be less than	$793,750	$542,500
Single non-homeowners part pension assets must be less than	$945,250	$742,500
Couple homeowners part pension assets must be less than	$1,178,500	$816,000
Couple non-homeowners part pension assets must be less than	$1,330,000	$1,016,000

One investment option that has surfaced relatively recently, and that SMSF trustees may consider as a part of their strategy to grow their fund, is investing through peer-to-peer lending.

Peer-to-peer lending involves an investor – a trustee of the SMSF in this example – providing funds to an online lending platform. This platform, which must have an Australian Financial Services License (AFSL), subsequently provides finances to an individual or business that requires a loan, and charges for providing that facility.

SMSF trustees considering entering into this kind of financial arrangement are reminded to take appropriate due diligence steps, but also to consider if it fits with the SMSF's investment strategy or risk profile.

Security of the investment is another important consideration. Checking professional registers to ensure that the purported peer-to-peer lender has a license that permits them to sell that product is critical, as is checking whether they have a credit license for the borrowing side of the business. These details must be disclosed by the entity itself, even if you are able to access them via the corporate regulator's website.

A product disclosure statement (PDS) may be a dry piece of literature, but it provides information that is essential before a trustee decides whether to take the plunge. ASIC suggests potential investors look at issues such as:

- the security of loans,
- interest rates and how they are determined
- the choice of loans, repayments, and conditions related to a defaulting borrower
- issues that can arise if a platform fails, and
- fees payable to access the service.

Other issues a potential investor should keep in mind include a borrower's credit risk and how this is assessed by the lending platform. Is the borrower likely to default based on past credit record? Is the borrower a person that would pay the loan amount in full plus interest, based on their credit history?

A further and more significant risk in these arrangements, especially for SMSF trustees, is the source of the money changing hands. The lending platform is not lending its own money, and it can be your retirement savings that will bear the brunt if a borrower defaults.

ASIC notes that some lending platforms may advertise that they have a compensation fund that can repay some losses in the event of a default, but ASIC warns that if a lending platform has a series of defaults their compensation fund may be unable to meet all the demands.■