



## **SMALL BUSINESS DISCRETIONARY TRUST EXPLANATORY MEMORANDUM**

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## SMALL BUSINESS DISCRETIONARY TRUST – FURTHER INFORMATION

The "small business" version of the Discretionary Trust Deed has been drafted to take advantage of the capital gains tax concessions currently available to small business under the *Capital Income Tax Assessment Act 1997(Cth)* (the "Act").

### 1.0 THE LAW

Under the Act, a small business is entitled to capital gains tax discounts or exemptions on the disposal of active business assets.

Capital Gains Tax (CGT) affects small business entities' income tax liability because any net capital gain will be included in its assessable income for the income year.

A small business entity's net capital gain is calculated by taking the total of its capital gains for the year reduced by its capital losses and any relevant concessions. Capital gains tax is generally incurred when a *CGT event* occurs. A CGT Event is simply a capital gain or loss, made or incurred from the disposal of a capital asset of the entity such as land or buildings.

Some entities, such as individuals, trusts and partners in a partnership are automatically entitled to an initial CGT concession of 50% as long as the capital asset disposed of was acquired at least twelve months before its disposal. Unfortunately, this initial concession is not available to companies.

There are several further CGT concessions and in some instances complete exemptions from CGT liability available to small business entities. These are outlined broadly here:

1. **15 year exemption:** allows for exemption from CGT where asset owned for 15 years and person 55 or older or permanently incapacitated.
2. **50% Active Asset Reduction:** Provides 50% reduction of capital gain where three tests outlined below are satisfied.
3. **Small business retirement exemption:** allows for an exemption from capital gains of up to \$500,000 when being used for retirement purposes (lifetime limit).
4. **Small business roll over:** provides a deferral of a capital gain if, broadly, another capital asset is bought in its place.

These concessions are explained in more detail at paragraph 3.0.

### 2.0 THE CONDITIONS

Before we discuss the conditions specifically you need to be aware that in order to qualify for these further concessions, there are two common threshold conditions that must be satisfied and further additional conditions for each individual concession. The application of these tests and concessions can result in a concession of up to 75% (including the initial 50% discount outlined above) or in some circumstances a complete exemption from CGT liability.

These conditions are in the form of two tests which are outlined below:

#### 2.1 Maximum Net Asset Value Test

There is a limit of five million dollars on the net value of the CGT assets that a small business entity and its connected entities can own and still qualify for the small business capital gains tax concessions.

An entity is **connected** with another entity if either entity **controls** the other entity, or both entities are **controlled** by the same third entity.

An entity controls another entity if it:

- (a) Beneficially owns or have the right to acquire beneficial ownership of interests in other entities that give the right to receive at least 40% of any distribution of income or capital by the other entity; or
- (b) If the other entity is a company beneficially owned or have the right to acquire beneficial ownership of shares in a company that give at least 40% of the voting power in the company.

Where the interest is at least 40% but less than 50% the ATO has discretion to determine if that entity does not control the other entity where the ATO is satisfied that a third entity actually controls the other entity. This rule has special significance for discretionary trusts as a beneficiary may be deemed to control the discretionary trust if the trustee could distribute to that beneficiary under the trust deed (regardless of any actual distribution) at least 40% of that distribution. The net result of this is that a beneficiary's total net assets will form part of the discretionary trust's net assets.

## 2.2 Active Asset Tests

In order to satisfy the active asset test the asset being sold must be an active asset. An asset is an active asset if it is owned by a small business entity and it is:

- (a) 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
- (b) Any tangible asset that is inherently connected with the business carried on by the small business entity, as an example, good will.

The active asset test is described broadly as followed:

If the business has not ceased and the asset has been owned for less than 15 years, the CGT asset must be an active asset just before it is disposed of, and for at least half the period of ownership. If the asset has been owned for more than 15 years it only needs to be an active asset for at least half the 15 year period ending at the time of disposal, or if earlier, the cessation of business.

