



Australian Government

The Board of Taxation

REVIEW OF TAX IMPEDIMENTS FACING SMALL BUSINESS

A Report to the Government

the **board** of **taxation**
www.taxboard.gov.au

The Board of Taxation
August 2014

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FOREWORD

The Board of Taxation is pleased to submit this report to the Acting Assistant Treasurer, the Minister for Small Business, and the Parliamentary Secretary to the Treasurer following its review of tax impediments to small business.

The Board appointed a Working Group of its members chaired by John Emerson AM, and comprising Teresa Dyson and Curt Rendall. The Board encouraged broad participation in the review, by writing directly to stakeholder groups and by holding preliminary consultation meetings with 48 stakeholder groups. It received 43 written submissions.

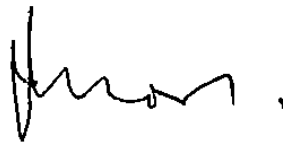
The Board would like to thank all of those who contributed to its consultation process.

The Board would also like to extend its gratitude for the assistance provided to the Working Group by the members of its Expert Panel, and by officials from the Treasury and the Australian Taxation Office.

The *ex officio* members of the Board – the Secretary to the Treasury, Martin Parkinson PSM, the Commissioner of Taxation, Chris Jordan AO, and the First Parliamentary Counsel, Peter Quiggin PSM – have reserved their final views on the recommendations in this report for advice to Government.



Teresa Dyson
Chair, Board of Taxation



John Emerson AM
Chair of the Board's Working Group
Member, Board of Taxation

GLOSSARY

AB Network	Australian Bookkeepers Network
ABN	Australian Business Number
ABS	Australian Bureau of Statistics
ACCI	Australian Chamber of Commerce and Industry
AFGC	Australian Food and Grocery Council
AFTS	Australia's Future Tax System
AMIF	Australian Motor Industry Federation
ASFA	Association of Superannuation Funds of Australia
ATA	Australian Trucking Association
ATO	Australian Taxation Office
AVCAL	Australian Private Equity & Venture Capital Association Limited
Board	Board of Taxation
BAS	Business Activity Statement
CGT	Capital Gains Tax
CAANZ	Chartered Accountants Australia and New Zealand (formerly the Institute of Chartered Accountants in Australia)
CCIQ	Chamber of Commerce and Industry Queensland
CPA	CPA Australia
DPN	Director Penalty Notice
ESS	Employee Share Schemes
ENYA	Enterprise Network for Young Australians
GDP	Gross Domestic Product
GST	Goods and Services Tax
FBT	Fringe Benefits Tax
ICA	Independent Contractors Australia
IGoT	Inspector-General of Taxation

IPA	Institute of Public Accountants
LCT	Luxury Car Tax
MBA	Master Builders Australia
MRRT	Minerals Resource Rent Tax
NSWBC	New South Wales Business Chamber
NSWSBC	Office of the New South Wales Small Business Commissioner
OTE	ordinary time earnings
PAYG	pay-as-you-go
PSI	Personal Services Income
PwC	PriceWaterhouseCoopers
RAI	Regional Australia Institute
R&CA	Restaurant & Catering Australia
R&D	Research and Development
SBR	Standard Business Reporting
SBAA	Small Business Association of Australia
SME	Small and Medium Enterprises
SG	Superannuation Guarantee
SG Charge	Superannuation Guarantee Charge
SBSCH	Small Business Superannuation Clearing House
STS	Simplified Tax System
TFN	Tax File Number
TPRS	Taxable Payments Reporting System
TTI	The Tax Institute

EXECUTIVE SUMMARY

This report identifies and recommends key reform priorities that aim to reduce tax impediments facing small business. Many of the reforms are also intended to reduce compliance costs and foster an environment in which more people are encouraged to take up business opportunities.

The Board was asked to identify the short and medium-term priorities for small business tax reform with a particular focus on high-priority options for simplification and deregulation. In particular, the Board looked closely at aspects of the tax system that unreasonably impede the goals of a broad cross section of businesses.

The Board has identified a number of compliance initiatives that may be implemented relatively quickly by the Australian Taxation Office (ATO). In this regard, the Board would like to acknowledge the willingness of the ATO to actively engage in the review. The ATO has been proactive by already implementing some recommendations and agreeing to implement others as soon as practicable.

Other issues identified in this review require legislative change or further consideration, perhaps in the context of current or future reviews. Some issues identified will also be further considered by the Board in its Ministerial Advisory Council role in providing advice to the Government on deregulation opportunities in the taxation system.

A list of the Board's recommendations is in Appendix A.

Chapter 8 reports on the Board's conclusions on reform priorities.

CHAPTER 1: INTRODUCTION

Synopsis

This Chapter describes the context of the current review. It includes an outline of:

- the terms of reference;
- the review team; and
- the review process (including consultation).

BACKGROUND

1.1 On 28 March 2014, the Acting Assistant Treasurer, the Minister for Small Business and the Parliamentary Secretary to the Treasurer announced that the Board would conduct a fast-track review to identify features in the tax system that are hindering or preventing small businesses from reaching their commercial goals.

1.2 The Board was asked to report to Government by 31 August 2014.

TERMS OF REFERENCE

1.3 The Terms of Reference for this review required the Board to identify features of the tax system that are unreasonably or unnecessarily hindering or preventing small businesses from pursuing and achieving their commercial goals.

1.4 As part of its report, the Board was asked to provide business and broader community perspectives on issues in the tax system that are of most concern to small businesses, and identify the short and medium-term priorities for small business tax reform in Australia, while noting that frequent change is often cited as a contributing factor to the compliance burden facing small businesses. It was requested that the Board's report should have a particular focus on high-priority options for simplification and deregulation.

1.5 In recognition of the diversity of the small business sector, the Board was asked to ensure that, as much as possible, its report focussed on aspects of the tax system that unreasonably impede the goals of a broad cross section of businesses, with a particular emphasis on impediments to small businesses growing into medium and large businesses. The Board was not constrained to use any specific definition of small business.

1.6 To facilitate the production of this fast-track review, the Board was asked to utilise its links with tax professionals and conduct targeted consultation with key business groups, and to work closely with the Treasury and the ATO.

1.7 As reference for this review, the Board was asked to utilise and build upon the conclusions of its scoping study of small business tax compliance costs, which was completed in December 2007.

REVIEW PROCESSES

Review team

1.8 The Board appointed a Working Group of its members chaired by John Emerson AM, and also comprising Teresa Dyson and Curt Rendall.

1.9 The Working Group was assisted by an Expert Panel comprising Matthew Addison (Executive Director, Institute of Certified Bookkeepers), Stephen Baxter (Director, Indirectax.net Pty Ltd), Michael Caruthers (Director, Hayes Knight (NSW) Pty Ltd), Michael Parker (Partner, Hall and Wilcox Lawyers), Robert Powell (Partner, Grant Thornton Australia), and Shannon Smit (Director, SMART Business Solutions).

1.10 The Expert Panel comprised taxation professionals who agreed to voluntarily contribute their knowledge and expertise in assisting the Board with the review. Panel members are appointed on the basis of their individual capabilities and expertise, and not as representatives of particular interests or organisations.

Consultation

1.11 The Board's consultation process has involved:

- encouraging broad participation by publicising the review on its website and by a targeted mail-out to over 90 stakeholders;
- preliminary face-to-face consultations before the due date for submissions, with over 48 stakeholder organisations out of the 56 invited; and
- targeted consultations to explore specific issues raised by stakeholders in written submissions.

Submissions

1.12 The Board received 43 written submissions, two of which were confidential. A list of individuals and organisations that made public submissions is included at Appendix B. Public submissions can be accessed from the Board's website.

1.13 The Board recognises the significant contribution made by stakeholders in making submissions. The Board considered all submissions, however, consistent with

the Terms of Reference asking the Board to identify issues impacting on a broad cross section of businesses, not all issues raised are addressed in the report.

Board's report

1.14 The Board has considered the issues raised by stakeholders in their submissions and at the consultation meetings, and the views of the members of the Expert Panel, Treasury officials and the ATO. However, the Board's recommendations and observations reflect its independent judgment.

1.15 While many of the impediments raised by stakeholders clearly fell within the scope of the Terms of Reference, some issues were not clearly within its scope. In these circumstances, the Board assessed whether in all of the circumstances, the issue was one that had a particular relevance to small businesses, even though it may also have wider application.

1.16 The Board has identified a number of complex reform issues unlikely to be resolved in the short or medium term and issues that are the subject of other current or foreshadowed reviews. These issues are discussed in Chapter 6, which focusses on capital gains tax (CGT) issues, and Chapter 7, which deals with broader tax issues. Many of the issues identified in these chapters are outside the scope of this review.

Further review

1.17 Having regard to the importance of small businesses in the economy and the complexities of tax legislation and compliance matters, the Board recommends a further and more detailed review of the tax impediments facing small businesses be carried out in the next few years, perhaps after the implementation of relevant outcomes from the White Paper on the Reform of Australia's Tax System.

CHAPTER 2: THE SMALL BUSINESS TAX LANDSCAPE

Synopsis

This Chapter provides an overview of the small business tax landscape and outlines:

- The role of small business in the Australian economy.
- A statistical profile of the small business sector.
- The history of small business tax concessions in Australia.
- Current policy settings.

SMALL BUSINESS IN THE AUSTRALIAN ECONOMY

2.1 Small businesses play a significant role in the Australian economy, particularly as a major employer and contributor of national Gross Domestic Product (GDP). According to the Australian Bureau of Statistics (ABS) data, small business accounted for around 43 per cent of non-financial private sector employment and produced around 33 per cent of non-financial private sector output in 2012-13.¹ Small businesses are represented across all sectors of the economy, including in construction, professional services and agriculture.

2.2 The contribution by small businesses within each sector varies. For example, small businesses account for around 80 per cent of output and employ around 80 per cent of people in agriculture. On the other hand, small businesses account for only eight per cent of output and 12 per cent of employment in mining.²

2.3 The contribution of small businesses to productivity and economic growth is well recognised. Small businesses can exhibit greater flexibility and responsiveness to changing markets than large businesses. Small businesses can also be highly innovative and dynamic, tapping into niche markets, responding to changing consumer preferences and contributing to the development and diffusion of new technologies.

2.4 However, small businesses can also face significant impediments to participation in economic markets, due to high barriers to entry and exit and difficulties in obtaining

1 ABS Cat. No. 8155.0.

2 ABS Cat. No. 8155.0.

access to finance. Other challenges for small businesses in Australia can arise from high compliance costs and regulatory burden which tend to disproportionately affect small businesses. The time and effort required to comply with tax obligations, in particular, are reported to account for a major portion of small businesses' total compliance costs.³

STATISTICAL PROFILE OF SMALL BUSINESS

2.5 For the purposes of ATO statistics, small businesses are defined as 'active' taxpayers in business with business income in the range of \$0 to \$2 million. Alternatively, the ABS generally defines small businesses as businesses that employ fewer than 20 people. According to ATO statistics, small businesses make up the vast majority of businesses in Australia (around 97.5 per cent), with around 2.7 million identified as small businesses with turnover of \$2 million or less. By contrast, the ATO reports only around 72,000 businesses with turnover between \$2 million and \$5 million.

2.6 The legal structures used by small businesses vary significantly. According to ATO statistics, around 36 per cent of identified small businesses operate as sole traders, around 13 per cent as partnerships, 23 per cent as trusts and 28 per cent as companies. The legal structure of a small business can significantly affect its tax obligations, interactions with the tax system and eligibility for available tax concessions.

2.7 Although small businesses are an important source of employment, small businesses tend to be non-employing, have very few employees or are mainly operated by family members. According to ABS data, around 61 per cent of actively trading small businesses are non-employing, while around 28 per cent of actively trading small businesses have between one and four employees and 10 per cent between 5 and 19 employees.⁴

2.8 In its 2011-12 Tax Statistics publication, the ATO reported that small businesses with turnover of less than \$2 million accounted for around 11 per cent of company income net tax collected in 2011-12, while companies with turnover between \$2 million and \$10 million accounted for around 10 per cent.⁵ The ATO also reported that around 600,000 small businesses with turnover of less than \$2 million paid net tax in 2011-12, which accounts for fewer than half of all such small businesses, noting that the majority are not structured as companies and therefore have different tax obligations.⁶

3 Lignier, P. and Evans, C., 2012, *The rise and rise of tax compliance costs for the small business sector in Australia*, Australian Tax Forum, Canberra.

