Deloitte Private Pty Ltd
ACN 120 167 455

550 Bourke Street
Melbourne VIC 3000
GPO Box 78
Melbourne VIC 3001 Australia

Tel: +61 3 9671 7000
Fax: +61 9691 7001
www.deloitte.com.au

Board of Taxation
The Treasury
Langton Crescent
Canberra ACT 2600
Australia

Email: taxboard@treasury.gov.au

23 May 2014

Dear Mr Brine,

REVIEW OF IMPEDIMENTS FACING SMALL BUSINESS

Thank you for the opportunity to make a submission to the Board of Taxation on tax impediments for small business in Australia.

Since 1993, Deloitte Private, a specialist group within Deloitte, has focused on serving Australian private businesses and the family groups who own them. Our 100 partners and 954 team members nationally represent a unique offering. We are the Big Four's only accounting, tax, audit and advisory services provider dedicated to serving family groups, small businesses and privately owned Australian businesses.

We believe we have the necessary expertise, combined with our status as one of the leading advisors to private businesses, to respond to the Board of Taxation on key tax impediments for small business as outlined in the key terms of reference.

Given our experience, we have provided comment on the following aspects of taxation impacting small business:

- Small Business CGT concessions;
- FBT system;
- Division 7A; and
- R&D Tax Incentives.

We enclose our comments which, whilst not exhaustive, focus on some of the main areas affecting small business and we would appreciate the opportunity to discuss our submission in more detail if required.

In anticipation we thank you for reviewing our submission and trust that the information set out in this document has provided you with a greater insight into the tax impediments for small business in Australia.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Touche Tohmatsu Limited

Deloitte.

If you have any questions or require clarification on any aspect of this submission please feel free to contact me on 03 9671 7818.

Yours sincerely

Keith Hardy
Director
Deloitte Private Pty Ltd

1. Small Business CGT concessions

Background

We submit that the small business CGT concessions (the concessions) in the Income Tax Assessment Act (Cth) 1997 (ITAA 1997) are complex and, as a result, poorly understood by relevant stakeholders (i.e. taxpayers and tax agents). Therefore, in our experience the correct application of the concessions, in determining the correct tax disclosures for a taxpayer, places a disproportionate resource burden on the small medium enterprise (SME) sector on the sale of interests in relevant businesses and commercial properties.

The complexity of the concessions arises from their design and the drafting of the law which. The consequences are high administration and compliance costs for SME taxpayers.

Issues

We consider that the significant drafting and design difficulties for SME taxpayers are as follows:

a. Net Asset Value (NAV) test: the requirement to be a small business entity (SBE) or satisfy the maximum NAV test to be eligible for the concessions.

The NAV test requires the taxpayer who or which has made the capital gain to determine whether the net value of the (relevant) CGT assets owned by:

- the taxpayer;
- entities connected to that taxpayer; and
- any affiliated entities, or entities connected with the taxpayers affiliates

exceed $6,000,000.

The mechanics of determining the NAV test are arbitrary, unpredictable and often inequitable. For example, The NAV test threshold of $6,000,000 is not adjusted for inflation.

It is not unusual for a taxpayer to exceed the NAV threshold while having an economic worth of less than $6,000,000. For example, assume an individual taxpayer who has a 50% interest in a company that is worth $7,000,000. If the taxpayer sells their shares for $3,500,000, the NAV test rules deem the taxpayer to have a net value of CGT assets of $7,000,000. In such circumstances, a taxpayer who should be eligible for the concessions would be excluded from them. On the other hand, a taxpayer may have an affiliate inclusive NAV of over $6,000,000 and yet be eligible for the concessions. For example, assume:

- An individual taxpayer sells their business for $6,000,000;
- The taxpayer has no other relevant CGT assets;
- Their spouse controls discretionary trusts that have significant assets not related to the business.