It is important to note that certain CGT assets cannot be active assets. These include:

- (i) shares in companies or interests in trusts (note the exception below);
- (ii) financial instruments such as loans, debentures, bonds, futures, and share rights and options;
- (iii) assets whose main use is to derive interest, an annuity, rent, royalties or foreign exchange gains.

### Company Shares and Trust Interests as active Assets

As noted in the preceding paragraph a share in a company or an interest in a trust will not be an active asset at a given time unless:

- (a) the total of the market value of the active assets of the company or trust; and
- (b) any capital proceeds that the company or trust received during the last two years before that time from disposals of assets happening to its active assets that the company or trust holds in the form of cash or debt pending the acquisition of new active assets;

is 80% or more of the market value of all the assets of the company or trust. This means a share in a company or an interest in a trust will be an active asset if the company or trust itself has active assets, the market value which is at least 80% of the market value of all its assets.

Where the CGT Asset is a Share in a Company or an Interest in a Trust then two further conditions must be met. These are:

- a) the controlling individual test; and
- b) the individual claiming the concession must be a CGT concession stakeholder in the company or trust.

A company or trust must have a controlling individual to qualify for small business CGT concessions for at least twelve months before the CGT event.

With discretionary trusts, an individual is a controlling individual during a year of income 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 these distributions. Where there are no distributions made in an income year there will be no controlling individual for that year.

A concession stakeholder is simply a controlling individual or a spouse of a controlling individual if, with respect to discretionary trusts, during the income year the trust made a distribution to which the spouse was beneficially entitled.

### **3.0 THE AVAILABLE EXEMPTIONS (refer to paragraph 1.0)**

#### **3.1 Small Business 15 Year Exemption**

A small business may completely disregard a capital gain on an asset owned for at least 15 years (note assets acquired before 20 September 1985 do not attract CGT) if:

- (a) satisfies basic conditions (see below);
- (b) 15 year ownership;
- (c) individual is 55 or older or permanently incapacitated at CGT event;
- (d) is an individual and the CGT asset is a share in a company or an interest in a trust, controlling individual existed throughout ownership of CGT asset;
- (e) is a company or trust and has a controlling individual for the entire time it owned the CGT asset and at the time of the CGT event that individual was either permanently incapacitated or over 55 with the event happening in connection with retirement.

With respect to trusts in the last point, the requirement that there must be a controlling individual is waived where the trust did not make a distribution and it had a tax loss for that year.

#### **3.2 Small business 50% active asset reduction**

Will be granted if the basic conditions in referred to in 3.1 are satisfied. Essentially allows for 75% reduction in capital gain where initial discount is allowed. Also does not preclude the remaining capital gain from attracting other concessions outlined above and below.

There are special rules that enable concessions to be obtained by a trust to be passed onto beneficiaries. If a beneficiary is presently entitled to the share of the income of a trust which includes a 50% active asset reduction, a “gross up” mechanism applies. This ensures that a beneficiary first applies capital losses and then applies the appropriate CGT discount percentage. This is done by multiplying by 2, their share of any net capital gains received from a trust that have already been reduced by the active asset reduction (by four when the reduction is both the initial CGT discount and the active asset reduction). This grossed up amount is then reduced by any capital losses of the beneficiary and the appropriate discount/s may then be applied.

### 3.3 Small business retirement exemption

All or part of a capital gain after other concessions have been applied can be disregarded under this head if the following conditions are satisfied:

- Basic conditions above satisfied
- The amount chosen to be disregarded is specified in writing
- If recipient under 55, capital gain must be rolled over under the Eligible Termination Provisions.

There is a \$500,000 limit reduced by any previous exemptions claimed under this head.

## 4. THE SMALL BUSINESS DISCRETIONARY TRUST

The Small Business Discretionary Trust places a limit on the power of the trustee, preventing the trustee from making distributions to tertiary beneficiaries that exceed 39% of the total of any distribution. The definition of Secondary Beneficiaries has been narrowed and is limited to the Primary Beneficiary's immediate family and the trusts and companies that they own. This limitation substantially eliminates the risk of losing certain capital gains tax concessions and does not otherwise unduly fetter the discretion of the trustee.