4 ABS Cat. No. 8165.0.

5 Australian Taxation Office, *Taxation Statistics 2011-12*, <https://www.ato.gov.au>.

6 Australian Taxation Office, *Taxation Statistics 2011-12*, <https://www.ato.gov.au>.

HISTORY OF SMALL BUSINESS CONCESSIONS IN AUSTRALIA

2.9 In 2001, the Government introduced the Simplified Tax System (STS) regime to reduce the tax compliance burden on small businesses. Small businesses that chose to use the STS had access to a range of tax concessions, including a cash accounting regime, simpler depreciation rules and easier trading stock rules.

2.10 In the 2006-07 Federal Budget, the Government announced it would standardise the eligibility criteria for small business tax concessions with effect from 1 July 2007. The concept of an STS taxpayer was replaced by a 'small business entity' definition, being any small business with an annual turnover of up to \$2 million or with a net asset value of up to \$6 million. As a result, small businesses only have to meet the 'small business entity' test to access the available small business concessions (subject to any additional criteria set out in the particular concessions), including the CGT concessions.

CURRENT POLICY SETTINGS

2.11 A small business entity is identified as a special category of taxpayer for the purposes of providing targeted concessions. A number of the key concessions are discussed below.

Income tax

A two year period for amending assessments (exceptions may apply)

2.12 For individuals and small business entities, the time limit for reviewing an assessment is generally two years from when the Commissioner issued a notice of assessment.

Simpler trading stock rules

2.13 Under Subdivision 328-E of the *Income Tax Assessment Act 1997* (ITAA 1997), small business enterprises are not required to value each item of trading stock on hand at the end of the income year, or account for any change in the value of trading stock on hand, if the difference between the value of the trading stock at the start of the income year and the end of that year is less than \$5,000.

Prepayments

2.14 Small business entities may be able to deduct prepaid expenses, where it incurs expenditure for something to be done – in whole or in part – in a later income year.

Simpler depreciation rules

2.15 Under Subdivision 328-D of ITAA 1997 small business entities have access to simplified depreciation rules. Under this subdivision, small businesses may choose to deduct amounts for most of their depreciating assets on a diminishing value basis using a pool that is treated as a single depreciating asset. These were intended to be

compliance cost savings measures, relieving the small business entity of the need to calculate depreciation on each asset.

2.16 The amendment or repeal of a number of small business concession measures is before Parliament. The *Minerals Resource Rent Tax Repeal and Other Measures Bill 2013 [No. 2]* is before parliament at the date of this report. Under the Bill:

- the \$6,500 threshold for depreciating assets, costs incurred in relation to depreciating assets, and low pool values under the small business entity capital allowance rules is to be reduced to \$1,000 (returning it to the level it was prior to the changes made by the *Tax Laws Amendment (Stronger, Fairer, Simpler and Other Measures) Act 2012*); and
- the special rules allowing small business entities to deduct up to \$5,000 for motor vehicles are to be repealed.

The four small business CGT concessions

2.17 There are four small business CGT concessions.

2.18 The **small business retirement exemption**, which allows a CGT exemption for capital gains made on active assets up to a lifetime limit of \$500,000 per individual and the **roll-over exemption**, which allows a deferral of capital gains made on active assets if within two years the proceeds are reinvested in another business asset, were introduced in 1997. The small business retirement exemption acknowledges that owners of small businesses often need to reinvest earnings into their business without being able to contribute to superannuation on a regular basis. It aims to provide a way for small business owners to contribute to their retirement using their accumulated capital gains. The roll-over exemption acknowledges that the tax liability relating to a capital gain reduces the amount of capital available to buy replacement assets and ensures that a lack of capital does not constrain the growth and development of small businesses.

2.19 In response to the 1999 *Review of Business Taxation* (the Ralph Review), the Government streamlined and simplified the existing small business concessions by standardising the eligibility criteria, introducing a **50 per cent active asset reduction**⁷ and allowing small businesses to benefit successively from all of the CGT concessions for any single capital gain. The Government also introduced the **15 year exemption** as an extension to its reforms that would provide a particular benefit to farmers.

2.20 Further changes were made in 2007 to standardise the eligibility criteria for all small business. These changes allowed access to the small business CGT concessions

7 Prior to the introduction of the active asset reduction, small business taxpayers were eligible for a 50 per cent goodwill exemption.

using a turnover test of \$2 million. The net asset test was retained as an alternative test for CGT purposes and increased from \$5 million to \$6 million.

Goods and Services Tax (GST)

Registering for GST

2.21 An entity running a business or enterprise is not required to register for GST if its current or projected GST turnover is less than \$75,000.⁸

The choice to account for GST on a cash basis

2.22 Under section 29-40 of *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act) a small business entity can elect to account for their GST on a cash basis. This has cash flow benefits to the business, as it allows remittance of GST to be effectively delayed until the customer pays the business.

The choice to pay GST by instalments

2.23 Under section 162-5 of the GST Act, an entity may elect to pay GST by instalments if, amongst other things, its annual turnover is \$2 million or less and it is not in a net refund position. Broadly, an entity will be in a net refund position if the sum of its net amounts (essentially GST less input tax credits) for a number of recent tax periods is less than zero (subsection 162-5(3)).

2.24 The intention of the measure is to ensure small businesses or non-profit bodies in a net refund position can access the benefits that the GST instalment option provides. These benefits include the fact that GST liability only needs to be calculated once a year (at the time of lodging an annual GST return) and the number of Business Activity Statements (BAS) that need to be lodged per year may reduce.

Annually apportioning GST credits

2.25 Under section 131-5 of the GST Act, small business entities can elect annual apportionment. Generally, this option allows taxpayers to claim a full input tax credit for a business purchase that they intend to use partly for private purposes. Broadly, these taxpayers will then be able to make an adjustment in a BAS that is due around the same time as their income tax return to account for the private portion of their purchase.

PAYG instalments based on gross domestic product-adjusted notional tax

2.26 Small business entities that are full self-assessment taxpayers (typically companies and superannuation funds) will be eligible for the GDP-adjusted notional tax method⁹ for calculating instalment liabilities from the 2009-10 income year.¹⁰ The

8 Current GST turnover is defined as turnover for the current month and the previous 11 months. Projected GST turnover is defined as turnover for the current month and the next 11 months.

9 That is, adjustments to instalment amounts to reflect expected changes in the economy.

purpose of this rule is to remove many taxpayers from the requirement to calculate their instalment income for the instalment quarter themselves, so as to reduce their compliance costs.

Simplified accounting for food retailers

2.27 The ATO has introduced a simplified accounting method for GST purposes available to retailers that sell taxable and GST-free food and whose turnover is not more than \$2 million. A qualifying business may, depending on its circumstances, have access to a choice of up to five simplified accounting methods.

Concessions if turnover less than \$20 million

2.28 Certain GST concessions are extended to entities with a turnover of less than \$20 million. These concessions are available, but not confined to small businesses. For these entities, the adoption of monthly tax periods is optional and electronic lodgement is not compulsory.

Fringe Benefits Tax (FBT)

The FBT car-parking concession

2.29 Under section 58GA of the *Fringe Benefits Tax Assessment Act*, an employer is exempt from FBT in respect of car parking if it is a small business entity, or if it has income of less than \$10 million.

10 Paragraph 45-130(1)(d) of Schedule 1 to the *Tax Administration Act 1953*.

CHAPTER 3: THE BOARD OF TAXATION'S 2007 SCOPING STUDY OF SMALL BUSINESS COMPLIANCE COSTS

Synopsis

This Chapter discusses:

- the Board's findings in its 2007 'Scoping study of small business tax compliance costs'; and
- tax reform processes conducted since 2007, as they relate to the small business sector.

OVERVIEW

3.1 In December 2007, the Board delivered to the then Government its 'Scoping study of small business tax compliance costs' (the '2007 study').¹¹

3.2 The 2007 study stemmed from the then Government's commitment 'to reducing the regulatory burden on businesses'. As part of this commitment, the then Treasurer asked the Board to 'undertake a scoping study of tax compliance costs facing the small business sector and identify the more important areas where compliance costs might be reduced'.

3.3 The 2007 study was, 'a qualitative, rather than quantitative, study, based on discussions with small business owners, tax agents, industry representatives and government agencies, and an examination of government and academic research'.

3.4 The Board noted that '[a]s there are a range of factors that affect the compliance costs of small businesses, there are no simple, ready-made solutions that will easily alleviate their tax compliance concerns'. It also emphasised the importance of carefully managing change, noting that change can, itself, increase compliance costs.¹²

11 Board of Taxation, Scoping study of small business tax compliance costs: A report to the Treasurer (December 2007).

12 *Ibid*, 1.

The Board's findings

3.5 The Board's 31 findings are replicated in full, in Appendix C. In summary, the main findings addressed the following items:

Findings 1-2	Small businesses account for the vast majority of Australian businesses and are very important to the Australian economy, producing 39 per cent of Australia's industry value added and employing almost half the non-agricultural workforce.
Findings 4-6	Compliance costs are regressive, and are not just financial. Government initiatives try to reduce them for small business.
Findings 3, 9-16	The small business sector is extremely diverse and compliance costs vary based on a range of factors including: size, turnover, the business structure, staffing levels, the industry sector, the skills and expertise of the proprietors, and accounting systems in place.
Findings 7, 8	Taxpayers can overestimate tax compliance costs by confusing them with essential functions of running a business. The discipline tax compliance brings can help business owners better understand the business and manage cash flow.
Findings 17-23	Increased compliance costs are attributable to a range of factors including inconsistent or different legal rules, operating across different jurisdictional legal systems, use of the tax system by governments to achieve social and other broader policy objectives, concessions and thresholds, and changes to the tax law.
Finding 24	The complexity of the tax system and recruitment difficulties are placing significant pressure on the tax agent industry.
Findings 25-26	Consultation with small business is important to the design of tax policy, legislation, administrative systems and supporting materials. Education of taxpayers and tax agents can also help reduce compliance costs.
Findings 28-31	Complying with CGT, FBT, BAS requirements and managing intergenerational transfers of business assets present particular complexity.
Finding 27	Otherwise, '[t]here is no single, precise aspect of the tax system driving the tax compliance concerns perceived by small businesses. Rather, changes to, and the accumulation of, regulation at all levels of government appear to be the problem.'

DEVELOPMENTS SINCE 2007

Government response

3.6 In releasing the Board's report on 12 November 2008, the then-Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, Chris Bowen, gave the then Government's response to it:

The study, although not identifying specific measures that would lead to a large reduction in compliance costs, will make a valuable contribution to the Government's deregulation agenda ... I have also asked that the report's findings be considered in the context of the comprehensive review of Australia's tax system (Australia's Future Tax System Review).

Australia's Future Tax System Review

3.7 Five recommendations made by the AFTS review were intended to 'result in significant simplification for small businesses'. Those recommendations and their implementation outcomes are set out in full in Appendix D.

3.8 The recommendations were, in summary, as follows, together with the Government's response or other outcome:

<p>Recommendation 17: CGT</p>	<p>The current small business CGT concessions should be reduced from four to two, with the removal of the active asset 50 per cent reduction and 15-year exemption concessions.</p> <p>Increase the lifetime limit of the retirement exemption by permanently aligning it with the CGT cap for contributions to a superannuation fund.</p> <p>Taxpayers who sell shares or trust units should be able to access the concessions.</p> <p>The CGT legislation should be rewritten in principles-based drafting rather than black-letter law.</p> <p>Grandfathering provisions for assets acquired before the commencement of the CGT regime, should be removed.</p> <p>Not adopted by government.</p>
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<p>Recommendation 29: Capital allowances</p>	<p>Depreciating assets costing less than \$10,000 should be allowed to be immediately written off. All other depreciating assets (except buildings) should be allowed to be pooled, with the value of the pool depreciated at a single rate.</p> <p>Enacted with modification: \$6,500 instant asset write-off from the 2012-13 financial year. Pooling at 30 per cent depreciation rate.¹³</p>
<p>Recommendation 30: Small business definition for tax purposes</p>	<p>The small business entity turnover threshold should be increased from \$2 million to \$5 million. Adjustments to the \$6 million net asset value test should be considered.</p> <p>Not adopted by government.</p>
<p>Recommendation 127: Practical government assistance to small business</p>	<p>The government should assist small businesses to be 'business ready', through education and financial assistance including Standard Business Reporting (SBR).</p> <p>SBR has been available for business use since mid-2010. A range of administrative mechanisms are in place to support business adoption of SBR.</p>
<p>Recommendation 128: Common information standards</p>	<p>The common information standards developed for SBR should be developed and adopted to support system interoperability between tax and transfer agencies, and between those agencies and third parties, such as employers.</p> <p>The SBR Program is working on multiple fronts toward this goal, as detailed in Appendix D.</p>

¹³ The proposed repeal of this measure is discussed above at paragraph 2.16.

