THE TAX INSTITUTE
THE MARK OF EXPERTISE

12 August 2014

Mr John Emerson AM
Chair of the Tax System Impediments
Facing Small Business Working Group
The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

By email: taxboard@treasury.gov.au

Dear John,

Review into Tax System Impediments facing Small Business – Supplementary Letter to Submission dated 30 May 2014

I write to you in order to amend The Tax Institute's original submission to the Board of Taxation (**Board**) dated 30 May 2014 (**Original Submission**). We have attached this earlier document for your reference.

Issue

The amendment involves an issue that is contained on page 4 of our Original Submission[1] under the heading: *4. Interaction between transfer pricing rules and thin capitalisation rules*. It is described at the first bullet point as:

- An unintended consequence arising from the proposed increase in the de minimis threshold for purposes of the thin capitalisation rules from $250,000 to $2 million.

We withdraw that bullet point[2] from our Original Submission and request that our Original Submission be amended accordingly.

Reason for amendment

Subsequent to lodging the Original Submission, The Tax Institute has now formed the view that Division 820 still applies to an entity within the de minimis threshold in section 820-35, as section 820-35 only excludes the operation of specific subdivisions within Division 820. Therefore, those taxpayers can satisfy section 815-140(1)(a). In this regard, we are of the view that taxpayers falling under the de minimis threshold in the thin capitalisation rules can still obtain the protection afforded by section 815-140 as they should regard Division 820 as applying to them.

[1] With further detail contained in Appendix 2 (a) of our Original Submission.
[2] And the associated material contained in Appendix 2 (a).

Level 10, 175 Pitt Street
Sydney NSW 2000
Tel: 02 8223 0000
Fax: 02 8223 0077
info@taxinstitute.com.au
taxinstitute.com.au
ABN 45 008 392 372

In discussions with Treasury in the context of the Exposure Draft legislation to increase the de minimis threshold to $2 million, Treasury has agreed with this view. Consequently, Treasury has inserted a note to confirm this interpretation of section 820-35 in the Explanatory Memorandum to the *Tax and Superannuation Laws Amendment (2014 Measures No.4) Bill 2014*[3] that was introduced into Parliament on 17 July 2014.

Therefore, the concern that we originally raised is no longer an issue.

If you would like to discuss any of the above, please contact me or Senior Tax Counsel, Robert Jeremenko, on 02 8223 0011.

Yours sincerely

Michael Flynn
President

[3] See paragraph 1.95 of the Explanatory Memorandum (http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r5318)

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The Board of Taxation
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By email: taxboard@treasury.gov.au

Dear John,

Review into Tax System Impediments facing Small Business

The Tax Institute welcomes the opportunity to make a submission to the Board of Taxation (**Board**) in relation to the review the Board is undertaking in relation to tax system impediments faced by small businesses.

We note that this is a fact-track review and in the interests of assisting the Board to review submissions received in a timely fashion, we have kept our submission brief.

<u>Overview</u>

Tax-related issues affecting small business

There are a range of matters stemming from the tax system that affect small businesses, such as:

- Ensuring Australian Taxation Office (**ATO**) practices and procedures do not impose an undue burden on or cost for small business;
- The appropriateness of current tax policy settings intended to support small businesses, and resulting regulatory requirements;
- Ensuring small business issues and concerns are represented in tax-related consultation with Government and are not subsumed by larger business interests (as small businesses often lack the available resources to consult with Government independently); and
- Exploration of the possibility of creating a separate small business entity structure through which small businesses can operate and which amalgamates

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the benefits of existing, available structures (such as company, trust, partnership and sole trader structures) (see further discussion below).

Relevant areas of the tax law affecting small business include:

- Taxation of trust income;
- Current problems with Division 7A of the Income Tax law (currently under examination by the Board of Taxation);
- Complicated small business entity tests (including grouping rules designed to counter tax-avoidance but which mostly cause complexity);
- Personal services income rules;
- Superannuation contributions restrictions (especially relevant if you need to contribute the gain from the sale of a business into Superannuation to get small business CGT concessions);
- Transfer pricing rules (on which we have advocated for small businesses to be exempted altogether or at least to have decreased record keeping requirements for small businesses – see further detail provided below); and
- The interaction between the transfer pricing rules and the thin capitalisation rules.

