The Institute of Public Accountants

Review of Tax Impediments Facing Small Business

2 June 2014

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Partnership beyond numbers

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Review of Tax Impediments Facing Small Business

The IPA welcomes the opportunity to provide a submission to the Board of Tax (The Board) to identify features in the tax system that are hindering or preventing small businesses from reaching their commercial goals.

The IPA is a professional organisation for accountants who are recognised for their practical, hands-on skills and a broad understanding of the total business environment. Representing more than 26,000 members nationally and in over 51 countries, the IPA represents members and students working in industry, commerce, government, academia and private practice. Over two-thirds of our members work in or with small business and SMEs and are recognised as the trusted advisers to these sectors. Through representation on special interest groups, the IPA ensures views of its members are voiced with government and key industry sectors and makes representations to Government including the Australian Taxation Office (ATO), Australian Securities and Investments Commission (ASIC), Australian Competition and Consumer Commission (ACCC) and the Australian Prudential Regulation Authority (APRA) on issues affecting the profession and industry.

Given the short time frame to respond to the review, our comments have been drawn mainly from our 2014-15 pre-budget submission which predominantly looks at issues affecting the small business sector.

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The highly regressive nature of compliance costs on small businesses has always been a concern for the IPA. We welcome any review that helps unshackle the small business sector and makes life simpler for small businesses, especially when it comes to their interaction with the tax system. The important role entrepreneurs can play in Australia's future economic growth cannot be understated. A strong and vibrant small business sector can play an active role in contributing to the economic growth of the Australian economy.

The Institute is strongly of the view that immediate and tangible incentives must be offered to entrepreneurs and innovators, to encourage their entry into, and long term engagement with, the Australian small business sector. The Federal Government needs to implement policies that will drive business activity and entrepreneurialism across all sectors.

In particular, we believe significant economic growth will occur if there is a more supportive regulatory environment, and tax policy is a critical part of the regulatory environment for small business owners.

Specific comments on tax impediments, as follows:

Whole of Government approach to definition of small business

There should be a whole of Government (Both Federal and State) approach to the definition of small business. There is a myriad of definitions of small business with multiple inconsistent criteria, definitions and thresholds. The process by which tax laws identify small business needs to be as consistent as possible to reduce the amount of complexity and compliance burden on small business.

Small Business CGT concessions

The small business CGT concessions are overly complex. Whilst the rules were subject to a post implementation review by the Board, the eligibility rules need to be simplified. Their complexity in part is due to having to deal with multiple business

structures and anti-avoidance provisions. There is an opportunity to rationalise and streamline the CGT concessions which has also been recommended by the Henry Review. The four current and separate small business CGT concessions require taxpayers to navigate complex legislation. A number of existing concessions such as the 50 per cent reduction and the 15 year exemption are highly concessional, and can eliminate any CGT liability when business owners exit their investment. These concessions are generally uncapped and are generous tax concessions.

Division 7A

The Board has recently released a second discussion paper on Division 7A. The IPA responded and lodged a submission as input into possible future reforms. Without repeating the points raised in our submission, it is important to highlight that small businesses face significant compliance costs dealing with the unnecessarily complex Division 7A rules. The cost of complying with the provisions contained in Division 7A is of a major concern to our members servicing small business clients. Since its introduction, Division 7A have become more and more complex and its reach has extended to capture more transactions, such as Unpaid Present Entitlements (UPEs).

The rules need to be simplified to remove unnecessary red tape and it should be easier for companies to reinvest business profits as working capital. The reinvestment of profit taxed at the corporate tax rate back into an active business, should be encouraged to promote entrepreneurship and productivity.

A move away from the existing prescriptive and at times inflexible, non-commercial based rules will be a welcomed step forward. As stated in the discussion paper, these reforms are intended to support growth and jobs by making the system simpler, reducing compliance costs and making it easier for small businesses to reinvest business income as working capital. The Board's proposals should be fast tracked to remove these impediments

Fringe Benefits Tax Overhaul

A comprehensive review of FBT legislation is required. Since its introduction in 1996 there have been significant changes to the workplace that cannot be accommodated by the existing legislative framework. Recent legislative changes constitute a 'band aid' approach to addressing systemic FBT problems. Any review of FBT must address compliance issues facing small business.