CHAPTER 4: IMPROVING INTERACTIONS BETWEEN SMALL BUSINESS AND THE ATO

Key Points

This Chapter considers the following stakeholder concerns relating to interactions with the ATO:

- The ability of new start-ups to obtain an Australian Business Number.
- The use of the ATO's employee/contractor decision making tool.
- The treatment of taxpayers under the Personal Services Income rules.
- Activity statements.
- The operation of the Taxable Payments Reporting System.
- The operation of the Director Penalty Regime.
- The use of the ATO's benchmarking data.
- Access by small businesses to ATO rulings and advice.
- Availability of resources and support to small businesses.
- Opportunities to streamline and simplify the income tax return for small businesses.
- Opportunities to reduce the transfer pricing compliance burden for small businesses.

INTRODUCTION

4.1 As Australia's tax system largely operates on a self-assessment basis, taxpayers shoulder the primary responsibility of correctly applying the law to their circumstances. The ATO plays a key role in educating taxpayers about their tax affairs and provides taxpayers with a range of guidance material as well as binding and non-binding advice.

4.2 The ATO's education, guidance and advisory role allows the ATO to respond to some stakeholder concerns through its own administrative practices. In particular, updating information to taxpayers, improving the transparency of processes and

consulting affected taxpayers to improve the usability of tools to assist small business decision making. This chapter discusses issues raised in submissions where the ATO is able to respond to, and in some cases is already responding to, concerns raised.

4.3 This chapter also discusses issues that would require legislative amendments to address stakeholder concerns.

SPECIFIC ISSUES RAISED IN SUBMISSIONS

Australian Business Number

4.4 The Australian Business Number (ABN) was introduced in 1999 to allow businesses to identify themselves reliably for the purpose of taxation laws and other dealings with government. The ABN is also intended to improve the integrity of the taxation system, complementing other reporting systems such as pay-as-you-go (PAYG) and providing a record of entities that carry on business-like activities.

4.5 The Commissioner of Taxation is the Registrar of the Australian Business Register (ABR). This is a responsibility separate to the Commissioner's duties in relation to taxation and superannuation.

4.6 Entitlement to be registered for an ABN is not restricted to entities carrying on an enterprise. Some entities such as companies, superannuation funds and government bodies are automatically entitled to an ABN. For other entities the entry threshold is the enterprise test. An 'enterprise' is legislatively defined as various types of 'activity, or series of activities', including business activities.¹⁴

4.7 The ABN is also the public registration number for GST purposes. An entity that supplies goods or services must provide an ABN when issuing a tax invoice; otherwise tax is required to be withheld from payments at the top rate of tax.

4.8 The ATO has published guidance on the meaning of 'carrying on an enterprise' for the purposes of entitlement to an ABN to include doing anything in the course of the commencement or termination of the enterprise.¹⁵ The Commissioner interprets this definition by describing the kind of activities undertaken, without consideration given to the outcomes of those activities.

4.9 The term 'activity, or series or activities', which is central to the definition of enterprise, is not legislatively defined. In its guidance, the ATO states that 'if the activities have the character of those ordinarily undertaken to commence an enterprise they will be accepted as falling within the statutory definition'.¹⁶ Accordingly, this

14 Section 9-20 of the GST Act.

15 Miscellaneous Taxation Ruling MT 2006/1.

16 Paragraph 124 of MT 2006/1.

'leads to a broad range of preliminary activities being accepted as an enterprise'.¹⁷ However, for many small businesses, the prescriptive interpretation of what constitutes an activity, or a series of activities, for the purpose of commencing an enterprise may pose problems for ABN registration. For example, many small businesses, particularly sole traders, do not need to, nor have the capacity to, undertake feasibility studies or develop business plans which are examples of activities listed in the ATO guidance material to establish the intention of intending to carry on an enterprise.

Views of Stakeholders

4.10 The main submission which addressed the administration of the ABR and the ABN registration process was from Independent Contractors Australia (ICA). ICA expressed concern with the current operation of the employee/contractor decision tool and implications for ABN registration. The employee/contractor decision tool is examined later in this Chapter.

4.11 Other stakeholders focused on the difficulty in establishing when an applicant for an ABN is intending to carry on an enterprise. Typically, this issue will arise for an individual wishing to carry on an enterprise as a sole trader but who is unable to provide evidence that he or she is carrying on an enterprise. Stakeholders also expressed frustration at the time taken to process an ABN application, often when the applicant has had a previous ABN cancelled by the ATO, and the lack of transparency around the registration process.

4.12 Another issue raised with the Board is the requirement that a business must validate ABN registration and GST registration status of a supplier before they are entitled to claim a GST input tax credit. However, it was submitted that technically, the results from an ABN check on the ABR (through the ABN Lookup tool¹⁸) are unable to be relied on in view of the disclaimer to that effect on the site, including its recommendation that users of the site should consider verifying any information on the site with other sources. As a result, it was submitted to the Board this removes certainty and creates unnecessary work for small businesses. It was suggested to the Board that businesses should be able to rely on the results of a search on the ABR.

ATO comments

4.13 The Commissioner, in his statutory role as Registrar of the ABR, is actively working to assist small businesses to obtain an ABN by ensuring that they are able to correctly complete the application at the time of registration. A new ABR website was released in early December 2013 to facilitate better interactions with users. Other measures, also introduced in December 2013, provide for a more streamlined and

¹⁷ *Ibid*, paragraph 124.

¹⁸ See <http://abr.business.gov.au/>.

intuitive user experience, including the use of 'drop-down' menus to more accurately capture client details and business activity.

4.14 Other work is underway to improve the operation and integrity of the ABR, while also promoting online interactions with the Government. Under the Reducing Business Costs project, expected to be delivered in December 2014, it will be easier for users to self-assess their entitlement to an ABN, while also making it easier to obtain an ABN by assisting the applicant to get the information right at the time of the interactive on-line registration process. The new functions include improving the validation of details, such as the identity information, and enabling users to save the application and return to complete it at a later time, if they do not have the required details at hand. This provision of certainty at the time of registration will reduce the number of applications referred for manual verification, which can take up to four weeks.

4.15 The focus on genuine (and ongoing) entitlement to an ABN is underpinned by the need to maintain the integrity of the ABR. The ABR is relied upon for various purposes, including use by the community and other businesses to verify the identity of entities they are dealing with.

4.16 The ABN Lookup tool currently provides a disclaimer that states that:

neither the Registrar of the ABR nor the Federal Government guarantee that the information available through this service (including search results) is accurate, up to date or complete. This is because the official ABR is based on information supplied by businesses to the Registrar of the ABR. That information may have changed since it was supplied by the business and was included in the ABR, despite requirements on entities to formally notify the Registrar of any changes.

4.17 Given the feedback received from stakeholders as part of the Board's review, the Commissioner is committed to reviewing the disclaimer with respect to the ATO's operations to see whether there is scope to provide more certainty (from an ATO perspective) for small businesses who use the ABN Lookup tool for tax purposes.

Board's Observations

4.18 The difficulty for some small businesses in obtaining an ABN can be a barrier for small businesses when they are most vulnerable in the start-up phase. This can have significant ramifications such as not being able to obtain a business name, being ineligible to obtain business inputs at wholesale prices and being unable to claim input tax credits.

4.19 There may also be issues with individuals seeking an ABN where their prospective 'employer' advises them that they will not be able to work unless they obtain an ABN.

4.20 The Board acknowledges the function of the ABR and the ABN in maintaining the integrity of the tax system. For small businesses wanting an ABN, however, the

concern is that the current interpretation of 'carrying on' an enterprise is too focused on preventing isolated examples of misconduct, rather than encouraging new business registration.

4.21 The Government's small business policy agenda includes reducing red tape, improving the business operating environment, and increasing the quality and effectiveness of Government engagement with small business. This is designed to increase the number of small business start-ups, encourage entrepreneurial behaviour, drive economic growth, as well as improve productivity and competitiveness.

4.22 In this context, the Board considers that there may be opportunities to relax the ABN registration process requirements for individuals and partnerships wishing to start a business. In addition, the inability of a business to rely on results of a search of the ABR imposes, in the Board's view, an unreasonable impediment to small businesses.

Recommendation 4.1

The Board recommends that:

- The ATO revise Miscellaneous Taxation Ruling MT 2006/1 and other guidance material to include activities which will evidence that an applicant is *intending* to carry on an enterprise and is therefore eligible for an ABN.
 - The additional activities should be typical of the kinds of things, from a practical perspective, a person may do prior to actually carrying on an enterprise but are not currently within the guidance material.
 - Further, the activities should be able to be selected from a list as part of the ABN application process.
 - Specifically, the Board recommends the online ABN application tool ask whether the applicant intends to carry on an enterprise, followed by a 'drop down' menu with the extended list of activities that confirm an applicant's eligibility for an ABN.

Recommendation 4.2

The Board also recommends that the ATO provide a 'hotline' so that where an application has not issued in circumstances where it is important to the applicant it be issued urgently, or is rejected, there is access to the ATO for assistance.

4.23 The Board endorses the ATO's approach to reviewing the disclaimer on the ABN Lookup tool so that users of the tool acting in good faith can rely on the result of an ABR search to evidence the validity of an ABN.

Employee/contractor decision tool

4.24 There is a long standing difficulty in drawing a distinction between employees and contractors for tax and superannuation purposes, which has become more of a practical issue as remuneration and business structure arrangements have become more complex. The distinction is important as it determines employers' obligations in relation to PAYG withholding tax and SG payments. The distinction between employees and contractors is also important for non-income tax purposes such as worker's compensation, payroll tax, unfair dismissal laws and entitlements to annual leave and long service leave.

4.25 The ATO has produced an online employee/contractor decision tool¹⁹ that businesses can use to assist them to work out whether a particular arrangement is employment or contracting. The ATO also hosts an employee or contractor home page²⁰ that contains additional information about the distinction between employees and contractors, including illustrative examples and explanations of common myths and misunderstandings. It is important to note that the ATO employee/contractor decision tool is not intended to be applicable to non-income tax obligations, although the Board understands it is relied on for some other purposes.

4.26 A number of stakeholders raised concerns with the operation of the online decision tool.

Views of Stakeholders

4.27 The Australian Bookkeepers Network (AB Network) raised concerns including that 'at present the tool can in some cases provide anomalous outcomes and appears to have a slight bias towards classifying workers as employees for superannuation purposes'.

4.28 A number of stakeholders suggested that the tool be re-designed in consultation with users. Alternatively, ICA submitted that 'the ATO's contractor vs employee decision making tool should be closed down'.

4.29 Two specific shortcomings with the operation of the current tool were raised with the Board. First, where a person is working through an interposed entity (company or trust) the tool automatically determines that the person is not an employee. However, what would otherwise be an individual's salary and wages, will

19 See www.ato.gov.au/EmployeeContractor.

20 See www.ato.gov.au/employeeContractorEssentials.

continue to have that character despite a direction to pay the amount to another person or entity. As a result, in these circumstances, the tool does not necessarily provide an employer with certainty as to its obligations.

4.30 The second shortcoming raised with the Board reflects the different definition of 'employee' for PAYG withholding and for SG purposes. The AB Network stated that this can mean that 'at present, a worker can be classified as a contractor; with the employer having no PAYG obligations but nonetheless being liable for superannuation.' It is noted that the ATO has issued guidance on who is an 'employee' for SG purposes and this could perhaps be incorporated into the tool to provide more certainty for employers in respect of their SG obligations.

ATO comments

4.31 The tool was developed nearly 10 years ago, with extensive industry consultation over an 18 month period. The tool was intended to provide taxpayers with a means of working out if their working arrangement is one of employment or contracting for PAYG withholding purposes through the use of a simple questionnaire style interaction. Before this tool was introduced, businesses had to refer to lengthy rulings for guidance.

4.32 The tool provides a decision that businesses can rely on without risk of penalties, in respect of PAYG obligations, where the tool is used in good faith. It is also important to note that where a taxpayer disagrees with the outcome that the tool provides they can request a ruling from the ATO.

4.33 In the last 12 months the ATO has updated the tool to include further examples and additional explanations. One aspect of this is to ensure the tool is suitable across different industries such as the building and Information Technology industries.

4.34 In response to stakeholders' submissions to this review, the ATO will further review and reposition the tool by updating/expanding information and to include examples in accordance with priorities identified by stakeholders to make the tool more user-friendly and contemporary.