Furthermore, some benefits within the tax law are almost off-limits to small businesses due to the complexity of the rules and the prohibitive cost of obtaining sophisticated tax advice to ensure the correct tax outcomes are achieved (for example tax consolidation, share buy-backs, and certain fringe benefits tax concessions).

In this regard, there should be a focus on:

- Streamlining definitions and access to small business concessions where possible;
- Greater harmonisation between small business definitions in State and Federal tax laws; and
- Simplifying existing tax laws.

We set out below particular priority issues for the Board to consider.

Issues for the Board to consider

We have listed out a variety of issues below for the Board to consider in its review.

Priority Issues

1. Small Business CGT Concessions

The current small business CGT concessions are very complex nature. The provisions are so complex that it is difficult for a small business to confirm that they qualify for a concession under the rules.

By way of illustration, uncertainty can arise in not knowing precisely how the concessions may apply to a particular taxpayer. For example, where assets are owned by spouses in discrete businesses, it is difficult to know if they will be aggregated by the ATO for the purpose of determining if the relevant thresholds for the concessions have been exceeded on the basis of control by the spouses of each other's businesses.

It is also unclear what valuations small businesses have to keep on file for the purpose of proving that the relevant thresholds are not exceeded.

Seeking advice on whether the concessions could apply can prove too costly for some taxpayers due to the complexity of the rules. The rules were intended to provide a simple tax concession, but they have become so complex that taxpayers often find it is not worth their while trying to determine if the concessions apply. Therefore, should it be the Government's policy to continue to make available CGT concessions to small businesses, the concessions should be simplified to make them more easily understood and more readily able to be applied.

2. Creation of a separate small business entity structure

The Tax Institute has a particular interest in an 'entity-flow through' proposal on which Treasury has consulted with members of the ATO's Small Business Consultative Group. This is part of exploring the possibility of creating a separate small business entity structure.

At the same time as considering the benefits of a consistent definition of small business, we suggest the Government could give consideration to entity flow-through treatment in the context of the creation of a separate small business entity structure.

Our members are broadly of the view that the proposal warrants further investigation and consideration, and could be constructed as a sufficiently attractive alternative to allow the consolidation/removal of existing, complicated ownership structures.

Nonetheless, it is our view that the proposal requires significant development and would benefit from wider exposure and consultation, as well as industry and private sector input, which could be facilitated by the Board.

An entity flow-through treatment for gains and losses would bestow many of the benefits currently available via the use of a trust with relatively little compliance costs. Such a structure may also counter some of the ATO's current integrity concerns with the use of trusts. If such a structure also allowed the optional retention of income at the corporate tax rate, it would allow almost all of the benefits that can currently be obtained via use of a company and discretionary trust via a cheaper and simpler to administer vehicle. The acceptance of such a structure would depend on the allowance of rollovers to defer the realisation of gains and obviate stamp duty liability on adoption of the structure.

Entity flow-through treatment could also offer reduced compliance costs if small businesses were able to structure their businesses through a single simplified structure rather than continue to use a collection of entities so commonly used to structure small businesses.

If the new entity structure offers currently available advantages, it should not result in a significant cost to the revenue, and will offer a unified set of data on the tax attributes of the small business sector that will prove advantageous in policy decision making. If such a structure eventually makes possible the eradication of other entity choices in the small business sector, taxpayers and the revenue authority alike will stand to benefit from a simplified mode of operation.

We note that the flow-through of losses would allow for greater symmetry in the tax treatment of losses but would be inconsistent with the optional retention of profits at the corporate tax rate. We are broadly supportive of elective flow-through of losses, but are cognisant that such a change will raise integrity concerns that may also need to be countered.

3. Transfer pricing and small business

Included in Appendix 1 are a series of suggestions for easing the increasingly onerous compliance burden on small businesses which are subject to the transfer pricing rules contained in Division 815 of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**) and the associated documentation requirements in Subdivision 284-E of Schedule 1 to the *Taxation Administration Act 1953* (**TAA 1953**).