FBT is an inefficient tax, intended as a disincentive, rather than a source of revenue. FBT incurs the highest compliance cost relative to the revenue generated and there is considerable scope to reduce the compliance burden on small businesses; including the small Not-for-Profit (NFP) organisations.

The FBT valuation and apportionment methodologies impose unnecessary compliance costs on small employers. Salary packaging arrangements add to administration and increase recording and reporting requirements.

The complexity of the FBT system is exacerbated by the fact that the incidence of the taxation of fringe benefits falls on employers. The taxation of fringe benefits to employers requires supplementary rules to ensure fringe benefits are factored into the various means tests in the tax and transfer system; such as family tax benefits and parenting payments.

In many overseas jurisdictions, fringe benefits are taxed in the hands of employees. It is the Institute's view that the taxation of fringe benefits at the employee level has the potential to deliver greater neutrality in the treatment of cash and non-cash remuneration; whilst simultaneously reducing compliance costs for all parties. Benefits that can be readily valued and assigned to an employee should be taxable in the employee's hands and reportable for transfer purposes.

The taxation of fringe benefits in the hands of employees would also alleviate the inequitable application of the top marginal tax rate to fringe benefits, which is

currently applied irrespective of the income of the employee. The Henry Review supports the transfer of FBT to employees.

Other benefits incidental to an individual's employment or otherwise difficult to assign, should be taxable to the employer. This approach would provide a more neutral taxation outcome by removing the need for the current grossing–up process and would facilitate the consistent and equitable treatment of fringe benefits for means tested taxes and transfer payments.

Reintroduce loss carry back regime

At the time of writing, there is a Bill tabled before Parliament which intends on removing the Minerals Resource Rent Tax (MRRT) and to discontinue certain tax measures that were intended to be funded by the MRRT.

Loss carry-back allows companies to offset current period losses against previously paid taxes. The loss carry back provisions recently introduced, struck the right balance between allowing losses and limiting the exposure to government revenues by placing a quantitative cap in conjunction with a two-year carry-back period. The quantitative cap reduces the Government's exposure to large losses incurred by eligible companies. Both the Henry Review and Business Tax Working Group recommended the adoption of loss carry-back.

Australian businesses are under pressure to adapt and change their business models to overcome challenges and make the most of opportunities arising from structural changes underway within the economy. It is for this reason that the tax system should encourage rather than get in the way of businesses wanting to invest and innovate. Without loss carry-back, our tax system penalises investments that have some risk of failure through its treatment of losses. This penalty against risk taking can influence the kinds of investments undertaken and how much investment occurs which can impact on productivity and employment.

Small businesses operating through a corporate structure that experience a sudden downturn would receive invaluable cash flow benefits to help them ride out any

economic downturn caused by external factors such as the Global Financial Crisis (GFC). Loss carry-back will help assist with the continual survival of viable companies during similar downturns in future years.

While recognising that businesses operate through a range of legal structures, loss carry-back only helps small entities that operate using a company structure. Nonetheless, there are 760,000 small business entities that could benefit from having loss carry-back as part of our tax system. It could be the difference between being able to survive a tough year as it provides an important boost to cash flow when it is needed most and at a time when it is most critical in ensuring survival of the business.

Employee Share Schemes

Changes to the tax rules in 2009 governing employee share schemes (ESS) effectively treat employee share options as income which is taxed at the employee's marginal tax rate. If no concessions apply, any discount on the market value of an interest in a share or right provided to an employee under an ESS is taxed as part of the employee's taxable income in the year it is acquired, rather than on disposal.

Many overseas countries such as the UK, USA, Canada and Singapore generally defer the taxing point to when the securities are sold. This treatment puts a dampener on using share options for little or no upfront cost as a remuneration option for cash strapped entities trying to attract and retain talent.