4.35 The ATO will canvass users of the tool to identify particular areas of concern and business practices that they consider the tool does not cover. The ATO is planning a number of consultations with associations, and will use these to obtain feedback. Once changes have been made the ATO will re-launch the tool in line with its communication strategy (Business Communication Strategy 2014-15 – compliance with contracting arrangements).

Recommendation 4.3

The Board recognises the complexities faced by some small businesses in deciding whether an employment or contracting relationship exists in particular circumstances. The Board endorses the ATO review of the tool and commends the ATO for its responsiveness to the stakeholder concerns

The Board recommends, as part of the ATO's review of the operation of the tool:

- it considers how the tool could better reflect or provide guidance in circumstances where a person is working through an interposed entity (company or trust); and
- it considers incorporating into the tool its guidance on who is an 'employee' for SG purposes to provide more certainty for employers in respect of their SG obligations.

The Personal Services Income rules

4.36 The alienation of Personal Services Income (PSI) rules were introduced on 1 July 2000, following a recommendation of the Ralph Review. The PSI provisions seek to prevent individuals from reducing their tax liabilities by diverting (or 'alienating') their personal services income through an entity, such as a company, partnership or trust, or through payments to associates, such as a family member. The rules also seek to prevent claiming of business deductions and the deferral of tax where employees providing similar services would not be eligible to do so.

4.37 For tax purposes, PSI is identified as a reward, rather than business income, that is earned by an individual for personal efforts or skills. Examples of PSI include salary or wages, income payable under a contract which is wholly or principally for the labour or services of a person, and income derived from consultants from the provision of personal expertise.

4.38 The PSI provisions are not intended to affect individuals or entities operating a genuine personal services business. The relevant legislation sets out a number of tests under which an individual or entity can assess whether they are a personal services business for the purpose of the provisions. The applicable tests are the results test, unrelated clients test, employment test and business premises test. If an individual or entity satisfies at least one of the tests, then it is deemed to be a personal services business and its income is not subject to the PSI rules.

4.39 In 2009, the Board of Taxation undertook a comprehensive post-implementation review of the PSI regime. In its report, the Board found that the introduction of the PSI rules had improved integrity and equity in the tax system to a certain extent. However, the Board identified difficulties in applying the rules, along with a limited level of compliance activity by the ATO. The then Government referred the Board's report to the AFTS Review, which recommended consideration of a revised PSI regime

that extends to all entities earning a significant proportion of income from the personal services of their owner-managers. This recommendation has not been implemented.

Views of Stakeholders

4.40 Stakeholder concerns around the PSI regime can be broadly categorised as the complexity, uncertainty and compliance burden associated with the way that the rules operate.

4.41 In its submission, the Chartered Accountants Australia and New Zealand (CAANZ) suggested exploring how the existing tests could be simplified to give clear guidance to small businesses on operating a personal services business. CAANZ also suggests 'improved technology and data matching could facilitate monitoring of compliance with certain tests such as the unrelated client and employment tests'. In its submission, CPA noted that work patterns have evolved considerably since the PSI provisions commenced, raising the need to ensure 'sufficient clarity of the various exemptions has been provided particularly in respect of the unrelated clients test.'

4.42 The Institute of Public Accountants (IPA) supported the policy intent of the PSI regime but noted in its submission that 'the existing framework needs to provide more certainty, ease compliance and reduce complexity'. In its submission to the Board, ICA stated that the PSI rules are workable but could be more clearly explained.

ATO comments

4.43 The ATO has advised the Board that it is not aware of any evidence that suggests that the rules inappropriately apply to bona fide businesses. Businesses that are in doubt can apply for a Personal Services Business Determination to provide certainty that the provisions do not apply.

4.44 To further assist businesses with understanding the provisions the ATO has developed a prototype on-line decision tool. The tool will ask taxpayers a series of questions which will be used in deciding if they are carrying on a personal services business.

4.45 The ATO is also investigating whether, if the questions are answered in good faith and the responses indicate that the taxpayer is carrying on a Personal Services Business, the result from the tool could be considered to be a Personal Services Business Determination upon which the taxpayer will be able to rely. If this is able to be achieved the taxpayer will not be required to lodge a further determination request with the ATO as is currently the case.

4.46 The ATO is looking to consult on the prototype with taxpayers and practitioners in the near future with a view to finalising the system specifications by the end of the 2014 calendar year.

4.47 While the decision tool will reduce compliance costs for taxpayers, the ATO is committed to working with interested parties to develop further solutions that will address regulatory concerns of business.

Board's Observations

4.48 Concerns about the PSI rules appear to be closely linked to broader issues regarding the employee/contractor distinction. While there have always been threshold issues in distinguishing employees and contractors, the proliferation of contractual work arrangements in recent years means that these issues have become more prevalent over time.

4.49 The profile of Australian workers is also evolving more generally, with more 'white-collar' workers adopting forms of contracting and self-employment in many sectors such as management consultancy and financial services. Closely connected to the proliferation of contractors is the growth in the provision of personal services.

4.50 Similarly to employees and contractors, the distinction between an individual operating a personal services business and working in an 'employee-like' capacity is not always clear. The use of multiple self-assessment tests may not always address this ambiguity, creating uncertainty for individuals in assessing their need to comply with the PSI rules.

4.51 In submissions to the Board, stakeholders have suggested that the PSI rules could be simplified to provide more certainty for individuals in undertaking self-assessment. However, the principle of simplicity must be balanced against the need for integrity in the tax system by ensuring that individuals in 'employee-like' situations do not gain tax advantages over other employees.

4.52 Recognising that employment structures and work patterns evolve over time (with contracting and other forms of self-employment becoming increasingly widespread in the Australian workforce), the rules regulating the taxation of such arrangements should also adapt to ensure that it is as simple as possible for individuals to identify the character of their income for tax purposes. Noting the complex nature of the PSI regime, there may be scope to simplify and rationalise the existing tests to deliver greater certainty for individuals undertaking self-assessment.

Recommendation 4.4

The Board commends the steps already undertaken by the ATO to develop a prototype on-line decision tool and recommends that the ATO continues to develop it.

The Board recommends that:

- The tool should go further than just working through the PSI tests; it should where possible incorporate material that clarifies what the result means for the taxpayer.

Recommendation 4.4 (continued)

- Furthermore, where the PSI tool is used in good faith the tool should provide a decision that will provide protection from the imposition of penalties where the user relies on the outcome.

Recommendation 4.5

Stakeholders' comments to the Board suggest that the current ATO guidance material can be disjointed and that any changes to improve understanding should be comprehensive.

As such the Board recommends that, given the uncertainty and complex nature of the PSI rules, that as well as the decision tool the ATO examine ways to better explain the PSI rules and how they apply.

Activity Statements

4.53 Businesses use Activity Statements to report and pay a number of tax obligations, including GST, PAYG instalments, PAYG withholding and FBT. Individuals who need to pay quarterly PAYG instalments use an Instalment Activity Statement.

4.54 The ATO provides a tailored Activity Statement based on the client tax profile or the tax obligations for which they are registered. The tailored Activity Statements are created drawing from over 40 potential labels.

4.55 A total of 21 Activity Statements are currently in use. Small businesses will usually lodge quarterly or annual statements; however, some may choose to lodge monthly particularly if they regularly receive a refund. It is noted that some businesses must lodge quarterly for GST and Instalment reporting but monthly for PAYG withholding. Larger businesses and some others must also report GST monthly.

4.56 Businesses self-assess their own indirect taxes. For tax periods starting on or after 1 July 2012, the ATO takes the information submitted on the Activity Statement as the respective tax assessment under indirect tax laws. The Activity Statement is treated as the notice of assessment, issued on the day it is lodged.

4.57 There is some suggestion that the reporting requirements for the current Activity Statements are overly complex and could be simplified by removing some labels that appear to be unnecessary.

Stakeholder submissions

4.58 The Office of the NSW Small Business Commissioner (NSWSBC) submitted that the BAS is the most time consuming tax compliance requirement for small businesses. It suggested that consideration be given to changing the BAS format, explanatory

materials and frequency (noting that there should be no increase in frequency beyond current quarterly reporting).

4.59 The frequency with which reporting is required was raised by other stakeholders. The AB Network stated that small businesses should be permitted to report and pay GST annually. It submitted that this would reduce the reporting burden and provide a cash flow benefit for businesses in a net GST payment position at year end. It was noted, however, that businesses in a GST net refund position should still be able to report quarterly or monthly if eligible under the current rules.

4.60 The Australian Food and Grocery Council (AFGC) also noted that the requirement to submit a BAS on a quarterly basis presents a cash flow challenge for small businesses as well as a resource cost. It also submitted that 'the requirement to have lodged a BAS within 28 days can be challenging for very small businesses. Options to lodge BAS on a 6 monthly or annual basis ... will help foster the growth of small businesses into medium enterprises.'

Recommendation 4.6

The Board recommends that the ATO, and its relevant advisory groups, review whether the quarterly reporting obligations for small businesses could be significantly simplified including whether at the end of each financial year businesses could complete a combined Income Tax Return and Annual Business Activity Statement based on the same data.

Taxable payments reporting system

4.61 Businesses in the building and construction industry must report the total payments they make to each contractor for building and construction services each year. These payments are reported to the ATO on the taxable payments annual report.

4.62 Taxable payments reporting system (TPRS) aims to improve compliance with tax obligations for contracting businesses. However, an issue raised by Master Builders Australia (MBA) is that the benefits of increased compliance are not sufficient to justify the additional compliance burden on affected businesses. The MBA also argues that the issues that the TPRS was implemented to address would be better treated by using the existing ATO benchmarks and data matching tools.

ATO comments

4.63 In 2011 the previous Government announced the introduction of the TPRS to improve the compliance levels in the building and construction industry. The Government considered a reporting system to be preferable to a reporting and withholding system due to the additional administrative costs that would have been incurred in a withholding system.

4.64 The first full reporting year (that is, 2012–2013) has seen a good response from businesses lodging their annual reports. The quality of the information reported has allowed the ATO to match the great majority of these transactions to contractor entities and the ATO will shortly be in a position to provide a full analysis of the first year.

4.65 Contractors that do not pay other contractors do not need to do anything. Individual contractors are also assisted by having their reported payment information provided to them in the ATO pre-filing service, helping them to complete their tax returns.

4.66 Reporting systems have the added benefit of improving voluntary compliance, as contractors know they are being reported on. This improved compliance allows the ATO to focus its efforts on identifying and dealing with those contractors that continue to fail to comply, through a range of assistance and compliance activities.

4.67 The ATO view is that third party reporting systems, such as taxable payments reporting do provide benefits to taxpayers and encouragement to voluntarily comply and consideration should be given to expanding it more broadly.

4.68 Another issue raised with the Board concerns the different reporting dates under the TPRS (21 July) and the BAS lodgement date (28 August). It was submitted that the TPRS reporting date should be aligned with the BAS reporting date.

Recommendation 4.7

The Board recommends the alignment of the 21 July TPRS reporting date with the 28 August BAS lodgement date to the latter date.

- The Board understands that a later reporting date will have implications for pre-filing income tax returns for contractors in the building and construction industry. However, on balance the Board considers that the reduction in compliance costs for small businesses outweighs the delay in the ATO's ability to pre-fill.
 - It is expected that only taxpayers who want to lodge their tax returns early will be impacted by the inability of the ATO to prefill their returns.
 - In addition, taxpayers who want to lodge early will have their own business records to complete their return.
 - It is also noted that reported payments in respect of taxpayers may not capture all payments a taxpayer has received therefore requiring adjustment to pre-filled data.

Recommendation 4.8

The Board recommends that a full analysis of the effectiveness of this reporting system be undertaken once complete data is available.

Director Penalty Regime

4.69 Under the PAYG withholding regime, employers are required to withhold tax from employee wages, and to remit the tax withheld to the ATO. Employers also have an obligation to comply with the SG regime and remit superannuation on behalf of their employees to the employees' superannuation funds.

4.70 The Director Penalty Regime makes company directors that fail to ensure the company's compliance with its obligation to remit amounts withheld under the PAYG withholding regime or the SG regime personally liable for the amounts that the company should have paid and the applicable penalties.

4.71 In relation to PAYG withholding regime, the penalties under the *Taxation Administration Act 1953* (TAA) apply, as is the case for other tax obligations, including income tax, GST and FBT. However, if a company fails to meet its SG obligations it becomes liable to the SG Charge, interest (10 per cent per annum) and an administration component (\$20 per employee per quarter) by operation of the law.