Such a taxpayer would not exceed the NAV test threshold if they have not received distributions of 40% or more of the discretionary trusts' income or capital in the preceding four years.

b. Concessions interaction with superannuation: the concessions were designed to enable taxpayers to contribute their proceeds from the sale of business assets to superannuation funds. However, contributions made from erroneously applying the concessions are often subject to excess contributions tax (ECT) at 46.5% which we submit is inequitable for SME taxpayers.

Solution

We submit that a solution is to amend the NAV test to accurately reflect the economic position of the taxpayer and also make appropriate amendments to the ECT rules.

2. FBT system

Background

We submit that the FBT system is complex and, as a result, poorly understood by relevant stakeholders (i.e. tax agents and taxpayers). Consequently, in our experience, the correct application of the FBT rules places a disproportionate resource burden on the SME sector (vis-a-vis the large / multinational corporate taxpayer). The complexity of the FBT system arises from its design and drafting, which lead to high administrative and compliance costs for SME taxpayers. In the section below we outline some of the issues and, where appropriate, proposed solutions.

Issues and proposed solutions

Drafting: We submit that key drafting difficulties are as follows:

	Issue	Proposed Solution
i.	***Valuation rules:*** the valuation rules in each division of the *Fringe Benefits Tax Act (Cth) 1986* (the FBT Act) largely replicate the rules in other divisions of the FBT Act with some subtle differences.	
ii.	***Definitions:*** the definitions of terms in the FBT Act are not always found in section 136 of the FBT Act, the main definition provision. This makes it difficult to identify and locate relevant definitions.	Definitions should be included in section 136 of the FBT Act, where appropriate. Defined terms included within the body of the FBT Act, which are defined in section 136 of the FBT Act (see above), should be asterisked consistent with the approach adopted in the ITAA 1997.
iii.	***Relevant rules together:*** parts of the FBT Act should be relocated so that, for instance, all of the relevant rules relating to that type of FBT benefit are located in the one place.	For example: • the relocation benefit rules should be found in one place; and • the meal entertainment and entertainment facility leasing expenses should be together and not at opposite ends of the FBT Act.
iv.	***Clarity of relevant benefit:*** it should be clear, on the face of the legislation, what the benefit is when say tickets or gift cards are provided, e.g. are they property, residual or entertainment benefits.	The property, residual and entertainment rules should specifically address this issue.

Design: We submit that the design of the FBT system results in complexity due to the following:

	Issue	Proposed Solution
i.	***Types of FBT employers:*** there are a number of different types of FBT employers in the FBT Act, which increases the complexity of the FBT Act for SME taxpayers. For example, there are ordinary FBT payable employers, FBT rebateable employers and FBT exempt employers.	
ii.	***Types of FBT benefits:*** there are a number of different types of FBT benefits and their treatment for FBT purposes differs, which increases the complexity of the FBT Act for SME taxpayers. For example, FBT benefits may be fully taxable, subject to concessional treatment or included in concessional caps of either $17,000 or $30,000.	
iii.	***Not for profit*****:** in the not for profit sector, an employer group could have multiple employers each subject to different FBT rules.	
iv.	***Top marginal individual taxpayer rate:*** imposing FBT at the top personal income rate when so few Australian resident individuals are top rate taxpayers is, in our view, inequitable.	

3. Division 7A

Background

We submit that Division 7A of the Income Tax Assessment Act (Cth) 1936 (ITAA 1936) (the Division 7A rules) is complex and, as result, poorly understood by the relevant stakeholders (i.e. tax agents and taxpayers). Therefore, in our experience, the correct application of the Division 7A rules places a disproportionate resource burden on the SME sector.

The complexity of the Division 7A rules arises from their design and drafting, which result in high administration and compliance costs. In the section below we outline some of the issues and, where appropriate, proposed solutions.