4. Interaction between transfer pricing rules and thin capitalisation rules

Included in Appendix 2 is information concerning the interaction between the transfer pricing rules and thin capitalisation rules that could be addressed by the Board in this review. More specifically:

- An unintended consequence arising from the proposed increase in the de minimis threshold for purposes of the thin capitalisation rules from $250,000 to $2 million; and
- A suggestion for the transfer pricing rules to be amended to ease the compliance burden on small businesses.

5. Simplification of carry-forward loss rules

Though not strictly limited to applying to small businesses only, the complexity in the carry-forward loss rules, namely the “continuity of ownership” (**COT**) and “same business” (**SBT**) tests, are difficult for any size business to apply when seeking to utilise losses.

In particular, the significant cost of obtaining specialised tax advice to assist to determine whether tax losses can be utilised is particularly costly and burdensome to smaller businesses.

We refer the Board to the report[1] prepared by the Business Tax Working Group (**BTWG**) on the loss carry forward rules. The BTWG considered that both the COT and SBT should operate together to balance two policy objectives: preventing tax driven trading in companies and ensuring the continued use of losses if a change of ownership occurred for commercial reasons. The BTWG noted that the COT performed a valuable function safeguarding against loss trafficking, but the SBT was not effective as a means for determining whether a change to a company's ownership was motivated by commercial considerations. In this regard, the BTWG considered that identifying appropriate amendments to the SBT to address the above should be a priority for the Government. This review presents an opportunity to carry this work through and review more broadly the complexities from the COT and SBT.

6. Foreign exchange for small entities

Where an Australian-resident entity transacts with other group entities that are not residents of Australia, for example buying and selling goods, often the transactions will be recorded in an inter-company loan account. Depending on the volume of transactions, it may become quite onerous to constantly recognise adjustments for foreign exchange.

A retranslation method applies to a "qualifying forex account[2]", such as a bank account, which is simpler to apply than the usual "first-in first-out" ordering rule to calculate the cost or value of a fungible foreign currency asset, right or obligation. The retranslation method allows total gains or losses to be accounted for on a periodical basis, rather than each time a deposit is made into the account or withdrawal is made from the account.

We suggest that a simplified method for recognising foreign exchange gains and losses on inter-company loans similar to the retranslation method, should be made available.

Additional Reference

We also refer the Board to a paper presented at the recent *2014 Australasian Tax Teachers Association Conference* entitled "Tangled up in Tape: The Continuing Compliance Plight of the Small and Medium Enterprise Business Sector" which details the results of a survey conducted by the Australian Research Council in early 2013 investigating the tax compliance costs of Australian SMEs in the 2012 fiscal year. It contains some useful information regarding where Australian SMEs most feel the burden of tax compliance.

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[1] *Business Tax Working Group – Final Report on the Tax treatment of losses* issued in April 2012 at Chapter 4

[2] Under the foreign currency gains and losses rules contained in Div 775 of the 1997 Act

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours sincerely

Michael Flynn
President

APPENDIX 1 - Transfer pricing and small business

a) **Exempt small businesses from operation of the transfer pricing rules**

Australia's new transfer pricing rules in Subdivisions 815-B and 815-C contained in the *1997* Act together with the associated documentation requirements in Subdivision 284-E of Schedule 1 to TAA 1953 and the penalty rules in Subdivision 284-C of TAA 1953 apply equally to small businesses as they do to large businesses. As such, the compliance burden applies equally to businesses of all sizes, regardless of the size and extent of their cross-border related party transactions. However, the cost associated with complying with these rules (eg adviser fees and internal staff costs) is disproportionately higher for small businesses relative to the (smaller) size of their cross-border transactions and to the potential revenue at risk.

However, other jurisdictions, such as the United Kingdom, have exempted small businesses from their domestic transfer pricing rules and significantly reduced the circumstances in which medium-sized businesses might be subject to those rules. De minimis thresholds per the table below apply based on number of employees, turnover and assets to determine what exemptions and concessions might apply:

	Maximum number of staff	**AND less than one of the following limits:**	
		Annual turnover	Balance sheet total assets
Small Enterprise	50	€10 million	€10 million
Medium Enterprise	250	€50 million	€43 million

The approach taken in the UK seems sensible where the compliance cost is weighed up against the (relatively small) risk to the revenue. Small businesses in particular are unlikely to pose much risk to the revenue and so eliminating a potentially sizeable compliance burden on such businesses provides an economically sensible outcome.