4.72 The Director Penalty Regime helps ensure that directors are vigilant in ensuring that their company meets its tax and superannuation obligations and deterring them from using amounts withheld on the employees' behalf for the company's or other purposes.

Views of Stakeholders

4.73 Some stakeholders consider that the Director Penalty Regime is detracting from investment in small businesses because of the potential liability it imposes on directors. There was also concern that there was not a mechanism to notify all directors of matters that could result in the issue of a Director Penalty Notice (DPN) within sufficient time to allow rectification of those matters.

4.74 The Small Business Association of Australia (SBAA) states that 'it has become very difficult for small private companies to attract funding because an investor would normally take a position on the Board to protect their investment'. The regime means this is no longer happening. In its view, the Director Penalty Regime 'effectively destroys limited liability so less people are starting businesses'.

4.75 The Australian Chamber of Commerce and Industry (ACCI) was concerned that:

the compliance regime for PAYG and SGC collection may have unintended consequences for company directors not engaged in fraudulent activities. It may also inhibit small business access to finance by dissuading potential equity investors who would normally seek a company directorship as a means of oversight.

4.76 ACCI suggested that the ATO establish an automated process for notifying directors once a PAYG or SG liability becomes overdue by a certain number of days, for example, 60 or 90 days.

ATO comments

4.77 Typically companies meet their tax and superannuation lodgement and payment obligations. However, some fail to do so. In most cases, they work with the ATO to bring their lodgements and payments up to date as quickly as possible. A very small proportion²¹ of companies refuse to work with the ATO requiring, amongst other things, the issuing of DPNs.

4.78 A DPN will be issued by the ATO before commencing proceedings against a director to recover a director penalty liability. A copy of this notice may be sent to a director's registered tax agent depending on the particular circumstances.

4.79 There are safeguards in the Director Penalty Regime for situations involving:

- illness;
- the taking of reasonable steps and other relevant circumstances; and
- different timeframes for new directors.²²

4.80 If a DPN has been issued and subsequently the company enters into an agreed payment arrangement to pay the debt, recovery action against the director would not proceed while the arrangement was in place and being adhered to.

4.81 In relation to stakeholder suggestions that the ATO implement a mechanism to notify all directors of its intention to issue a DPN, the ATO advised the Board that in its view the appropriate response is to improve the timing and visibility of the ATO's administrative approach to DPNs. In addition, tax agents have raised concerns with the ATO that it should correspond with the registered tax agent as the nominated representative of the director rather than directly with the director.

4.82 Where a small business operating as a company has a debt and all attempts to recover that debt as part of the ATO's early engagement strategy have failed, the ATO will send a 'Firmer Action Warning Letter' to the company's primary mailing address advising of the debt and the attempts to contact the company's tax agent or representative. This letter outlines that the ATO intends to take firmer steps to recover the debt, although it is generic across taxpayers. The ATO has proposed to the Board that it is through this letter that it can provide early notice, albeit in a generic manner,

21 In 2013-14, the ATO issued DPNs in relation to about 3,300 companies, representing 0.7 per cent of the companies with PAYG withholding liabilities. In 2013-14, the ATO issued DPNs in relation to about 1,400 companies, representing 2.8 per cent of the companies with SG Charge liabilities.

22 The provisions allow a director 30 days after his or her appointment to take action in respect of the outstanding liability. The ATO considers this appears to provide a suitable mechanism for newly appointed directors to avoid personal liability.

of the impending DPN. At present, information about an impending DPN is not included.

4.83 The ATO advised that it will work with the tax profession through its consultative forum (ATO Tax Practitioner Advisory Group) to modify the content of the 'Firmer Action Warning Letter' and review the content of the DPN. It will also develop an approach to appropriately engaging a director's registered tax agent regarding the Director's Penalty Liability.

Board's Observations

4.84 The Board's view is that the policy intent of the provisions is sound as the amounts are held to discharge the employee's tax liability or the employee's superannuation benefits. Cash flow is a well-established issue for small business operators; however, it is inappropriate for employers to use outstanding tax liabilities or delay payment of employee entitlements as a means of alleviating those cash flow concerns.

4.85 However, the Board considers that there is scope for improving administrative processes to provide greater comfort to directors that they are not going to receive a DPN without warning. The ATO has undertaken to modify the 'Firmer Action Warning Letter' sent to the authorised tax representative of a company to incorporate information about the impending DPN. Further, the notice should make it clear that the authorised representative should be communicating with all the directors to resolve the issues. The Board endorses these proposed changes.

Benchmarking

4.86 Small business benchmarks are financial ratios developed from information provided to the ATO by businesses on their tax returns and activity statements. Benchmarks can be used by a small business to help compare performance against similar businesses in a respective industry.

4.87 Benchmarks are published for more than 100 industries, with multiple turnover range options in each industry to take into account different scales of business activity. Benchmarks are published as a range to recognise variations that occur between businesses due to factors such as location and the businesses circumstances.

Stakeholder submissions

4.88 Some stakeholders noted that benchmarks should not be the sole audit case selection tool. If they are not accurate or reliable this could impose an unreasonable cost on businesses facing audit queries. The Australian Trucking Association (ATA) noted that the ATO benchmarks for motor vehicle/turnover considerably underestimate the vehicle expense that can be incurred by legitimate trucking businesses. This can trigger compliance action on the basis that motor vehicle expenses turnover ratio is outside the ATO's expected benchmarks but within the typical range for an interstate trucking business.

4.89 NSWABC supported implementation of the Inspector-General of Taxation (IGoT) recommendations aimed at 'improving the ATO's risk identification and audit processes to exclude compliant taxpayers from audits, thereby minimising unnecessary compliance costs'.

ATO comments

4.90 The ATO does not use benchmarks as the sole audit case selection tool. It accepts that there may be legitimate reasons for a business to be outside the benchmark range for their industry and publicly advises businesses that complete and accurate records are the best way to ensure that any contact is minimized.

4.91 The ATO risk assessment process for small businesses compares every business against computerized risk assessment models that look at factors such as unrealistic business income. Other stages of the risk assessment process include data-matching, consideration of community information about specific businesses and comparison with benchmarks. Small business benchmarks are not used in isolation as part of the ATO's risk assessment process.

4.92 The small business benchmarks reflect actual data reported by businesses. They are updated each year so they also take into account the economic circumstances prevailing each year for each industry. The IGoT verified that the benchmark ranges for each industry take geographical differences into account²³ and an independent statistical expert reviewed the methodology used by the ATO and found that the small business benchmarks are '... sound and robust' and '... correctly calculated and published'.²⁴ These factors allow businesses to be confident that the benchmarks are accurate and reliable.

Board's Observations

4.93 The Board notes ATO advice that benchmarking is not the sole audit case selection tool and there are other relevant factors that may contribute to the commencement of audit activity such as data-matching and community information about specific businesses.

4.94 The Board considers that individual businesses should be able to use the benchmarking data to get a better indication of how they are performing compared to others in the relevant industry. The Board supports the ATO providing businesses with greater access to benchmarking data.

23 Review into the ATO's use of benchmarking to target the cash economy, Inspector-General of Taxation, July 2012.

24 Cumpston and Sarjeant, Review of Statistical Methodology used in producing Small Business Benchmarks (September 2013).

4.95 The Board notes the *Review into Aspects of the ATO's use of compliance risk assessment tools* released by the IGoT in February 2014. The Board acknowledges that the ATO agreed with all 16 of the IGoT recommendations and is in the process of implementing them. The main themes of the recommendations include, improving community understanding of, and confidence in, the ATO risk approach and how that is communicated, process improvements for risk categorisation, including more guidance for taxpayers and for ATO staff and consulting with the community to explore taxpayer circumstances used in the consideration of risk categorisation.

ATO rulings/advice

4.96 The ATO provides taxpayers with advice and guidance products to help them understand how the tax laws apply to their affairs and meet their obligations. This has been a key strategy in a self-assessment system to encourage people to do the right thing and make it as easy as possible for them to do so.

4.97 Some stakeholders noted that small businesses find it difficult and time consuming to obtain advice or a ruling from the ATO and that the material currently available is difficult to understand and hard to find.

Stakeholder submissions

4.98 One submission (confidential) suggested that the ATO establish a:

small business interpretive unit that can provide binding rulings online to small businesses to reduce often wasteful tax law interpretation time, and to give more readily available certainty in business transacting to small businesses (that must presently comply with often complex laws in the same way as larger businesses).

4.99 The Combined Small Business Alliance of WA (inc.) (stated that there should be improved phone communication and access to the ATO by small businesses.

4.100 The CAANZ suggests establishing a:

portal (or dashboard) model because busy small business owners are unlikely to have the time to regularly visit and read a small business news site on the public ATO website containing generic tax information: they need information specifically targeted to their business and industry.

ATO comments

4.101 The ATO's assistance and rulings processes are evolving. The ATO continues to work with small business and industry to update topics and issues where advice and information is required, and to review its delivery platforms.

4.102 The ATO provides advice on technical matters, through public and private rulings on how the law applies to the particular circumstances of a business. This advice is binding on the ATO and provides the highest level of protection and

reliability for small businesses. The ATO also provides guidance regarding how the law generally applies to help small businesses in a wide variety of circumstances. This information can be provided over the phone or in writing.

4.103 The ATO is reviewing how it can streamline complex advice processes, including private rulings. It is identifying the causes of disputes and the need for private rulings by determining trends and patterns of issues arising from its advice work.

4.104 To help address these causes, the ATO is currently improving how they communicate their view to the community. This includes:

- increased use of email, improving response times and investigation of contemporary media such as Twitter and Facebook to provide advice and information on its programs;
- minimising the detail in its responses where rulings are positive; and
- referring taxpayers to web based advice for common enquiries.

Board's Observations

4.105 The Board supports the ATO's work in this area, in particular, minimising the detail in responses where rulings are positive and referring taxpayers to web based advice for common enquiries. The Board notes, however, that timely and certain tax advice is critical for small businesses that are unlikely to be able to afford to go through the process of seeking a private ruling.

Small Business Resources and Support

4.106 As Australia's tax system largely operates on a self-assessment basis, taxpayers shoulder the primary responsibility of correctly applying the law to their circumstances. Small businesses often do not have the resources to determine how the law applies in a range of different circumstances that they face, without appropriate guidance material as well as access to binding and non-binding advice from the ATO.

4.107 It is important that the ATO support small businesses by providing relevant information, guidance and advice in a timely and accessible manner.

Stakeholders

4.108 Some stakeholders considered that the Government needs to take a more active role in improving the management skills of small business owners. The Association of Superannuation Funds of Australia (ASFA) suggests that 'the Government should actively support the development of business management resources aimed at developing the business management skills of those engaged in small business'. Another stakeholder submitted that 'most small businesses are not properly equipped to run a business' and that 'there needs to be a form of induction and ongoing training for anyone who holds an ABN'.

4.109 ASFA also recommends that ‘the Government, in addition to simplifying small business interactions with the ATO, encourages and supports the adoption by small business of integrated business management software’. It submitted that:

Technological systems should be developed that can be easily accessed by all businesses, regardless of size, and which ultimately enable all small businesses to use software and portal interface products that service their accounting and taxation obligations at the same time. A positive consequence of this should be a compliance requirement that is only minimally higher than that necessary for regular business operations.

4.110 The AB Network suggested that:

On a broader level, such is the importance of small business to the creation of employment; consideration should be given to the development of a new, user-friendly website/portal as a ‘one-stop shop’ for employers who are hiring workers. This should house all the State and Federal information required to hire new employees including Tax Office information (TFN declarations, superannuation choice, PAYG links and superannuation guarantee etc.) as well as State-based resources for Workers Compensation, payroll tax etc. Fair Work Australia material should also be included. Such a website/portal would make the employment of extra staff a much simpler process for small business. It makes no sense that red tape alone is a disincentive to employing additional staff.

4.111 The Chamber of Commerce and Industry Queensland (CCIQ) states that the ATO should support small businesses through timely, targeted information on compliance obligations and changes to the system, review online resources, publications and improve communication to aid understanding and develop tools to aid small businesses in compliance obligations. While the SBAA would like to see the regular provision of industry statistics.

ATO comments

4.112 The ATO’s relationship with small businesses is maintained through a multi-tiered approach to the provision of information and services. This includes online tools, support and publications that are tailored to meet the needs of small businesses at particular stages of their life cycle, an online business viability assessment tool to help manage cash flow and debts and the small business assistance program that tailors assistance to meet the needs of small businesses such as business assistance visits.