Issues and proposed solutions

Drafting: We submit that the main drafting difficulties are as follows:

	Issue	Proposed Solution
i.	***Plain English (complicated language):*** the complicated manner in which the Division 7A provisions are written i.e., the nature of the language.	We submit that there is a need for a rewrite of Division 7A using clearer, simplified, plain English as well as more unified provisions within Division 7A so that it is more accessible to SME taxpayers.
ii.	***Unified language:*** the alterations and expansion of the provisions on numerous occasions since its implementation has led to a piecemeal Division 7A.	See above proposed solution.
iii.	***Unpaid present entitlements:*** the lack of legislative clarity on the characterisation of unpaid present entitlements (UPEs), i.e., whether they are loans or debts for Division 7A purposes is causing concern. In particular, the Commissioner's position in *Taxation Ruling* 2010/3 has changed the Commissioner's interpretation of a long standing provision. This has adversely affected the cash flow of many Australian business conducted through trusts.	The legislation should deal with this issue specifically to provide clarity and certainty.

Design: We submit that the design of Division 7A results in complexity and inequitable results for SME taxpayers. In particular:

	Issue	Proposed Solution
i.	***Tiered structures:*** Division 7A deals with tiered structures (i.e. trusts that have conferred (in) direct entitlements to private companies that make payments or loans to shareholders or associates of those companies) in an overly complicated manner.	
ii.	***Complying loan repayments:*** the stringent repayment requirements concerning complying loans.	
iii.	***Calculation of profits:*** an inefficient framework for calculating a company's profits; i.e. 'distributable surplus', that isn't necessarily a true reflection of economic worth.	
iv.	***Breakdown of marriages:*** the clear inequities for individual taxpayers who receive distributions of assets from private companies or relevant trusts following the breakdown of their marriage. CGT relief is (in principle) generally available where there is an asset disposal due to a marriage breakdown. However, the Commissioner's recent reversal of the prior well-established position on section 109J (see draft taxation ruling TR 2013/D6) results in the distribution of property being a deemed dividend. That the dividend might be franked is still unhelpful for most individual taxpayers.	We submit that: • draft taxation ruling TR 2013/D6 should be withdrawn; and • the deemed dividend rules should be rewritten so they are clearer and provide relief for payments (or distributions) following marriage breakdown.

4. R&D Tax Incentives

Background

Generally, the presence of research and development (R&D) tax incentives has a positive benefit on the SME sector. Such incentives are recognised to encourage businesses to develop an R&D strategy and increase expenditure on R&D, which in turn gives a company a greater chance of successful development with later commercialisation of products and services.

Indeed, an October 2013 OECD report entitled *Supporting Investment in Knowledge Capital, Growth and Innovation* concluded that types of well-designed direct support such as grants, payroll credits and refundable tax incentives may be more effective in stimulating R&D than previously thought, especially for 'young firms'.

The introduction of the refundable R&D tax incentive for income years commencing on or after 1 July 2011 has been of significant benefit to Australian small businesses, in particular those with an aggregated turnover of less than $20m. Those smaller entities can access cash based support in periods where income is lower than expenditure, and improved cash flow through reduced income tax as they develop their income stream and grow their business. Compared to the former R&D concession, additional cash based support is extended to SMEs previously only entitled to tax deductions because of the former refundable concession benefit being limited to entities with turnover under $5m.

Now in its third year of operation, the program has largely been welcomed by small business and AusIndustry has reported an increase in the SMEs that have sought to claim the incentive since its introduction.

AusIndustry reports that as at 31 December 2013, 5,036 companies (some of which are grouped for tax purposes) had registered $8.91 billion of R&D expenditure for the 2012-13 income period. Compared to registrations received during the same period in the previous year, there has been an increase of more than 1,200 R&D-performing entities making claims.

In addition, over 950 companies are new to the program and 76.5% of registrations received for 2012-13 were from companies with an aggregated turnover of less than $20 million - small companies are clearly a large proportion of total claimants, although their claim amount tends to be smaller than that of larger entities.

The government targets the R&D incentive legislation towards SME entities, noting in the explanatory material for the incentive that *"Internationally, there is broad support for the view that small firms are more responsive than large firms to increasing their R&D spending as a result of Government incentives."*

There are areas associated with the R&D tax incentive program that we believe could be improved to remove impediments to entities at the different stages of a company's lifecycle. These are discussed below.