If tax is paid by the employees and the value of the securities has fallen due to market forces, the employee is not eligible for a tax refund, but would instead have a capital loss under the capital gains provisions. This makes participation in an ESS an unattractive proposition especially when you consider the high failure rate of start up companies. The current ESS rules fail to recognise that unlike large well funded companies, start ups require employees to participate in long term equity incentives as they do not have cash to pay competitive salaries to incentivise employees.

Innovation is vital to a country like Australia which is transitioning away from its more traditional employment sectors to a digital economy. New innovative technology start-ups have the potential to generate new markets and significant employment growth. Without the cash flow to offer a competitive wage, an equity stake is the best option to attract and incentivise employees, but the current rules make this strategy ineffective.

Encouraging the growth of innovative start ups is in the national interest as it can lead to benefits for the economy more broadly. ESS provide wider benefits to the economy as research has shown that employees involved in ESS have improved performance which can contribute to the growth of the business. In addition, Australian technology firms have made significant contributions to the ability of Australian firms in other industries to take advantage of the digital economy by providing the tools to do business online affordably and easily.

A more supportive regulatory environment for start ups could help address one of the main challenges of attracting and retaining experienced skilled employees faced by start ups. A more favourable ESS regime could also greatly assist established businesses with succession planning as it would make offering shares to employees more attractive.

Simpler structure options for small business to streamline and reduce regulation and red tape

One of the Institute's long term aspirational goals is the simplification of the small business taxation system through the application of a structure which eliminates the need for multiple structures. Multiple structures are commonly needed to achieve tax outcomes which would be otherwise unavailable through a single entity. A simplified small business entity regime can significantly reduce regulation and red tape for small businesses.

Small businesses seek measures which promote asset protection, the retention of profits for working capital, lower tax rates, access to CGT discounts, succession

planning and income distribution. A combination of entities is generally used to achieve these outcomes. A typical example may be where a business operates through a partnership whose interests are held by a discretionary trust with a company amongst the trust beneficiaries. When a small business operates through separate legal structures; the current taxation system treats the structures as taxation entities separate from their owner(s); resulting in a quantum leap in tax compliance and complexity.

International evidence exists of entities specifically designed for small businesses. For example in the United States, small businesses may set up using an S-Corporation that offers a number of advantages such as asset protection and flow-through tax treatment. The creation of a new small business structure allows small business entities to use a single simplified structure rather than the current complicated ownership structures such as trusts. If such a structure allowed the retention of income at the corporate tax rate, it would allow most of the benefits that can currently be obtained via the use of a company and discretionary trust via a cheaper and simpler vehicle to administer. A simpler structure option could represent a better pathway to avoid the complexity that exists in relation to Division 7A and trusts.

We suggest a separate type of entity be established specifically for small business with attributes of various existing structures that make it attractive for small business taxpayers to use. Ideally business profits that are reinvested in a business should be taxed at uniform corporate tax rate as other entities are able to reinvest at least 70 cents of each dollar of profit back into the business.

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 lower compliance costs.

Trustee resolutions

A trust compliance matter that has caused significant compliance issues to a large number of our members servicing SMEs is trustee resolutions. Since June 30th 2012, there has been a requirement for trustees to complete trustee distribution resolutions by June 30th each year. This change was brought about by the ATO on September 1st 2011 when it withdrew its long standing practice of allowing trustees an additional two months to prepare trust distribution resolutions. This administrative practice had been in place since 1966. It recognised the practical difficulties faced by trustees and their advisors in making trustee resolutions prior to the end of the financial and income tax year ended June. 30th

The ATO acknowledged this administrative difficulty in paragraph 31 of IT 328 of the now withdrawn administrative statement:

"Where a trustee is carrying on a business, it will be impossible to determine the amount of the net income of the trust estate until after the close of the year of income."

