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The Board of Taxation
C/ The Treasury
Langton Crescent
PARKES ACT 2600

27 May 2014

Dear Sir/Madam

REVIEW OF TAX IMPEDIMENTS FACING SMALL BUSINESS

BDO welcomes the opportunity to provide a submission in respect of the Board of Taxation's Review of the tax impediments facing small business (Review) announced on 28 March 2014.

We make the submissions set out in the Annexure in respect of such impediments.

Should you have any questions, or wish to discuss any of the comments made in the annexed submissions, please do not hesitate to contact Lance Cunningham on 02 9240 9736 or lance.cunningham@bdo.com.au or Matthew Wallace on 02 9240 9760 or matthew.wallace@bdo.com.au.

Yours sincerely

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ANNEXURE

Unless otherwise indicated, statutory references are to the Income Tax Assessment Act 1997 (ITAA 1997). References to the ITAA 1936 are to the *Income Tax Assessment Act 1936.*

1. Reintroduction of company loss carry back

The loss carry measures that have been announced to be repealed, were popular amongst most taxpayers, as evidenced by responses to the BDO 2014 Tax Reform Survey. Assuming these measures are repealed, we suggest that consideration be directed towards their reintroduction as soon as budgetary constraints permit.

2. Taxes in respect of employment generally

As a general observation, taxes and resulting compliance obligations imposed in respect of the employment of people by small businesses are multitudinous, and in the case of compliance obligations, substantial and inconsistent. This in turn creates uncertainty and imposes substantial costs in both time and money. These issues apply across PAYG, Fringe Benefits Tax (FBT), the Superannuation Guarantee Charge (SGC), workers' compensation cover and similar schemes and the various state payroll taxes. Streamlining of the relevant definitions (particularly in the delineation between employees and non-employees) and payment and documentation requirements would be a desirable outcome.

3. FBT

To the best of our knowledge Australia is one of only three countries in the world that impose a tax on employers in respect the provision of fringe benefits to employees. Other countries sensibly assess the value of such benefits to the employees who receive them. The result of the Australian FBT is an unnecessary additional tax that imposes onerous and substantial obligations on small businesses.

The current design and rate of FBT is such that it is implicitly assumed that the full burden of the tax is passed on to employees with the broad intention that employees paying the maximum marginal rate of income taxation should thus be indifferent as between receiving salary or wages or receiving the equivalent value in fringe benefits. A corollary of this is, that in addition to taxing the wrong taxpayer (being the employer rather than the employee), FBT applies regressively, as it implicitly taxes benefits provided to earners of income whose marginal rates of income tax are less than the maximum marginal rate, at the maximum marginal rate. In other words, the tax unfairly penalises the provision of fringe benefits to low income earners.

Our preferred solution to this problem would be the repeal of the FBT with fringe benefits being instead assessed to employees. From a collection perspective, this would be facilitated by the PAYG system. Much of the necessary work, from this perspective, is already undertaken in the collection and reporting of data in respect of "reportable fringe benefits".

If fringe benefits are taxed to the employees, there may some problems in identifying and

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collating all the fringe benefits to be included in the employee's payment summaries by the 14 July deadline for issuing payment summaries. However, other countries that tax fringe benefits to employees have appropriate mechanisms that deal with this issue. We suggest the methods used by other countries could be studied to determine if any or a combination of any of them would be appropriate for Australia to use.

If our preferred solution were not to be adopted, we submit, as an alternative, that the timing of the compliance obligations in respect of income tax and FBT should be aligned. Currently the ordinary income tax year runs from 1 July to the following 30 June and the FBT year runs from 1 April to the following 31 March. Any previous workload based justification for this differential would no longer apply.

4. SGC

The measure for calculating the minimum level of superannuation support required for individual employees under the *Superannuation Guarantee (Administration) Act 1992* (SGAA) is 'ordinary time earnings'. That concept is inherently difficult to interpret and apply and should be replaced with a measure which is easier to apply.