Removal of proposed quarterly R&D credit system

Issue

In our view, and the view of many of our SME clients, it was unfortunate that a decision was taken[1] not to proceed with the proposed R&D quarterly credit system.

Cash flow is a critical issue for the start-up stage of any entity and, in particular, those undertaking significant R&D activities not generally matched by income. The available of ongoing cash flow is often a critical issue in survival of start-up companies. Addressing this matter was the primary purpose of the proposed quarterly credit system, as evidenced by the explanatory memorandum to the proposed measure which noted at para 1.13 that *"Allowing taxpayers with an expected entitlement to the R&D refundable tax offset to receive their anticipated refund in quarterly instalments during the year provides additional cash-flow for them to reinvest in their R&D activities and so deliver wider benefits to the Australian economy."*

The arrangements set out in the draft legislation prepared before the announcement in November 2013 were much improved from those originally proposed in the earlier consultation paper and reflected many of the suggestions made by Deloitte in our submission of 31 August 2013 (a copy of which is available on request). We believe that the proposed legislation reflected an appropriate balance between simplicity and necessary integrity issues.

Solution

We submit that introduction of the quarterly refund system should be reconsidered. We also submit that should a quarterly refund system be introduced, it would benefit from:

- An exemption from any history rule requiring a past R&D claim, for private companies in their first year one or two years of operation that otherwise satisfy the requirements for the quarterly credit. These companies are among those most in need of ongoing cash support and are a key target of the R&D tax incentive program. Such a rule would ensure genuine start-ups can access the quarterly refunds earlier than under the original proposal;
- We submit that provision for discretion on the part of the Commissioner to waive GIC if quarterly refunded amounts are varied (beyond set limits acceptable to the Commissioner) due to events beyond the control of the company (akin to ss.205-70(6)) would also be appropriate.

Tax exempt ownership rules

Issue

We submit that the threshold in respect of control by (unrelated) exempt entities which can preclude eligibility for the 45% refundable R&D tax offset is currently too low. Generally speaking, the law currently provides for only a 40% non-refundable tax offset where ownership by an exempt entity is equal to or greater than 50%.

Solution

We submit that it would be beneficial for start-up entities to be able to be owned and or financed at least 50% by an exempt entity before the refundable 45% credit is not available and that an altered threshold higher than 50% (say somewhere between 50.1% and 75%) should be used.

In this context we note that (income tax exempt) university bodies often perform first stage research and subsequently attempt to further develop and apply that research in a new start-up company using funds contributed by private sector investors.

[1] Refer Media Release No 008, Assistant Treasurer, 14 December 2013

Currently equally shared (50%) ownership of the start-up entity by the university and the private investor prohibits a refundable tax credit (whereas a 49.9% ownership does not). 50% ownership is a commonly desired ownership percentage, however, the current law denies the start-up entity set up in this manner a valuable source of cash flow, effectively putting the start-up entity at a disadvantage compared to other private companies.

We also note that the aggregated turnover provisions can also deny access to the refundable credit for entities jointly owned by university entities, despite the restrictions placed on those universities regarding permitted use of their funding. That is, unlike private entities, university bodies often have limits on their ability to support start up entities, such that application of the aggregated turnover provisions may not be as appropriate as it is for companies supported by other large private entities.

A change in the law to permit refundable credits companies to be owned up to 50% by exempt entities, with accompanying changes in the aggregate turnover provisions to allow ownership by exempt entities such as universities would likely assist in the incubation and development of new technology based companies.

Practical Implications of Applying the COT and SBT rules

Issue

There are significant practical implications to applying the continuity of ownership (COT) and same business test (SBT) rules to smaller 'start-up' entities in relation to the utilisation of carried forward R&D tax offsets.

The nature of many start-up companies conducting R&D is that there is a need to issue equity (often repeatedly) to raise capital during the innovation phase, which raises the potential for failure of the COT. Further, depending on the level of dilution, the entities may also be at risk of failing the SBT when they start commercialising what has been developed from their R&D, resulting in the loss of carried forward R&D tax offsets and eliminating the benefit of legitimate past R&D claims.