4.113 The ATO has developed a number of new initiatives co-designed with small businesses that provide a ‘light touch’ or ‘no touch’ experience, including a contemporary online news and information service that streamlines ATO communications with small businesses which was launched on 11 August 2014. In addition, from September 2014 small businesses will be able to ‘click to chat’ and talk in real time online to an ATO small business specialist.

4.114 The ATO also recognises that small business interactions go beyond the ATO. To this end the ATO has commenced project based work with small business owners to improve business to government interactions, referred to as the 'fix-it squad' concept. This initiative goes to the heart of how the ATO can better support small business.

4.115 The concept is based around choosing a topic of interest to small businesses and analysing the problem from the shoes of a small business to identify solutions. Small businesses are invited to register their interest in consulting on the squad, and other initiatives, via AusTender.

4.116 Small business fix-it squads are comprised of representatives from federal, state and local government, intermediaries and small businesses and each squad considers a specific issue faced by small businesses. A small business fix-it squad will commence shortly to review issues for small businesses in relation to the process of restructuring from a sole trader to a small proprietary limited company. It is anticipated that, among other things, this will include looking at the small business CGT concessions from the perspective of a small business. A number of stakeholders raised concerns about the complexity and compliance costs associated with the small business CGT concessions. The fix-it squad process may identify where improvements could be made to help business understand the concessions.

4.117 Finally, in relation to the stakeholder comments about improving small business use of software that can meet their accounting and taxation obligations, the ATO is working with small businesses to make it as easy as possible for them to adopt Standard Business Reporting (SBR). Using natural systems and expanding the use of SBR-enabled software the ATO can immediately reduce the regulatory reporting burden on small businesses, eliminating the need to fill in some forms and reports.

Board's Observations

4.118 The Board supports the ATO's work in this area and the recent initiatives to streamline ATO communications with small businesses and the proposed online facility to enable small businesses to 'click to chat', that is, to communicate in real time online with an ATO small business specialist.

4.119 The Board also supports the work of the ATO in looking at interactions between small businesses and government beyond the ATO and from the perspective of a small business as part of the 'fix-it squad' concept.

Income tax returns

4.120 Most taxpayers are required to lodge an income tax return each financial year. Unlike individuals who have etax and more recently myTax, there is no means of electronic lodgement for businesses other than sole traders that choose to prepare and lodge their own tax returns. It was suggested that a tailored electronic lodgement experience be available for small businesses.

Views of Stakeholders

4.121 The Enterprise Network for Young Australians (ENYA) considers that the company income tax return is overly complex and that each return label should be examined to determine whether it is necessary for small businesses. Another stakeholder submitted that there should be 'a simplified income tax return regime for businesses (any entity type) that are BAS lodgement compliant'.

4.122 ENYA also suggested that an etax equivalent should be established for small business entities while another stakeholder (confidential) called for an online portal for standard reporting of financial statements.

ATO comments

4.123 The ATO will be rolling out, from the 2015-16 financial year, simplified income tax returns for small businesses operating as companies and partnerships followed by simplified reporting experience for lower risk trusts and sole traders from the 2016-17 financial year.

4.124 In particular, the ATO is delivering a simplified income tax return in Tax Time 2015 for lower risk small business companies and partnerships with simple affairs. This will deliver a simplified reporting experience through tailoring based on taxpayers business circumstances. Eligible lower risk small businesses will only need to consider and complete return labels relevant to their circumstances.

4.125 Up to 500,000 taxpayers are expected to be eligible for company reporting simplification which represents 53 per cent of the lodging population. Around 300,000 taxpayers are expected to be eligible for partnership reporting simplification which represents 84 per cent of the lodging population.

4.126 The ATO will also be designing and implementing reporting simplification for simple, lower risk trusts. At the same time, it is designing a new information set for all business individuals to replace the current Business and Professional Items (BPI) data set that leverages information available in a taxpayer's natural business systems.

4.127 Taken together with the 2015-16 changes for small business companies and partnerships, these two next steps for trusts and sole traders would complete a simplified 'light touch' level of reporting covering all business entity types within the returns based model of reporting.

Board's Observations

4.128 The Board supports the ATO's work in this area to significantly simplify income tax returns for all small business entities (see also recommendation 4.6). The reporting requirements should also be aligned to standard business systems. In particular, stakeholders noted that a small business often has to restructure and/or recalculate information from its financial accounts in order to complete the annual tax return.

Transfer Pricing

4.129 With the increasingly global nature of business operations, small businesses are becoming involved in international dealings and transactions. There are a number of rules and requirements in respect of such dealings. In particular, some stakeholders noted transfer pricing as an area of particular concern.

4.130 The transfer pricing rules are intended to ensure that transactions or arrangements between related parties are priced in accordance with the arm's length principle, consistent with the OECD Transfer Pricing Guidelines. The rules apply to all businesses with related party cross-border transactions or arrangements, irrespective of the size of the business. Stakeholders have suggested that, to reduce the compliance burden on small businesses, safe harbours should be included in the transfer pricing rules so that they do not apply to small businesses with related party transactions.

Views of Stakeholders

4.131 In its submission, BDO stated that consistent with the thin capitalisation de minimis threshold, there should be similar arrangements for other international anti-avoidance measures such as transfer pricing as these measures can impose substantial compliance costs in respect of relatively small transactions or investments.

4.132 Consistent with this view CPA noted that, in its view:

it is anomalous that an SME with international related party transactions of \$5 million has the same compliance burden as a large business whose cross border transaction with associated taxpayers exceeds \$5 billion.

4.133 Both CPA and The Tax Institute (TTI) suggested that consideration should be given to legislating some safe harbours to reduce compliance costs for small businesses.

Board's Observations

4.134 Safe harbours in the tax law are useful in limiting the scope of rules so that they apply in a measured way. For example, safe harbours may be warranted where there is little risk to revenue, or where the compliance burden on taxpayers or restrictions on economic activity outweighs any gains to the revenue. On the other hand, safe harbours in some circumstances may encourage manipulation of transactions or business structures by providing 'bright line tests' indicating the parameters within which manipulation could take place.

4.135 Arguably, the use of safe harbours is particularly problematic in the context of transfer pricing because of the extent to which price manipulation can take place between related parties to meet safe harbour thresholds. However, it may be possible that targeted safe harbour rules focussing on specific types of common small business transactions may be less problematic than a blanket exemption from the transfer

pricing rules for small (or small to medium sized) businesses with the inherent difficulty of prescribing an 'eligible' small business.

4.136 As an alternative to safe harbours embedded in the law, there may be some scope for administrative practice to tailor guidance to small business taxpayers. There are no transfer pricing documentation requirements in the law, however, taxpayers that have not prepared transfer pricing documentation run the risk of not being able to establish a 'reasonably arguable position' to justify prices used between related parties. Without any specific guidance about what documentation is reasonable, businesses with comparatively simple and low value transfer pricing arrangements may keep extensive documentation disproportionate to the size and scope of their arrangements.

Recommendation 4.9

The Board recommends that the ATO develops guidance for small businesses to provide some certainty as to documentation requirements for transfer pricing transactions.

- In particular, the ATO should take into account stakeholders' comments that the most significant compliance costs for small businesses relate to benchmarking data which can be hard to establish and/or costly to obtain from a third party.
- It would reduce compliance costs if the ATO could outline its expectations for small businesses when they are sourcing benchmarking data to support transfer pricing transactions, such as whether the use of ABS data or ATO statistics may be acceptable.
- In undertaking this work, consideration needs to be given to the transfer pricing work being completed by the OECD as part of the international project on Base Erosion and Profit Shifting (BEPS).

CHAPTER 5: SMALL BUSINESS TAXATION — CONCESSIONS AND INCENTIVES

Key Points

This Chapter considers a number of issues raised by stakeholders concerning larger questions of tax policy.

- Increasing the small business entity turnover threshold.
- The different definitions of 'small business'.
- The different definitions of 'employee' for SG and PAYG purposes.
- Employer's obligations to provide superannuation contributions.
- The calculation of employees' superannuation contributions.
- The payment of superannuation contributions to employees' superannuation funds.
- Access to the Small Business Superannuation Clearing House.
- The Superannuation Guarantee Charge and associated penalties.
- Deductibility of superannuation contributions for self-employed.
- Small Businesses FBT compliance burden and increasing exemptions.
- Improving Employee Share Scheme arrangements to facilitate small business start-ups.
- Improving Research and Development arrangements to encourage small business innovation.

INTRODUCTION

5.1 In considering the tax impediments facing small business, the focus of the report until this point has been issues of tax administration. Building on stakeholder feedback, the Board has suggested a number of reforms that could be implemented in the short and medium term to reduce these impediments.

5.2 It is clear to the Board that the tax issues of concern to small business are not confined to issues of tax administration. Stakeholders also raised a number of issues concerning larger questions of tax policy.

5.3 In making these submissions, stakeholders have emphasised the tax system should acknowledge that, as a category of taxpayers, small businesses face a range of challenges not experienced by their larger counterparts.

5.4 As discussed in Chapter 2, concessions and incentives targeted at small business are a feature of the small business tax system. Specifically, there are a number of concessions that depend on whether an entity satisfies the 'small business entity' test. Submissions expressed concern not only with the eligibility criteria for these concessions but also with the extent of relief to which they provide access.

5.5 Stakeholders also noted the existence of other tax measures that, although not confined in operation to businesses of a particular size, are seen as being particularly important to the small business sector. For example, provisions such as the research and development tax incentive, and the rules governing employee shares schemes were seen as particularly important given the cash constraints typically faced by small businesses and start-ups.

SPECIFIC ISSUES RAISED IN SUBMISSIONS

Small business entity threshold

5.6 A small business that qualifies as a 'small business entity' for an income year is able to access a range of concessions. The small business entity concessions include:²⁵

- the four small business CGT concessions;²⁶
- simpler depreciation rules;
- simplified trading stock rules;
- immediate deductibility of certain prepaid business expenses;
- accounting for GST on a cash basis;
- annual apportionment of input tax credits for acquisitions and importations that are partly creditable;

²⁵ Subsection 328-10(1) of the ITAA 1997.

²⁶ In addition to the \$2 million turnover test, to qualify as a small business entity, as discussed below, a small business owner can also qualify for the small business CGT concessions if the owner's assets, worked out on an aggregated basis, have a market value of \$6 million or less. This test is discussed in Chapter 6 of this report.

- paying GST by instalment on a quarterly basis;
- FBT car parking exemption;
- PAYG instalments based on GDP-adjusted notional tax; and
- a two-year period for reviewing an assessment.

5.7 An entity will be a small business entity if its aggregate turnover for the income year is less than \$2 million. The aggregate turnover includes the turnover of the entity seeking to apply the concessions and turnover of some of the entity's related entities, being entities that are 'affiliates' or 'connected with' the entity seeking to access the concessions. The purpose of these grouping rules is to ensure that the concessions are targeted to genuine small businesses.

5.8 Under the grouping rules, an entity is generally an affiliate of another entity if it is an individual or company and could reasonably be expected to act according to the first entity's wishes or 'in concert' with the first entity. An entity is 'connected with' another entity if either entity control the other or both are controlled by the same third entity.

5.9 The turnover test is usually applied to an entity's previous year's turnover. However, special rules sometimes operate to allow an entity to use an estimate of its turnover or actual turnover for the current year.

Views of Stakeholders

5.10 A number of stakeholders expressed concern with the small business entity test. They drew attention to the fact that the \$2 million turnover threshold has not been changed since its introduction in 2007 and is out of date. In the short term, stakeholders would like to see the threshold increased.

5.11 An increase in the threshold to \$5 million was generally favoured, in line with the recommendation of the AFTS review. However, at a minimum, stakeholders believed that reform is necessary to ensure that the real value of a threshold is maintained. Some of the suggestions were to index the threshold by reference to the consumer price index (CPI) or to conduct regular, timely reviews.

5.12 The NSW Business Chamber (NSWBC) outlined a number of approaches to maintaining real value, in relation to the \$2 million turnover threshold:

There are different ways to assess what a \$2 million turnover test in June 2007 means in contemporary terms. One option is to investigate how high the threshold would need to be raised to cover the same proportion of businesses. Alternatively, indexation to consumer prices may be an appropriate way to adjust the threshold, as the income small business owners derive from their activities will ultimately be spent on consumption. Inflation in producer prices or wages may also be appropriate, since they reflect the change in turnover that is purely due to the change in the price of inputs.

5.13 Having regard to these factors, the NSWBC submitted that \$3 million may be an appropriate approximation of the threshold in contemporary terms.