5. Payroll tax

Although a state tax, pressure should be applied for standardisation of the tax bases of the various payroll taxes imposed in Australia. Currently there are variations in the payroll tax free thresholds, as between the states, in the payments which attract the tax.

Considering payroll tax was one of the taxes that was supposed to be replaced by the GST, consideration should be given to abolishing the payroll taxes and other more appropriate methods of raising State revenue should be considered, including a review of the GST rate and broadening its base.

6. Small business entity threshold too low

There is a strong argument that for the purposes of the concessions granted to small business entities the $2 million turnover thresholds imposed under s328-110 are too low. Many businesses that should still be considered as small are denied access to the small business concessions.

7. Change the ESS taxing point for employees of small businesses, especially start-ups under Division 83A

This issue has already been the subject of consultation by Treasury, so we have not provided detailed submissions. The default operation of Division 83A is to tax any discount on shares or rights to shares 'up front'. It would make it easier for small start-up companies to recruit skilled staff if any shares or rights to shares that were issued under employee share acquisition schemes were assessed and taxed upon realisation.

8. As there is a *de minimis* threshold on the thin capitalisation measures there should be similar *de minimis* thresholds for other international anti-avoidance measures

Based on a sensible weighing of compliance costs against forgone tax revenue, the thin capitalisation measures apply a *de minimis* threshold (proposed to be $2 million dollars in debt deductions) under which they will not apply. Other international anti-avoidance measures, such as the transfer pricing measures in Subdivs 815-B, 815-C and 815-D and the CFC measures in Part X of the ITAA 1936 can impose substantial compliance costs in respect of relatively small transactions or investments.

Consideration should be given to encouraging the overseas expansion of Australian small businesses through allowing *de minimis* exclusions from the operation of the transfer pricing and CFC regimes and the completion of the International Dealings Schedule.

9. Relief from double taxation for small business expanding offshore

One of the main deterrents for small business expanding into foreign countries is the prohibitive cumulative global tax rates. Where the foreign business is undertaken by a company (either as a branch of an Australian company or a foreign incorporated company) there are generally no foreign income tax offsets (FITO) that can be used by the Australian individual owners of the company. In most cases the result is overall tax rates of about 65% - 70%.

There is an alternative that allows the FITOs for the individual owners where their investment in the foreign business is a direct investment by the individuals or through a partnership or trust. However, in most cases it will not be not legally possible or not commercially viable to invest directly by the individual or through a partnership or trust.

We suggest that small businesses that have expanded overseas through the use of foreign companies be given the ability to pass on FITOs to their shareholders based on the foreign tax paid by the company or its foreign subsidiary. As an integrity measure this could be limited to non-portfolio investments in the relevant companies paying the foreign tax.

10. Taxation of trusts – an alternative optional model

Trust estates are a common vehicle for small businesses. The taxation provisions in respect of the taxation of trusts are voluminous, complicated and replete with provisions that are subject to uncertain interpretation. This makes a good case for a comprehensive rewrite of the trust taxation provisions.

In addition, consideration should be given to allowing trusts and their beneficiaries to elect to be taxed in a manner analogous to a company and its shareholders.

11. Taxation of trusts - mismatches between s95(1) 'net income' and trust law income and streaming of different classes of 'net income'.

At least since the judgment of the High Court in *Commissioner of Taxation v Bamford; Bamford v Commissioner of Taxation* [2010] HCA 10 the Commissioner has taken the view that the current trust provisions in Division 6 of Part III of the ITAA 1936 do not authorise the streaming of different classes of the 'net income' of the trust to different beneficiaries. This deficiency has had "band-aid" interim solutions applied in respect of capital gains, through amendments to Subdiv 115-C

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and franked dividends through amendments to Subdiv 207-B. The desirable capacity of trustees to stream other classes of 'net income' to different beneficiaries should be authorised through changes to the law.