In recognition of that practical difficulty, which still remains almost 50 years later, the ATO allowed trustees and their advisors a two month extension until August 31st to draft appropriate resolutions. This enabled trustees and their advisors to draft trustee resolutions using completed financial statements.

The withdrawal by the ATO of this administrative practice meant that for the income tax year ended June 30th 2012 and thereafter, all trustees were strictly required to ensure that these resolutions were made by June 30th each year.

The compliance issues this causes can be summarised as follows:

- this additional work of estimating June 30th balances is not otherwise required, if a trustee is able to prepare its distribution resolutions on actual finalised accounts for the income year;

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- no incremental commercial benefit flows to trusts and their advisors from requiring trustees to make trustee resolutions earlier. The additional work is purely a compliance issue. The change in ATO practice, however, meant that a lot more work was required in order to reach that same outcome;
- this increased work load arose and will continue to arise at a particularly busy time for SME groups and their advisors as they are also required to prepare at this time Business Activity Statements, group certificates and payment summaries, WorkCover reconciliation documents, Tax File Number withholding reports, and a lot more June 30th compliance related documentation;
- advisors had to perform this additional work with full knowledge that, in this current difficult economic climate, many SME clients could not, or would not, bear the additional cost caused by the change of ATO practice. As a result some, or all, of the related time cost would have to be written off, thereby reducing their income
- all these compliance issues are likely to cause similar compliance problems annually and into the future.

Alienation of personal services income

The rules surrounding the 'alienation of personal services income' (PSI) were introduced in July 2000, primarily to enable taxpayers to self assess as to whether they operate as a personal services business. Taxpayers unable to satisfy PSI rules would have their income attributed back, irrespective of whether they operated through an interposed entity.

The rules were aimed at ensuring that PSI taxation applied equally, regardless of the arrangements under which income is earned and that business deductions income splitting and tax deferral are not available to entities not genuinely conducting a business enterprise.

Whilst we are supportive of the policy intent of the legislation, we believe the existing framework needs to be reviewed to provide more certainty, ease compliance and

reduce complexity. The PSI rules are relevant for small businesses and therefore need to be clear, understandable and conducive to the average taxpayer being able to discharge their obligations with certainty. There is too much uncertainty as to the interpretation of key elements of the law.

The use of interposed entities is often a legitimate commercial means by which contractual arrangements can be satisfied. It should not be viewed prima facie as an attempt to engage in income splitting and/or tax deferral. The use of personal services entities continues to expand in line with the growth of flexible workplace arrangements.

To promote economic growth, Australia requires a tax system which is consistent, cognisant of commercial reality and encourages productivity. Accordingly our taxation system should acknowledge the real benefits of contracting arrangements. The Henry Review has called for a revision of the rules and an extension of the PSI scope to cover all entities earning a significant proportion of business income from the personal services of their owner/managers.

Safe harbours for small business

Greater use of safe harbours can reduce compliance costs for eligible small businesses. The use of de minimis exclusions from the operation of certain regimes, such as transfer pricing can be an effective way to balance compliance costs against the possibility of loss revenue.

Remove the 10 per cent rule for making concessional contributions

The Institute does not believe there to be any valid reason for the restriction on members making personal concessional contributions if the member earns more than 10 per cent of his or her income from employment services or any of the services listed in subdivision 290-C of the ITAA 1997.

It is felt that this prohibition is inequitable for a number of Australians.

The Institute believes the source of the concessional contribution should not matter and that this particular item of legislation should be repealed. It is felt that Australians should be subject to a concessional contributions cap that does not discriminate against the source of the contribution.

Small business superannuation compliance

Small business, as with large business, has a plethora of reporting obligations. However, unlike large business which is usually better resourced to deal with the multitude of reporting requirements, the cost of compliance for small business is disproportionately higher.

The Institute therefore welcomes the Government's commitment to reduce the compliance burden on small business. As it relates to superannuation payments on behalf of employees, the Institute believes that small business compliance costs will be reduced if they no longer administer superannuation payments on behalf of employees. And whilst it commends the introduction of the small business superannuation clearing house, the Institute believes this could be further enhanced to benefit small business through the following recommendations.