Solution

We submit that consideration should be given to the creation of a provision that allows start up entities to carry forward R&D tax credits without reference to the SBT and COT rules for a defined period of time. This time period should be sufficient to allow the company to progress to a point where income is being earned and the benefit of the tax credit can be utilised.

Support for post-R&D commercialisation activities

Issue

Over time, a company that has sought refundable R&D tax incentive offsets in the early years of operation will seek to commercialise the new knowledge generated by the R&D it has undertaken. At these early profit-making stages an entity would benefit from a reduced tax liability on the profits generated directly from the R&D work undertaken.

Australia's SME manufacturing industry currently faces significant challenges and there is a push to reposition R&D and manufacturing activities offshore where cost structures (both capital and labour) represent a significant competitive advantage.

Currently, Australia's R&D tax incentive regime encourages the conduct of R&D in Australia but does not support or incentivise the initial establishment of facilities and infrastructure to manufacture new products developed.

To date, the government has committed to considering the introduction of a patent-box model such as introduced in the UK, to cut the rate of company income tax on targeted income derived from technologies developed in Australia. At the time of writing, no further news has been released.

Solution

We recommend that consideration be given to the implementation of a similar ‘patent box’ approach to the taxation of royalty income from R&D/patent based innovation. This would assist the ongoing growth of high value SMEs that develop valuable IP. It would also encourage larger and multinational businesses to derive income from commercialisation of their IP generating R&D activities in Australia and to retain resulting intellectual property in Australia.

Issue

Over time a company that has sought refundable R&D tax incentive offsets in the early years of operation will often mature and generate profits, which are returned to the investors that supported the company through a high risk R&D phase.

The R&D tax credit is promoted for SME entities with turnover below $20 million as an incentive that gives a tax benefit equal to 45% of the eligible expenditure. In reality, the value companies obtain is much lower when the impact on the company’s future ability to frank dividends is taken into account.

Under the current refundable R&D tax incentive program, the refund of an excess R&D tax offset is defined in the law to be a ‘refund of income tax’. To prevent an R&D tax offset refund creating a potential liability to Franking Deficit Tax; the law provides that a franking debit does not arise in the franking account as a result of an R&D claim. Instead this debit is deferred and treated as reducing future franking credits that would otherwise arise on the payment of income tax in the future. That is, the deferred franking debits from R&D claims are recovered from future income tax payable before franking credits can be accumulated and paid out to investors with dividends.

This net effect is that when an entity grows to the point of making profits, the company paying a dividend will either need to pay back income tax if it franks its dividend or pay income tax for a significant period of time before they generate a franking credit that can accompany a dividend. In these cases, the actual benefit to the company over time, and the cost to the Federal Government of providing the incentive, is potentially much lower than the headline rate of the incentive.

Once the full relevance of this mechanism is recognised by investing entities expecting dividend income, it discourages initial investment into start up entities undertaking R&D, at the very point in time that investment is vital to progress company development.

Solution

We submit that the definition of a refundable R&D tax offset as a refund of income tax should be reconsidered and that for SME entities at least (for example, those with turnover lower than $20 million), the R&D credit provided should not result in a franking debit. This would establish the real benefit of the incentive for those entities at the value currently promoted by AusIndustry and the Federal Government.

Deloitte Private

Submission only
This document and the information contained in it is confidential and should not be used or disclosed in any way without our prior consent.

About Deloitte
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.
Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's approximately 170,000 professionals are committed to becoming the standard of excellence

About Deloitte Australia
In Australia, the member firm is the Australian partnership of Deloitte Touche Tohmatsu. As one of Australia's leading professional services firms, Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, and financial advisory services through approximately 5,700 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit Deloitte's web site at www.deloitte.com.au

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Touche Tohmatsu Limited

© 2014 Deloitte Touche Tohmatsu

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Touche Tohmatsu Limited

Deloitte.