5.14 The ATA considered that the \$2 million turnover threshold does not capture businesses that would be considered a small business according to other definitions such as the ABS small business definition of less than 20 employees. ENYA stated that the threshold discriminates against businesses that operate on a high turnover and low margin basis such as computer hardware businesses. In these circumstances, the threshold is considered too low.

5.15 Stakeholders were also critical of the complexity of grouping rules and the associated costs. CAANZ attributed the complexity to the well-intentioned work of policy designers to cater for a wide variety of structures and asset holding arrangements but believed there is a strong case for simplification.

Board's Observations

5.16 The Board considers that the small business entity concessions provide important assistance to small businesses but agrees with stakeholders that eligibility thresholds need to be monitored to ensure that the concessions remain current and appropriately targeted. A significant majority (by number) of Australian businesses have a turnover of less than \$2 million. According to ATO statistics, there are 2.6 million small businesses with a turnover between \$0 to \$2 million but only 72,000 with a turnover between \$2 million to \$5 million. Raising the threshold to \$10 million would capture a further 25,000 small business clients.²⁷

5.17 The statistics show that there may be considerable scope to increase the turnover threshold without significantly increasing the number of businesses that can access the concessions. Importantly, this is likely to reduce the number of businesses that are at or near the turnover threshold and therefore face the greatest uncertainty. It would also assist those businesses that operate on a low margin and therefore consider themselves disadvantaged by the test.

5.18 The Board has noted that although the number of businesses with turnover in the \$2 million to \$5 million range is numerically small, that group accounts for a significant proportion of tax revenues. A comparison of small businesses with turnover below \$5 million shows that those in the \$2 million to \$5 million range account for less than three per cent of businesses by number but account for 20 per cent of the gross tax for that segment of the market. Accordingly, the revenue impacts of extending the concessions should be considered carefully, particularly in relation to the generous small business CGT concessions. These are discussed in Chapter 6.

²⁷ It is noted that these statistics do not account for the turnover of related entities and do not therefore give a precise indication of the numbers of entities that are eligible for the concessions.

5.19 Given the concentration of businesses with relatively low turnovers, some improvement could be achieved by a more modest increase in the thresholds. For example, increasing the threshold in line with the CPI would result in an increase to approximately \$2.5 million. The disadvantage of this approach is that the real value of such an increase would soon become eroded by future inflation. It would also provide limited assistance to low margin, high turnover businesses. In the circumstances, if the Government opts for a modest increase, the Board considers that the suggestion that the threshold be raised to \$3 million would achieve a reasonable balance and provide a degree of future-proofing.

Recommendation 5.1

Based on an analysis of business population data, the Board recommends that the small business entity turnover threshold be increased to at least \$3 million and investigate the feasibility of an increase to \$5 million.

The definitions of small business

5.20 The absence of a consistent definition of small business in legislation can mean that a business may be a small business for one purpose, for example, for ABS survey obligations, but not for others, for example, eligibility for the small business CGT concessions.

5.21 In its 2007 Small Business Compliance Costs Report²⁸, the Board noted that there is no standard measure of a ‘small business’ in Australian legislation. It was also noted that since 1 July 2007 a single threshold is applied to determine eligibility for a variety of small business tax concessions. Although this is a significant improvement, small businesses continue face inconsistent definitions for different government purposes.

Views of Stakeholders

5.22 A number of stakeholders submitted that having clear and consistent definitions for small business in legislation would improve regulatory burdens by removing the need to reassess whether a business is a ‘small business’ for different purposes.

5.23 There were varying views as to what the definition of a ‘small business’ should be including the ‘small business entity’ \$2 million turnover test in the tax law or the ABS definition based on number of employees.

5.24 The CAANZ stated that there should be a simpler definition of small business which should be applied consistently throughout tax legislation. Consistently, IPA’s

28 The Board of Taxation, Scoping Study of Small Business Compliance Costs, A Report to the Treasurer, December 2007, p. 27.

view is that there should be a whole of government (Federal and State) approach to the definition of small business.

Commentary

5.25 Across the taxation legislation, the most common test for a small business is based on turnover. Many of the small business concessions use the same definition of 'small business entity', reflecting the 2007 amendments to rationalise small business definitions. There is a departure from a turnover test for the purposes of eligibility to use the Small Business Superannuation Clearing House (SBSCH) where the test is 19 or less employees.

5.26 Some measures, like the company loss carry-back rules, do not use a definition as a 'gateway' and instead allow access for all businesses (in this case companies) up to a modest cap. Using a cap the benefit will be more material for small businesses than for larger businesses. It also avoids creating a hurdle for smaller businesses to clear.

5.27 While other areas of the tax law use turnover tests the thresholds vary, generally to reflect the targeting of assistance to, or imposing reporting requirements on, a broader base of businesses. For example, the R&D Refundable Tax Offset has a turnover threshold of \$20 million.

5.28 While the tax legislation does not have 'small business' tests based on number of employees (except the SBSCH noted above), other agencies such as ABS and Fair Work Australia use employee based tests. State based definitions use different criteria such as size of payroll for payroll tax or number of employees for workers compensation purposes.

Board's Observations

5.29 The Board recognises that while consistency of definitions across government is desirable, it is not an end in itself. Definitions of small business are used for different purposes that may justify and require varying definitions to reflect policy objectives. However, to the extent possible, particularly where objectives and underlying policy rationale align, definitions should be as consistent as possible.

5.30 The Board considers it would be useful to review different definitions of 'small business' across the Commonwealth Government more broadly, not just in the tax law. This would require representatives from different Commonwealth agencies.

Superannuation issues

5.31 The mandatory payment of superannuation contributions for employees is a core part of Australia's retirement income system. Employers face administrative costs to comply with this requirement and can face harsh and, in some cases, disproportionate penalties if reporting and payments are not strictly adhered to. This section discusses a number of superannuation issues raised by stakeholders.

5.32 While the Board makes a number of superannuation recommendations below, the Board understands that the Government is considering a potential review of the retirement income system which, if it goes ahead, could include consideration of the issues raised below as part of a broader holistic review.

5.33 In addition, the Government made an election commitment to reduce superannuation compliance costs for small businesses. Treasury and ATO officials have consulted with a range of stakeholders to better understand the superannuation compliance concerns of small business employers, as part of developing reform options for Government consideration in late 2014. The Board's recommendations could also be considered as part of this process.

Definition of employee — PAYG and SG purposes

5.34 The definition of employee varies for different employer obligations including SG, PAYG withholding, Fair Work provisions, workers compensation, State payroll taxes and a number of State labour laws. For SG purposes, the definition of employee is extended to include some workers who are not ordinarily employees, such as contractors primarily engaged for their labour. As discussed in Chapter 4, determining the status of workers can be complex.

5.35 To align the definition of 'employee' for SG purposes with any other definition for the purposes of other employer obligations will involve some groups of workers losing their current entitlement to superannuation contributions.

Board's Observation

5.36 The Board's view is that consistency in definitions is desirable. However, in the case of 'employee' definitions, they vary for tax and non-tax purposes and vary across Commonwealth and State Governments. The Board considers it would be useful to review different definitions of 'employee' to explore harmonisation. This would require consultation involving Commonwealth and State agencies. It could perhaps be looked at by the ATO 'fix-it squad' process referred to in paragraph 4.116.

Entitlement to Superannuation Contributions

5.37 If a person is an employee for SG purposes, the employer, among other things, has an obligation to pay superannuation contributions on behalf of the person, provided the employee earns more than a minimum amount. In particular, employers are required to make the prescribed minimum superannuation contribution²⁹ on behalf of each employee earning more than \$450 in a month. The contributions must be paid at least quarterly. This monthly threshold has not changed since the introduction of the SG in 1992.

²⁹ The Government has announced the rate will remain at 9.5 per cent until 30 June 2018 and then increase by 0.5 percentage points each year until it reaches 12 per cent.

5.38 Small businesses, in particular those industries employing a large number of seasonal workers, have complained about having to pay superannuation contributions for a large number of workers. Restaurant & Catering Australia (R&CA) submits that, based on growth in the minimum wage the threshold should be raised to \$600 per month or \$1,800 per quarter and should be indexed to CPI. Alternatively, the current \$450 monthly threshold could be maintained but with the addition of an option allowing employers to assess superannuation obligations for employees against a quarterly threshold of \$1,350.

5.39 Increasing the threshold or applying the threshold quarterly would be alternative ways of reducing some of the compliance costs associated with making superannuation contributions. However, it is likely to exclude some low income earners or casual workers from superannuation coverage.

5.40 In relation to the threshold, ASFA noted that while payment of small amounts is a concern (with a monthly payroll threshold of \$450, the smallest superannuation contribution is \$41.62 per month with an SG rate of 9.25 per cent), ASFA considers that:

the issue is not so much with the size of the payment, but rather in determining whether an employee's remuneration is under or over the threshold in any given month. This is a particular problem in sectors of the economy with a highly casualised workforce. With the introduction of the data standards and a requirement to pay all contributions electronically it is perhaps appropriate, once the new arrangements have been bedded down, to re-consider the need for a minimum SG payroll threshold: the last remaining challenge for these employers.

5.41 The ATO advises that the addition of a quarterly threshold would be relatively straightforward to implement, however, this change could not be implemented until legislative amendments were made increasing the threshold, or allowing the use of a quarterly threshold.

Recommendation 5.2

The Board recommends allowing employers to assess superannuation obligations for employees against a quarterly threshold of \$1,350. Employers who do not wish to change their current systems and processes will still meet their superannuation obligations if they continue to test on a monthly basis.

The Board recognises that this may exclude some low income earners from superannuation coverage. However, it will reduce compliance costs for small businesses, particularly for those with a large number of short-term casual employees.

Calculation of superannuation contributions

5.42 Currently, employers must pay a minimum of 9.5 per cent of each eligible employee's 'ordinary time earnings' (OTE) each quarter in superannuation. If an employer fails to meet the minimum requirements they become liable for the SG

Charge (see discussion below). The calculation of the SG Charge is not based on an employee's OTE but is calculated on a different base of 'salary and wages'. These calculations are set out in the legislation.

5.43 The ATO ruling *SGR 2009/2 SG: meaning of the terms 'ordinary time earnings' and 'salary or wages'* explains that OTE amounts are a subset of salary or wages. It contains a checklist of different payment types made to employees and whether each type is included under OTE and salary or wages. Examples of payment types that are treated differently are overtime related payments and termination payments. These are excluded from OTE but included in salary or wages.

5.44 BDO and IPA noted that the concept of 'ordinary time earnings' is, in itself, a definition which is inherently difficult to interpret and apply and should be replaced with a simpler base that is easier to apply. While the use of 'salary and wages' for both SG and SG charge calculation may be simpler, using salary and wages as a base would typically increase the amount of SG contributions employers would be required to make.

Recommendation 5.3

The Board recommends that the superannuation guarantee charge be calculated on the basis of OTE rather than salary and wages to align it with the way that superannuation contributions are calculated. While OTE is a more complex definition it would mean no change to employers' current calculations.

Payment of contributions

5.45 From 1 July 2014, medium to large employers began using SuperStream to make contributions on behalf of employees. All contributions from this employer group must comply with the SuperStream requirements by 30 June 2015. Small employers (19 or fewer employees) have a one year transitional period from 1 July 2015 through to 30 June 2016 in which they must comply with SuperStream. To simplify and streamline processing within the superannuation system SuperStream requires employers and superannuation funds to transact using a standard electronic format with linked data and payments.

5.46 In effect, this means employers may utilise the service of a 'clearing house' or other service provider. A 'clearing house' accepts information about the employees and the superannuation contributions for each employee. The clearing house then

transforms, packages and distributes the contributions to employees' superannuation funds as advised by the employer.³⁰

5.47 Notwithstanding the implementation of SuperStream, IPA considers 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 is paid in a timely manner. We believe one option to achieve this objective would be to have SG payment made with and attached to the quarterly business activity statement.

5.48 However, it is noted that this would not avoid the requirement for an employer to set out which employees the superannuation payments are for, how much for each employee, and which superannuation funds they have to be paid to. Therefore it would not simplify the information requirements for employers.

5.49 In contrast to the IPA view, ASFA notes that it does not support the proposal that businesses should pay superannuation contributions to the ATO as part of their pay-as-you-go (PAYG) obligations, with the ATO being tasked with distributing the money and the contribution details to the employee's fund. ASFA considers that such a process would undermine the SuperStream initiatives currently being implemented.

Board's Observation

5.50 The Board notes there may be a reduction in compliance costs once SuperStream is fully implemented. The Board considers following full implementation an assessment be made of its effectiveness in terms of reducing small businesses compliance costs and simplifying superannuation administration.