We suggest that a similar approach for small (and medium) businesses be considered. To apply a similar approach in Australia would require a definition of a 'small business'. An appropriate definition of a 'small business' for transfer pricing purposes would be one based on a combination of criteria such as turnover, assets and number of employees similar to that adopted in the United Kingdom. A similar approach, albeit for different purposes, has been taken by the Australian Securities and Investments Commission (**ASIC**) for the purpose of relieving small proprietary companies which are controlled by a foreign company from the requirement to prepare and lodge audited financial accounts[3].

[3] Refer to ASIC Class Order [07/505] (http://www.comlaw.gov.au/Details/F2007L02228) and its accompanying explanatory statement (http://www.comlaw.gov.au/Details/F2007L02228/Explanatory%20Statement/Text) where a proprietary company which does not satisfy at least two of the three criteria is therefore regarded as being small.

By comparison, the small business capital gains tax threshold of $2 million turnover used for purposes of Division 328 of the 1997 Act is not a practical threshold for transfer pricing purposes where entities can have much higher levels of international related party dealings but pose very little risk to the revenue where the pricing of such dealings is not consistent with arm's length pricing.

We would be pleased to provide the Board with more background information about the approach in the United Kingdom if required.

b) Introduce legislated safe harbours to reduce compliance costs for small businesses

From discussions within the ATO's Division 815 Working Group, we are aware that the ATO is currently examining potential administrative practices that could simplify transfer pricing documentation. However, such arrangements provide only limited certainty to taxpayers[4]. A better solution would be to introduce targeted safe harbour measures into the transfer pricing rules that would provide certainty to taxpayers (and to the ATO) where the relevant requirements are met.

Legislated safe harbours could be considered in the following areas:

- Interest rates on related party debt of, for example, less than $20 million; and
- Low value or back office services.

c) Changes to the ATO's International Dealings Schedule

Taxpayers with international related party dealings exceeding $2 million (including loan balances) are required to complete Section A of the ATO's International Dealings Schedule (**IDS**) and lodge it with their annual income tax return. The IDS is primarily a disclosure document to assist the ATO with risk assessment.

A number of simple changes could be made to the IDS which would reduce compliance costs for small businesses:

- Increase the $2 million threshold referred to in Question 2 of Section A of the ATO's IDS to $10 million; and
- Introduce a threshold (preferably also $10 million) for purposes of Question 18 (Branch operations) of Section A of the IDS.

We emphasise that the above changes would only require changes to the IDS form itself rather than any changes to the ATO's IT systems and therefore could be implemented quickly and simply.

Section A of the IDS contains 17 questions, many with multiple sub-questions and multiple sub-parts. Information is required about the type of international related party

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[4] See for example, *Macquarie Bank Limited v Commissioner of Taxation* [2013] FCAFC 119

dealing, the quantum of such dealings, the countries in which the counterparties were located, the main transfer pricing methodology used and the extent to which transfer pricing documentation has been maintained to show that the pricing of such dealings have been undertaken on an arm's length basis. The level of detail required to be disclosed by small businesses in Section A of the IDS is disproportionate to the potential revenue at risk.

In this regard, The Tax Institute recommends that the $2 million threshold referred to in Question 2 of Section A of the ATO's IDS be increased to $10 million.

Question 18 (Branch operations) currently contains no de minimis threshold. Consequently small businesses with just $1 of intra-entity dealings with foreign branches are required to complete Question 18. The absurdity of the current situation can be illustrated by an example. A number of small businesses operate New Zealand branches. If they had conducted their New Zealand operations through a subsidiary rather than a branch, and their international related party dealings were in aggregate less than $2 million, they would not be required to complete Section A of the IDS.

Therefore, The Tax Institute recommends that a threshold (preferably also $10 million) be introduced for purposes of Question 18 (Branch operations) of Section A of the IDS[5].