12. Taxation of trusts - 'fixed trusts'

The definition of 'fixed trust' in the trust loss measures in Schedule 2F (which is also used in the "qualified person" provisions in respect of dividend franking credits in Division 1A of former Part IIIAA of the ITAA 1936, given continued life through s 207-145(1)) requires, by reference to s272-65 and s272-5 of such Schedule 2F that persons have vested and indefeasible interests in all income and capital of the trust. Recent case law (such as *Colonial First State Investments Ltd v FC of T* [2011] FCA 16) has indicated that due to, amongst other things, the trustee's right of indemnity from trust assets, that it is a practical impossibility to have a fixed trust under the existing Schedule 2F definition. For trust loss and franking credit availability tests it is essential that a new and achievable "fixed trust" definition be adopted.

13. Taxation of trusts - reversal of CGT event E4

In very broad terms, under CGT event E4 (see s104-70) where a trustee makes a distribution to a beneficiary in respect of the beneficiary's interest in the trust, and (with certain exceptions) a portion of such distribution exceeds amounts assessable to the beneficiary, the surplus reduces the cost base of the beneficiary in respect of such interest in the trust and produces a capital gain where such cost base is reduced to zero. The typical circumstance producing such a phenomenon is where the "income" of the trust estate exceeds the "net income" of the trust for the purposes of Div 6 of Part III of the ITAA 1936.

There is not a mechanism, but should be, for reversing the impact of CGT event E4 where the excess of "income" over "net income" is due to a mere timing difference, with a corresponding excess of "net income" over "income" in a subsequent year.

14. Deductibility of superannuation contributions – 10% employment income threshold too low

The deductibility, under s290-150, of personal superannuation contributions is subject, amongst other things, to the "maximum earnings as an employee" test in s290-160. Section 290-160 requires that such earnings be less than 10% of the taxpayer's:

(a) Assessable income for the year

(b) Reportable fringe benefits total for the income year;

(c) Total reportable employer superannuation contributions for the year.

It is arguable that it is too easy to exceed this threshold, particularly when applied to start-up businesses where the principals may need to supplement business income with employment income. This criticism could be addressed by increasing the threshold to, say, 25% or, alternatively, allowing all taxpayers to make supplementary deductible superannuation contributions up to the concessional cap.

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15. Simplify the small business CGT concessions in Division 152.

The small business CGT concessions in Division 152 are some of the most complex provisions in all the Australian Income Tax Legislation. The rationale of these concessions should be to assist small businesses in restructuring their businesses and to help them provide for their retirement by investing in their businesses in substitution for superannuation savings. However, most small business and many of their tax advisers find it difficult to comply with the complex requirements of these provisions. An argument can be made for simpler, more robust rules.

16. Division 7A deemed dividends and unpaid present entitlements

No review of the tax impediments to small businesses would be complete without consideration of the application of the deemed dividend provisions in Division 7A of Part III of the ITAA 1936 and their interaction with unpaid trust present entitlements. We have abstained from commenting on these matters due to the separate review being undertaken by the Board of Taxation.

17. Establishment of a small business entity combining some the attributes of companies, trust and partnerships.

Currently small businesses utilise all types and combinations of entities in their business structures, including sole traders, partnerships, trust and companies. Each of these has advantages and disadvantages and it is difficult to determine which is the best for a particular case. We suggest a separate type of entity be established with attributes of each of these to make it attractive for small business taxpayers to use.

The attributes of such a “small business entity” could include:

- having a separate legal identity,
- the taxing of profits in the entity at a concessional rate (say the corporate rate)
- taxation of distributed profits to individuals at the individual’s marginal tax rate, with credit for entity tax paid
- flexibility of distribution of profits and gains to family groups
- the optional flowthrough of losses to entity owners
- CGT discount available to entity
- Small business concessions available to entity and entity owners

As an impetus for taxpayers to use this structure the small business concessions could be restricted to such “small business entities”. There could also be appropriate and simple integrity rules to ensure against misuse.

If such a structure was sufficiently attractive for small businesses to use it could result in much simpler compliance for both taxpayers and the Australian Tax Office.