### 4.1 Amending Discretionary Trusts into Small Business Discretionary Trust

The risk with amending a trust deed is the potential to "resettle" the trust and thus create a new trust. This potentially has a stamp duty and CGT consequence.

### 4.2 Meaning of "resettle" under the Income Tax Assessment Act.

Resettlement will occur when there have been changes to the trust that fundamentally redefine the relationship between the trustee and the beneficiaries in respect of trust property. This will create a new trust.

Examples given by the Australian Tax Office are:

1. Converting a Fixed Trust to a Discretionary Trust;
2. Inserting or variation of an income definition (in some circumstances).

Discretionary beneficiaries do not have a present entitlement to income and therefore have no legal or beneficial interest in the assets or income of the trust fund. An amendment to a trust deed which limits the trustee's power to distribute no more than 39% of the income or capital to that discretionary beneficiary should not fundamentally redefine the relationship between the trustee and the beneficiary in respect of trust property as the amendment has no impact on the beneficiaries interest in the trust property.

We can therefore amend trust deeds, without resettling them by only amending the power of the trustee, and making no alteration to any beneficiary's interest in the trust property. By making the amendment in this way, there will be no resettlement of the trust as defined by the Australian Tax Office.

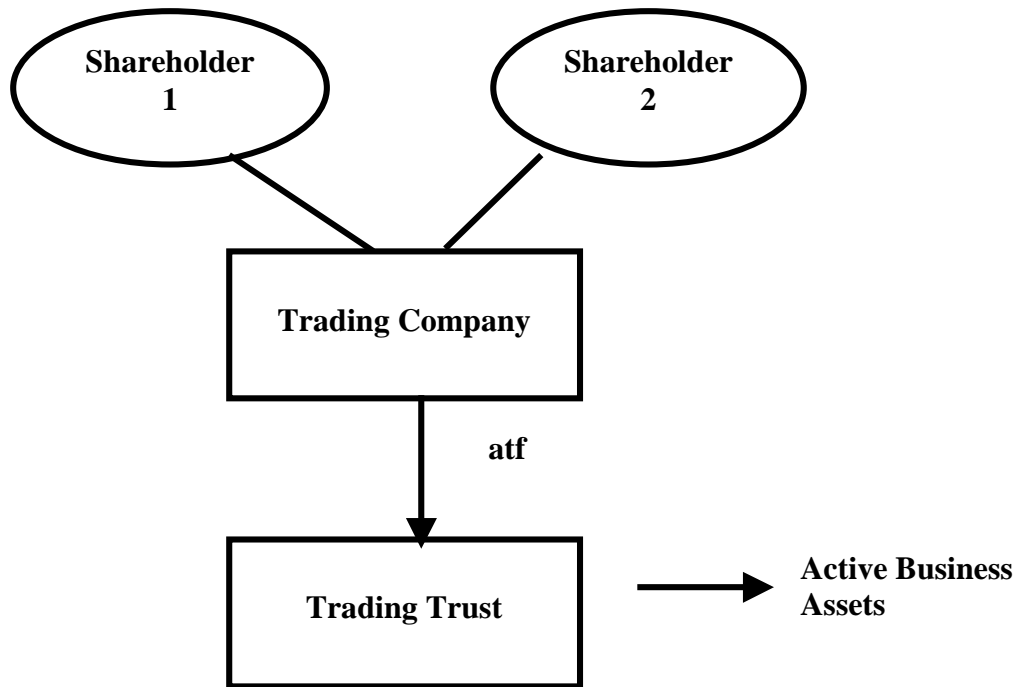
### 4.3 When to use a Small Business Discretionary Trust

A Small Business Discretionary Trust should be used when the trading entity is to be a trust. However the *Income Tax Assessment Act* also requires the inclusion of the CGT assets of those that "control" the

trust, and also "affiliates" of the trust and entities "connected" with the trust's affiliates. Following are some examples of when using a Small Business Discretionary Trust should be considered.