[5] A number of matters relating to the IDS were raised with the ATO in January 2014 during consultation on the IDS, however, we understand the ATO does not intend to modify the 2014 IDS.

APPENDIX 2 - Interaction between transfer pricing rules and thin capitalisation rules

a) **Address unintended consequences associated with the proposed increase in the de minimis threshold from $250,000 to $2 million for thin capitalisation purposes**

The proposed increase in the de minimis threshold for purposes of the thin capitalisation rules from $250,000 to $2 million will be welcome relief from the compliance costs incurred in applying the thin capitalisation tests for the many small to medium enterprises that have already expanded overseas or are planning to do so. However, the proposed increase in the de minimis threshold will have unintended consequences for a number of small businesses by increasing, rather than decreasing, the amount of tax they will be required to pay. It

The Tax Institute supports in principle the proposed increase in the *de minimis* threshold, however, the proposed increase in its current form will leave some small businesses worse off.

This is because the increase in the de minimis threshold will not preclude the potential application of the new transfer pricing rules in Subdivision 815-B of the 1997 Act to small and medium enterprises in relation to whether their capital structures are consistent with arm's length conditions. Rather, the increase in the de minimis threshold could actually result in some small and medium enterprises being in a worse tax position.

The protection offered from the transfer pricing provisions in relation to the deductibility of certain interest costs is only available where the thin capitalisation rules apply to that taxpayer (section 815-140). As a consequence, all taxpayers that will no longer be subject to the thin capitalisation rules as a result of the increase in the de minimis threshold will now be exposed to the potential application of the new transfer pricing rules in Subdivision 815-B in relation to whether their capital structures are consistent with arm's length conditions (see further below).

To demonstrate, take an entity which has debt deductions which exceed $250,000 and are below $2 million and the entity is subject to the thin capitalisation rules (with interest payable at an arm's length rate). Under the current rules, in the absence of section 815-140, the arm's length conditions (eg an arm's length capital structure of 1:1) are deemed to replace the actual conditions (eg a capital structure geared at 3:1). Consequently, either the ATO or the entity on a self-assessment basis could re-characterise a portion of the debt as equity and the interest paid on the re-characterised portion of the debt would be disallowed.

However, by operation of section 815-140 − which allows taxpayers to gear up to the thin capitalisation safe harbour limits notwithstanding a different gearing outcome arises under the transfer pricing rules − as the entity is within the thin capitalisation safe harbour limits and has paid an arm's length rate of interest on its related party debt*, the transfer pricing rules would not apply to disallow any interest expense.*

However, should the $2 million de minimis threshold apply, the entity would no longer be subject to the thin capitalisation rules and therefore could no longer rely on the protection afforded by section 815-140.

Consequently, *the transfer pricing rules would apply to disallow some portion of its interest deduction*. The entity is therefore worse off than it was before the de minimis threshold was increased. In our view, such an outcome could not have been intended by the government. We recommend the Board consider taking the opportunity to address this concern in the context of this review.

In addition, small to medium enterprises that become exempt from the thin capitalisation provisions as a consequence of the increase in the de minimis threshold will now be required to incur high compliance costs of preparing transfer pricing documentation to show that their capital structures are consistent with arm's length conditions for purposes of the transfer pricing rules.

b) **The transfer pricing rules should be amended so that a taxpayer's actual gearing, provided it is less than the thin capitalisation safe harbour gearing limits, is used to determine arm's length interest rates**

As outlined above, the transfer pricing rules apply independently of the thin capitalisation rules, but subject to section 815-140. This creates an unnecessary compliance burden, particularly for small businesses, as they need to have regard to, and to document, arm's length conditions relating to their capital structure for purposes of the transfer pricing rules in order to subsequently show that the pricing of any related party debt is arm's length. This is notwithstanding that the thin capitalisation safe harbour rules allow taxpayers to gear up to certain specified limits.

The Tax Institute recommends that the transfer pricing rules be amended to ensure that where a taxpayer's gearing ratio falls within the safe harbour limits in the thin capitalisation rules, a taxpayer's debt deductions are priced for purposes of the transfer pricing rules on the basis of the taxpayer's actual gearing ratio and not by reference to a notional arm's length capital structure.