

TD 2006/D27 - Income tax: capital gains: small business concessions: what 'liabilities' are included in the calculation of the 'net value of the CGT assets' of an entity in the context of subsection 152-20(1) of the Income Tax Assessment Act 1997 ?

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This document has been finalised by This draft Determination has been finalised by TD 2007/14.



Draft Taxation Determination

Income tax: capital gains: small business concessions: what ‘liabilities’ are included in the calculation of the ‘net value of the CGT assets’ of an entity in the context of subsection 152-20(1) of the *Income Tax Assessment Act 1997*?

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Ruling

1. The term ‘liabilities’ in the context of subsection 152-20(1) of the *Income Tax Assessment Act 1997* (ITAA 1997) has its ordinary meaning. It extends to legally enforceable debts due for payment and to presently existing obligations to pay either a sum certain or ascertainable sums. It does not extend to contingent liabilities, future obligations or expectancies.

Example 1

2. *Cool Tool Pty Ltd is selling its business. The assets and liabilities of the company are as follows:*

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Assets:	\$	\$
Plant and machinery	1,500,000	
Freehold premises	<u>3,500,000</u>	<u>5,000,000</u>
Liabilities:		
Mortgage (secured over the premises)	2,000,000	
Provision for leave of employees	500,000	
Accrued expense (business consultant)	200,000	
Provision for rebates	200,000	
Provision for possible damages payout	<u>100,000</u>	<u>3,000,000</u>
Net assets:		<u><u>2,000,000</u></u>

3. The net value of the CGT assets of the company is calculated as follows:

Assets:	\$	\$
Plant and machinery	1,500,000	
Freehold premises	3,500,000	5,000,000
Liabilities:		
Mortgage (secured over the premises)	2,000,000	<u>2,000,000</u>
Net value of CGT assets:		<u><u>3,000,000</u></u>

4. The following items are not taken into account in working out the net value of the CGT assets of Cool Tool Pty Ltd because they are contingent liabilities, future obligations or expectancies:

- Provision for possible damages payout;
- Provision for leave of employees;
- Accrued expense (business consultant); and
- Provision for rebates.

Example 2

5. Pretty in Pink Pty Ltd is selling its clothing business. The assets and liabilities of the company are as follows:

Assets:	\$	\$
Fixtures and fittings	300,000	
Freehold premises in Parramatta	3,500,000	
Freehold premises in Penrith	<u>2,500,000</u>	<u>6,300,000</u>
Liabilities:		
Bank overdraft	600,000	
Mortgage (secured over Parramatta premises)	500,000	
Bill of exchange for Penrith premises	<u>400,000</u>	<u>1,500,000</u>
Net value of CGT assets:		<u><u>4,800,000</u></u>

6. The fixtures and fittings may be depreciating assets and the gains from them may be treated as income rather than capital gains but they are still CGT assets. Hence, they are included in the calculation of the net value of CGT assets of Pretty in Pink Pty Ltd.

7. The bank overdraft is taken into account in working out the net value of the CGT assets of Pretty in Pink Pty Ltd because it is a general liability that relates to all the assets of the company.

Example 3

8. Cassandra operates a dancing school. Five years ago, Fancy Foot Pty Ltd, which is wholly owned by Cassandra, bought a dancing studio where she conducts the dancing school. Fancy Foot Pty Ltd has no other CGT assets. The studio has a current market value of \$5 million with \$0.5 million of the loan used to purchase the studio still outstanding.

9. Last year, Wanadance Pty Ltd, also wholly owned by Cassandra, bought a warehouse to store dancing costumes and stage materials. Wanadance Pty Ltd has no other CGT assets. The market value of the warehouse subsequently fell, and is now \$2 million. \$2.8 million of the loan to purchase the warehouse is still outstanding.

10. Cassandra has accepted a leading role in a Broadway show overseas. A contract has been entered into to sell both the studio and the warehouse.

11. Both Fancy Foot Pty Ltd and Wanadance Pty Ltd are connected with Cassandra for the purposes of small business concessions. Cassandra has no small business CGT affiliates. She has other CGT assets, which have a net value of \$1 million.