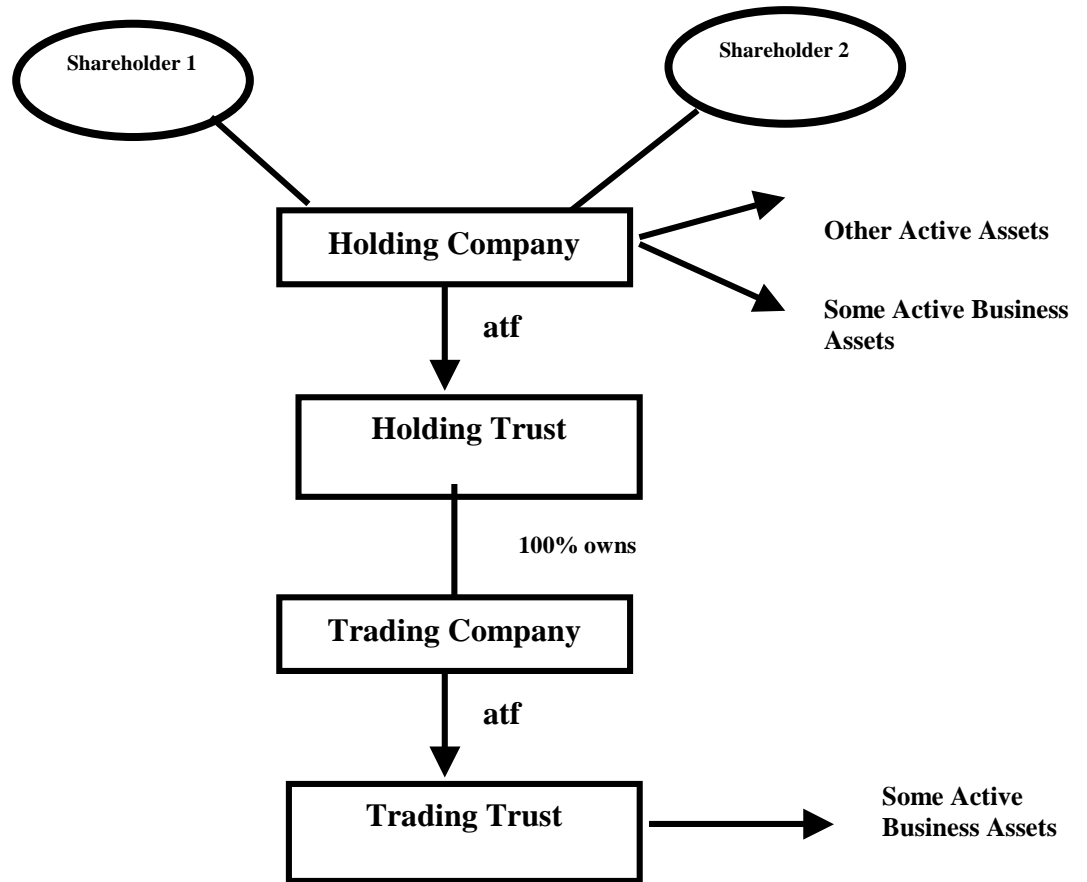
## EXAMPLES OF WHEN A TRUST SHOULD BE A SMALL BUSINESS TRUST

### Example 1: Disposal of Active Assets by Small Business Trading Trust



Where the active asset is being disposed of by the Trading Trust, it may be preferable if it were a Small Business Discretionary Trust, to ensure it meets the active asset evaluation test.

