

TAX TALKS

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263 | In Connection With Your Retirement

In connection with your retirement – this is the gateway to claiming the 15-year exemption. But you might not even have to retire.

In Connection With Your Retirement

The 15-year exemption is the most generous tax concession around after the CGT main residence exemption. And one important hurdle to take is that the CGT event must happen in connection with your retirement. But this might not mean that you actually need to retire.

As Andrew Henshaw of Velocity Legal in Sydney will tell you in this episode.

Here is what we learned but please listen in as Andrew explains all this much better than we ever could.

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Complex

The small business CGT concessions are complex. They cover over 50 pages in Div 152 ITAA97. And that is even before you look at rulings and case law and take Div 328 ITAA97 into account.

Basic Conditions

The 'basic' conditions are anything but basic. But you already know that. So just a very quick recap. To meet the basic condition in ss 152-10(1), you must have:

- 1 – a CGT event (unless it is CGT event D1 in s152-12); and
- 2 – a capital gain; and
- 3 – a CGT asset that satisfies the active asset test (s152-35); and
- 4 – satisfied either

- (i) the small business turnover test (turnover < \$2m), or;
- (ii) the maximum net asset value test (s152-15).

Small Business CGT Concessions

There are 4 small business CGT concessions.

- 1 – 15-Year Exemption
- 2 – Small Business 50% Asset Reduction
- 3 – Retirement Exemption
- 4 – Rollover

Only the 15-year and the retirement exemption allow funds to be extracted tax-free from corporate or unit trust structures.

15-Year Exemption

The 15-Year Exemption sits in Subdivision 152-B. It is by far the most effective concession, especially for internal restructures within family groups.

The 15-Year Exemption eliminates the entire capital gain, and it is not necessary to consider any of the other concessions. For that reason, it is the toughest to qualify.

- 1 – You must have continuously owned the CGT asset for 15 years.
- 2 – You must be over 55.
- 3 – The transaction happens ‘in connection’ with your retirement.

And it is this ‘in connection with your retirement’ that causes the most confusion.

In Connection with Retirement

For the 15-Year exemption to apply, the CGT event must be in connection with ‘your retirement’ (in the context of an individual) or in connection with a significant individual’s retirement (in the context of a company or trust).

‘In connection with your retirement’ is not defined in the ITAA97 or an explanatory memorandum, and, to date, there has been no case law (either in the AAT or Federal Court) that has examined its meaning. And the ATO has not released any formal public rulings or taxation determinations outlining the Commissioner’s interpretation of the requirement.

ATO’s 15-Year Exemption Guide

The ATO’s 15-year exemption guide states that whether a CGT event happens in connection with an individual’s retirement depends on the particular circumstances of each case, and that there needs to be a significant reduction in the number of hours you work or at least a significant change in the nature of your activities.

The ATO’s 15-year exemption guide also states that a CGT event may be ‘in connection with your retirement’ even if it occurs at some time before your retirement; and ‘retirement’ does not require a permanent and everlasting exit from the workforce.

Internal Restructures

In a third party sale – so in an ‘external’ transaction – it is usually straightforward to determine whether the sale of the asset is in connection with the individual’s (or a significant individual’s) retirement.

However, in an internal restructure as part of an individual’s retirement or succession plan, things get more blurry. A review of the Private Binding Rulings issued by the ATO in the income year ended 30 June 2020 reveals mixed, and often inconsistent results regarding the circumstances in which the ATO will consider internal transactions to be sufficiently connected with an individual’s retirement.

Timing of Retirement

Consider Private Binding Ruling No. 1051634024657 (issued 21 February 2020). In this ruling, company A held commercial property and the shareholders of company A were two individuals (the 'parents'). The commercial property was used in connection with a business carried on by company B.

Some years ago, the parents sold all of the shares in company B to companies controlled by their children (and likely claimed the 15-year exemption). After the sale of the shares in company B to their children, the taxpayers continued to be involved in the management of company B's business, but gradually wounddown their involvement over several years.

Company A now proposed to transfer the commercial property to a discretionary trust controlled by the children. The intention was to get funding through a vendor finance arrangement.

ATO Ruling

Ultimately, the ATO held that company A did not qualify for the 15-year exemption. The ATO argued that at the time of the transaction, the parents had already retired from company B's business.

In contrast, had the transfer of the property happened at the same time as the sale of shares in Company B, the 15-year exemption would probably have applied to both.

This ruling would suggest that for a CGT event to be in connection with an individual's retirement, the CGT event must either occur before the process of reducing activities and hours worked, or at the very least before the individual ceases to have any involvement with the business.

Funds for Retirement

Consider Private Binding Ruling No. 1051613162467 (issued 26 February 2020).

In this ruling, the ATO held that the taxpayer (person A) could apply the 15-year exemption (and the lifetime CGT cap contribution rules) in relation to an in specie contribution of their interest a certain real estate to their self managed superannuation fund.

Relevantly, the private ruling notes that during the current financial year, Person A has not been employed or self-employed for gain or reward. Person A does not foresee that he will ever again be employed for gain or reward; and selling the real estate is for Person A's intentions to retire. Person A will significantly live off the proceeds of the Real Estate's ultimate disposal via the SMSF.

ATO Ruling

Somewhat perplexingly, the ATO held that the disposal of Person A's share of the real estate will be in connection with their retirement as they have ceased working and will live off the proceeds of the sale. The decision in this ruling also serves to further highlight the inconsistency of the ATO's application of the 15-Year Exemption, in that the ATO has essentially taken the opposite view to the decision in Private Binding Ruling No. 1051634024657 (above).

Private Binding Ruling No. 1051613162467 says,

"The provisions relating to the small business 15-year exemption do not define what is meant by the phrase 'in connection with your retirement', nor does it give any indication of the degree of retirement required in order to take advantage of this concession. It could be argued that the phrase 'in connection with your retirement' means that the capital gain arising from the disposal of active assets is to be used to provide funds for a person's retirement rather than to precipitate retirement at the time of the CGT event. The words used in the EM support this interpretation."

Door Wide Open

So the ruling suggests that an in specie contribution will inherently qualify for 'in connection with your retirement' by virtue of the fact that an individual will ultimately access their superannuation in their retirement.

This pushes the door wide open for claiming the 15-year exemption. It means a significant loosening of the 'in connection with retirement' requirement (as currently understood) and a widening of the circumstances in which a CGT event will be connected with retirement.

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