12. The net value of Cassandra's CGT assets is calculated as follows:

Net value of CGT assets of Cassandra	\$1.0m
Net value of CGT assets of Fancy Foot Pty Ltd – Studio: (\$5m less \$0.5m)	\$4.5m
Net value of CGT assets of Wanadance Pty Ltd – Warehouse: (\$2m less \$2.8m)	<u>nil</u>
Total net value of CGT assets:	<u>\$5.5m</u>

13. Cassandra will not qualify for the small business CGT concessions because she does not satisfy the \$5 million maximum net asset test. Note that the \$0.8 million excess liability in respect of Wanadance Pty Ltd's CGT asset (the warehouse) cannot be offset against the value of Cassandra's assets or Fancy Foot Pty Ltd's CGT asset (the studio).

Date of effect

14. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination.

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.*

Explanation

15. One of the basic conditions that must be satisfied to qualify for the small business CGT concessions is the maximum net asset value test in section 152-15 of the ITAA 1997. Under this test, the net value of the CGT assets of the taxpayer and certain related entities must not exceed \$5 million just before the relevant CGT event.

16. The 'net value of the CGT assets' of an entity is the amount (if any) by which the sum of the market values of those assets exceeds the sum of the liabilities of the entity that are related to the assets (subsection 152-20(1) of the ITAA 1997).

17. The term 'liabilities' is not defined for the purposes of the 'net value of the CGT assets' definition. Accordingly, it has its ordinary meaning reflecting the context in which it is used. *The Macquarie Dictionary*, revised 3rd edition, defines liability to mean: 'an obligation, especially for payment; debt or pecuniary obligation'.

18. In the context of subsection 152-20(1) of the ITAA 1997, 'liabilities' extend to legally enforceable debts due for payment and to presently existing obligations to pay either a sum certain or ascertainable sums. The term does not extend to contingent liabilities, future obligations or expectancies.

19. A 'contingent liability' is a liability which will become due only on the occurrence of an event that may or may not happen. An example is a possible obligation to pay damages in future if the judgment in a pending lawsuit is unfavourable.

20. Examples of amounts that are not included in 'liabilities' for the purposes of determining the 'net value of the CGT assets' of an entity include:

- provisions for possible obligation to pay damages in a pending lawsuit;
- provisions for liabilities in respect of earn-out contract;
- provisions for guarantee of a loan;
- provisions for long service and annual leave entitlements;
- provisions for income and other taxes;
- accounting liabilities arising as a result of receiving prepaid income;
- expenses that are not yet due; and
- provisions in general for such things as quantity rebate and the like.

Liabilities that are related to the assets

21. The 'liabilities of the entity that are related to the assets' in subsection 152-20(1) of the ITAA 1997 include liabilities directly related to particular assets that are themselves included in the calculation, for example, a loan to finance the purchase of business premises.

22. The 'liabilities of the entity that are related to the assets' also include liabilities that, although not directly related to one particular asset, are related to the assets of the entity more generally, for example, a bank overdraft or other short term financing facility that provides working capital for the operation of the business.

Lowest net value is nil

23. Subsection 152-20(1) of the ITAA 1997 determines the net value of the CGT assets on an entity by entity basis. The liabilities of one entity therefore cannot be taken into account in determining the net value of the CGT assets of another entity. The subsection refers to an amount (if any) by which one sum exceeds another sum. In other words, it refers to an excess, if there is one. As there cannot be a negative excess, the lowest possible value of the 'net value of the CGT assets' of an entity is nil.

Note

24. As noted in the Treasurer's Press Release No. 38 of 2006 (9 May 2006), the Board of Taxation's report on its Post-Implementation Review of the small business CGT concessions contains a number of administrative recommendations. This Draft Taxation Determination is part of the Commissioner's response to Recommendation 6.1 of the Board's report. The Board's report also contains a number of legislative recommendations. This Draft Taxation Determination may be affected by the legislative change relating to Recommendations 6.2 & 6.3 of the Board's report.

Appendix 2 – Your comments

25. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date. (Note: The Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

Due date: 11 August 2006

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References

Previous draft:

Not previously issued as a draft

Subject references:

- basic conditions for relief
- capital gains tax
- CGT assets
- CGT events
- CGT small business relief
- contingent liabilities
- maximum net asset value test

Legislative references:

- ITAA 1997 152-15
- ITAA 1997 152-20(1)

Other references:

- The Macquarie Dictionary, 2001, rev. 3rd edn, The Macquarie Library Pty Ltd, NSW
- Treasurer's Press Release No. 38 of 2006

ATO references

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