Firstly, we welcome the recent transfer of the clearing house from the Department of Human Services, to the ATO. The ATO is the more logical department to handle superannuation payments made via the small business superannuation clearing house as superannuation payments align more closely with the ATO.

Secondly, we feel the threshold of 19 staff to be eligible to use the clearing house should be increased to 100 staff to help more businesses reduce their compliance costs.

Thirdly, the Institute believes that a single payment to the ATO on behalf of employees, comprising income tax and the superannuation contribution would ensure that employee's Superannuation Guarantee (SG) is paid in a timely manner.

We believe one option to achieve this objective would be to have the SG payment made with and attached to the quarterly Business Activity Statement.

And lastly, the measure for calculating the minimum level of superannuation support required for individual employees under the Superannuation Guarantee Act, should be replaced with a simpler base which is easy to apply. The current base on which SG is calculated 'ordinary time earnings' is a definition which is inherently difficult to interpret and apply and should be replaced.

Treasury have already begun looking at superannuation compliance for small business which the IPA has participated in the stakeholder consultations.

Concessionary tax rate for active small business income via tax offset

As the engine room of the economy, small business would benefit from a differential rate of income tax to compensate for their disproportionate regulatory burden.

With the exception of Capital Gains Taxation (CGT) concessions, most small business tax benefits currently merely provide for a deferral of tax, a marginal benefit at best. Only those small business owners able to sell business assets at a profit are able to enjoy CGT tax concessions at the time of 'exit'.

The concessions currently available to qualifying businesses at the time of exit should be redistributed and applied at start up and in the subsequent growth years.

Small business income earned by individuals is subject to the same progressive tax rates as individuals, the majority of whom do not have the same regulatory burdens or exposure to risks.

The level of taxation compliance and complexity facing small business has increased substantially over the last few decades. With the introduction and development of Fringe Benefits Tax (FBT), CGT, Goods and Services Tax (GST), the paid parental leave scheme and compulsory superannuation, our taxation system has become excessively onerous and more than 95 per cent of businesses currently engage a tax

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practitioner. Tax compliance is in addition to the already heavy burden faced by small business in administration and reporting relevant to workplace and OH&S laws, and the superannuation guarantee.

The Institute proposes a concessionary rate of tax for small business income to compensate for the regressive nature of compliance costs and to reward entrepreneurial activity. The small business income component of an individual's total income should receive a tax offset to reduce the effective tax rate on small business income. All other income would be subject to existing tax rates. A lower tax rate would be more equitable, efficient and cost effective.

The proposal would operate on a similar basis to the entrepreneurs tax offset (ETO), which was recently abolished. This measure was originally intended to offer an incentive to small business in the early stages of development by way of a tax offset of up to 25 per cent for those with a turnover of less than $75,000.

There is evidence to support the proposition that the majority of small businesses would prefer a lower tax rate and a simpler system than a plethora of complex tax concessions which they may not be able to fully access. The existing small business turnover threshold of $2 million would determine eligibility. The current anti-avoidance rules provide the necessary integrity measures to discourage larger businesses from being separated into smaller entities to take advantage of a lower rate. The lower tax rate for small businesses also compensates this sector for the difficulty and higher costs associated with accessing finance. It also frees up more after tax income for the purposes of reinvestment and expansion.

Compliance burdens in respect of employment

A significant number of small businesses do not have employees. Whilst most are one person businesses, the issue of why there is reluctance for small businesses to employ people would in part be attributable to compliance obligations imposed on entities associated with employment. Some of the compliance burdens are tax related such as PAYG, Superannuation Guarantee Charge, FBT and workers

compensation. These compliance burdens impose substantial costs of time and money which when combined with other non tax regulations impose disincentives to employing staff.

The IPA welcomes the opportunity to discuss further any of the matters we have put forward in our submission. Please address all further enquires to me (tony.greco@publicaccountants.org.au or 0419 369 038).

Yours sincerely

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