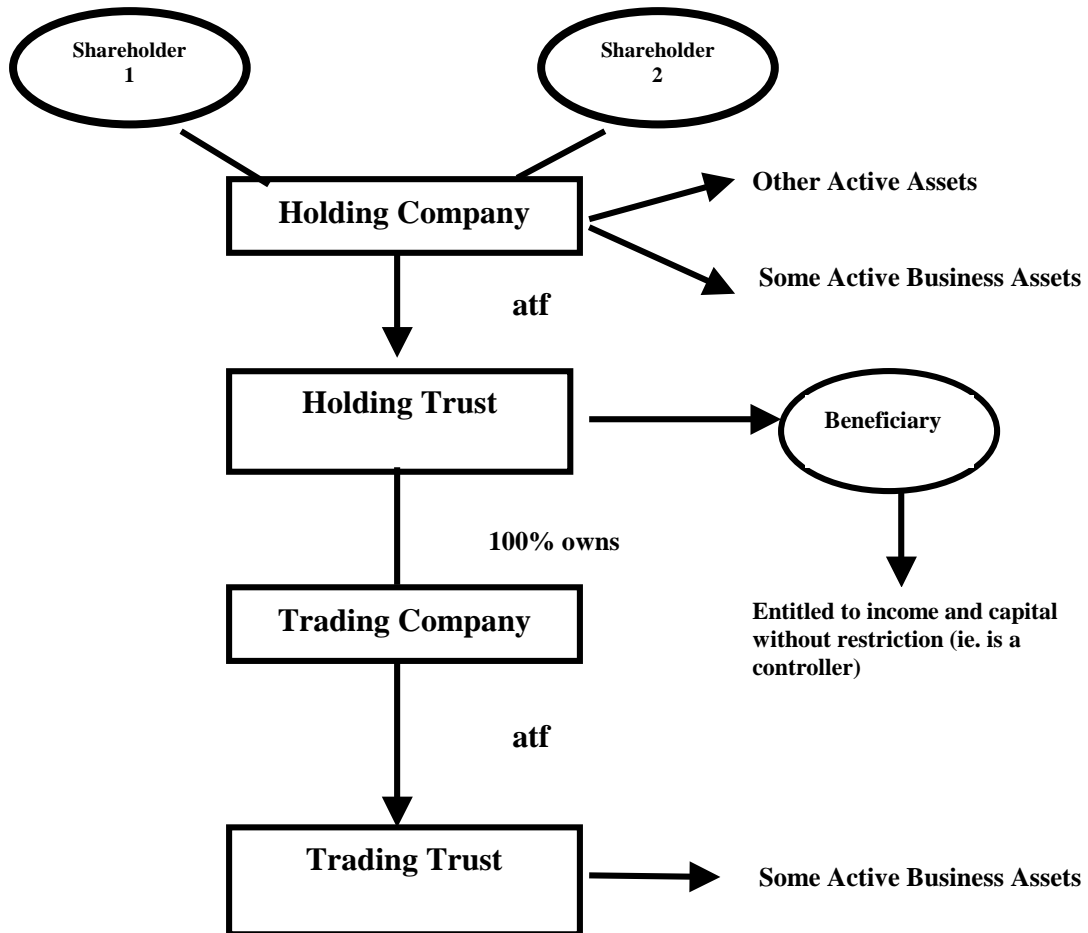
**Example 2: Disposal of Active Assets by Holding Trust**



Where the active asset is being disposed of by the Trading Trust both the Trading Trust and the Holding Trust may need to be Small Business Discretionary Trusts. Because the Holding Trust is connected to the Trading Trust it's active assets and the active assets of those that "control" the Holding Trust will be taken into account to value the active assets of the Trading Trust.

Similarly, if the Holding Trust is making the disposal, the active assets of the Trading Trust and those that "control" the Trading Trust, will be valued. So both trusts should be Small Business Discretionary Trusts.

### Example 3. Impact of Assets of Beneficiaries/Controllers of the Holding Trust on Exemptions



When considering the value of the active assets of the holding trust (on a disposal by the trading trust) you also include in that assessment the assets of controllers (or beneficiaries) of the holding trust and **its** affiliates and connected entities.

Where the beneficiary is entitled without restriction to income and capital and is therefore, a controller of the holding trust, that beneficiary's active assets will be included in the valuation of active assets of the trading trust if it disposes of an active asset. This will be the case where the beneficiary is a controller of the both trading trust and the holding trust and also if he is only a controller of the holding trust (and not the trading trust) Trust because he controls an affiliate of the trading trust. Therefore both the holding and trading trusts should be an Small Business Discretionary Trust in order to minimize the beneficiaries who are "controllers" and maximize the likelihood of being entitled to the capital gains tax concessions.

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