Small Business Superannuation Clearing House (SBSCH)

5.51 The SBSCH, administered by the ATO³¹, is a mechanism that allows employers with 19 or fewer employees to make one payment to the SBSCH which then makes the payments to the different funds for each employee. The threshold of 19 employees has been identified as an unnecessary restriction particularly for small businesses that have a high turnover of staff or seasonal based employment requirements.

5.52 The IPA submits that the current threshold of 19 staff to be eligible to use the SBSCH should be increased to 100 staff to help more businesses reduce their compliance costs. To align with ABS definitions, the number of employees could be increased to 200 employees (classified as a medium business).

30 Employers must offer their employees 'choice of fund', if an employee does not exercise a choice, an employer will pay the employee contributions into the employer's chosen default superannuation fund.

31 The SBSCH was initially administered by Department of Human Services. The administration of the clearing house was transferred to the ATO from 1 April 2014.

5.53 An alternative to increasing the threshold number of employees could be to extend eligibility to ‘small business entities’ with a turnover threshold of \$2 million. The advantage of such a proposal is that the number of employees becomes an irrelevant factor. This could improve access to the SBSCH by employers with a large number of casual employees. Using the existing definition of ‘small business entity’ aligns two current ‘small business’ definitions. The ATO advises that increasing the threshold number of employees would only marginally increase administration costs.

Board’s Observation

5.54 The Board notes the significant reduction in compliance costs SuperStream is intended to achieve for employers, including small businesses with 19 or less employees, once fully implemented. At that time, the need for an expanded clearing house service operated by the ATO could be revisited.

Superannuation Guarantee Charge, penalties and deductibility

5.55 As noted above, employers are required to pay a minimum of 9.5 per cent of each eligible employee’s ‘ordinary time earnings’ each quarter in superannuation. Superannuation contributions must be paid into the employee’s superannuation fund by the 28th day of the month following the end of each quarter.³² If an employer fails to meet the minimum requirements, under the SG legislation they become liable for the SG Charge, interest at a rate of 10 percent per annum and an administration component of \$20 per employee per quarter by operation of the law. The Commissioner currently has no discretion to remit these components.

5.56 When an employer becomes liable to the SG Charge, they have an obligation at law to lodge an SG Charge statement. This statement self-assesses their charge liability and the charge is then payable to the ATO. The employer must provide detailed and extensive information for each of their employees about the amount of superannuation each was entitled to, how it was calculated, and how much has been paid. The provision of this information is by way of a manual process and can impose a significant compliance burden on employers.

5.57 The SG Charge is also specifically not deductible under the legislation. The SG Charge, interest and administration charges are payable to the ATO who then sends the SG shortfall amount and the interest to the employee’s fund. If an employer has paid late contributions to a superannuation fund they can be applied to offset the SG Charge liability, however, the payments that are applied to offset the SG Charge are also not deductible.

32 For example, for the quarter ending 30 June, the superannuation contribution must be paid to the superannuation fund by 28th July.

5.58 In addition to the primary tax liability (that is, the SG Charge), where an employer fails to provide information or lodge SG Charge statements, they can be liable for a penalty of up to 200 per cent in additional SG Charge. The Commissioner has discretion to remit part or all of this penalty. The ATO remission guidelines are published and set out in Practice Statement PS LA 2011/28.

5.59 The Board notes the relevant statements by the IGoT in a 2010 review into the administration of the SG Charge. One of the report's recommendations was that 'the Government consider whether the current multi-faceted and complex penalty system applying to SG (such as non-deductibility of SG Charge, the application of interest and the administrative component from the beginning of each quarter and Part 7 penalties) should be streamlined and better targeted to improve voluntary compliance'.

Board's Observation

5.60 The Board considers that the operation of the SG Charge regime is unnecessarily harsh, often with disproportionate outcomes, and very limited discretion by the Commissioner to take into account factors surrounding a late payment.

5.61 The Board understands that each of the components in the SG Charge regime is trying to achieve a different purpose. For example, the Explanatory Memorandum to the original Bill stated that the interest component was a proxy for investment earnings the employee would have received if the employer had provided adequate superannuation support. The administration component was intended to assist in recovering costs of administration of the SG scheme.

5.62 Despite the intention of the regime, the Board is aware of a number of examples where the application of the law gives rise to disproportionate interest and administration elements. With no discretion by the Commissioner, factors surrounding a late payment cannot be considered.

5.63 One possible solution is to retain the current SG Charge regime but provide a broad discretionary power for the Commissioner to remit SG Charge components. However, this would require the Commissioner to have a basis on which to remit these components and would have to take into account the intent of their enactment.

5.64 Discretions provided to the Commissioner also give rise to review or objection rights which can further complicate and extend the process for employers. It is considered to be more efficient for the law to produce the desired outcome in the first instance, rather than the Commissioner exercising discretion to remit in each case that is unfair or has a disproportionate result.

Recommendation 5.4

The Board recommends that the calculation of the SG Charge components be redesigned by legislation.

Recommendation 5.4 (continued)

In this respect, it is noted that the SG Charge and interest components are distributed to employees' super funds representing the superannuation contributions they are entitled to and interest.

In relation to other penalties, such as the Part 7 penalty and the administrative component (\$20 per employee per quarter), these should be replaced with the administrative penalties provided for under the TAA.

Recommendation 5.5

The Board considers that the non-deductibility of the SG Charge is unreasonable. The Board recommends that the SG Charge and any employer contributions paid to a superannuation fund that are used to offset the SG Charge payable should be deductible to the employer when the amounts are paid.

Recommendation 5.6

In relation to the SG Charge reporting requirements, the Board recommends the removal of the automatic requirement on employers to lodge an SG Charge statement (and the associated documentation) with the ATO when they become liable to the SG Charge.

The employer instead should be required to pay the late superannuation contribution and the associated interest directly to the superannuation fund. An employer would be required to provide the details contained in the SG Charge statement if requested by the ATO or if ATO compliance activity was initiated. It should not be an automatic requirement by operation of the law any time an employer is more than one day late with superannuation contributions.

Deductibility of superannuation contributions for self-employed

5.65 The self-employed are not required to make superannuation contributions for themselves, however, they are encouraged to do so by tax concessions. For example, concessional contributions can be claimed as a tax deduction, within caps. However, to be eligible to claim a deduction the person must earn no more than 10 per cent of their income from employment services and have contacted their superannuation fund advising they wish to claim a deduction for the contributions they have made.³³ This restriction is intended to ensure that a person is essentially self-employed. Some stakeholders consider that the restriction should be removed or that the threshold should be increased.

³³ Section 290-160 of ITAA 1997 contains the 10 per cent test for deducting personal superannuation contributions. Section 290-170 contains the requirement to provide a notice to the fund.

5.66 IPA does not believe there is 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. BDO argues that 10 per cent employment income threshold is too low and that 'it is arguably 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'. It considers that 'this could be addressed by increasing the threshold to, say, 25 per cent or, alternatively, allowing all taxpayers to make supplementary deductible superannuation contributions up to the concessional cap.

5.67 The '10 per cent rule' has been a feature of the retirement income system since 1992. As the self-employed do not benefit, or benefit only to a limited extent, from the SG rules, the rule was an attempt to provide a tax deduction for the self-employed where they contribute to superannuation. The limitation on the benefit constrains the cost to revenue of this benefit.

Board's Observation

5.68 The Board considers that there is equity and merit in aligning the total annual superannuation concessional contributions cap for employees and the self-employed. The cost to revenue of making that alignment would of course be needed to be taken into account. That is, regardless of employment status a person can contribute or have contributions made on their behalf up to the 'concessional contributions cap'. For a person who receives employer SG contributions, the amount of deductible personal contributions the person can make will be the applicable contributions cap less the SG contributions paid on their behalf.³⁴

FBT

5.69 FBT was introduced in 1986 and applies where non-cash benefits are provided by an employer to an employee – such as through the provision of free or discounted goods and services. In most cases, fringe benefits are provided as a substitute for salary and wages; however, in some cases, they are incidental to an individual's employment.

5.70 Prior to 1985, employees were taxed on non-cash benefits. However, this approach was replaced with the FBT because the previous model suffered from certain compliance and valuation difficulties.

5.71 Stakeholder submissions focussed on three main categories to reduce the FBT compliance burden on small business employers. That is, improvements to administrative arrangements, increasing FBT exemptions and, significantly, structural reforms to the FBT system including that FBT be imposed on employees. This section

³⁴ From 1 July 2014 the general concessional contributions cap is \$30,000 with a higher cap of \$35,000 applying to people who are 50 years or over.

discusses administrative arrangements and exemptions while structural proposals are discussed in Chapter 7.

Views of Stakeholders

5.72 A consistent theme raised by many stakeholders was the complexity of the FBT system and the disproportionate burden on small businesses.

5.73 ACCI noted FBT can have the effect of:

limiting options a small business can utilise to remunerate their staff in a way that is mutually more beneficial than cash-only remuneration. This hampers their ability to compete with larger businesses for staff.

5.74 The Australian Motor Industry Federation (AMIF) noted that the FBT is cumbersome and resource consuming. However, the significant compliance burden associated with FBT could be mitigated if the ATO were to re-examine requirements and revisit compliance obligations. ACCI suggested that:

Significant compliance cost reductions could be achieved by the ATO requiring less documentation and applying broad and simple formulas, and applying risk management techniques to compliance.

5.75 Stakeholders made a number of specific suggestions including BDO's suggestion that the timing in respect of income tax and FBT should be aligned and ACCI's submission that 'the application of FBT to allowances paid for employment in remote areas and certain costs relating to relocation are counter-productive to other economic and social objectives for Australia'.

Increase exemptions

5.76 One of the AFTS recommendations (recommendation 9(d)) was that a small de minimis threshold, below which fringe benefits are exempt from tax, should apply and that the threshold could vary depending on the number of employees within an organisation.

5.77 A number of submissions are consistent with this AFTS recommendation, for example, Australian Private Equity & Venture Capital Association Limited (AVCAL) recommended that the minor and infrequent threshold should be increased to reduce compliance burden for small businesses. AVCAL stated that:

Compliance costs for minor benefits such as meal entertainment, gift vouchers and car parking are onerous, time consuming and impose a disproportionately high financial burden on small business. As a result, small businesses are required to employ considerable resources to perform data capture, examine and report large volumes of information on overall minor benefits to prepare the data required for the FBT return.

5.78 In addition, R&CA suggested that small business with an annual turnover of less than \$2 million should be exempt from FBT entirely. ENYA submitted that:

the removal of requirements to comply with the FBT regime, as long as total FBT payments in small and micro businesses was below a reasonably low grossed up figure like \$20,000, would have little effect on revenue, yet avoid the need to lodge FBT returns for small FBT liabilities that exceeded the threshold.

ATO comments

5.79 The main benefit categories provided by small businesses include the private use of cars, car parking, expense payments and entertainment. Many of these include various methods to simplify the calculation of benefits.

5.80 The minor benefits exemption is one area that creates a lot of discussion and uncertainty. The current provisions have evolved since the introduction of FBT in 1986. The exemption is limited to benefits valued at less than \$300 per occasion and meeting further conditions. This requires employers to apply a number of subjective tests to ascertain whether a benefit is subject to FBT or exempt.

5.81 The minor benefit provisions have applied since the commencement of FBT in 1986. Originally the law referred to benefits that were 'small' in value and satisfied other conditions. The ATO provided guidance, stating that amounts in excess of \$50 were unlikely to be considered 'small'. The legislation was amended in 1996, replacing the reference to 'small' with 'less than \$100'. A further amendment was made in 2006, increasing the \$100 value to \$300.

5.82 In response to the working group discussions, the ATO has advised the Board it is willing to work with relevant stakeholders to identify and discuss specific areas where administration can be improved. Improvements may come from changes to ATO information products.

5.83 The minor benefit exemption is a topic which should be included in any ongoing discussions. The subjective aspects of this exemption create a lot of uncertainty for employers. A common example is deciding how many times a particular benefit item, for example, a restaurant meal, may be provided to an employee in a given year and still fit within the exemption.

Recommendation 5.7

The frequency with which FBT issues were raised by stakeholders suggests FBT creates a significant and disproportionate compliance burden for small businesses. A number of options to relieve some of this burden were suggested.

One suggestion is to raise the minor and infrequent threshold which is currently \$300. This threshold was increased from \$100 to \$300 on 1 April 2007. The Board recommends an increase to the 'minor and infrequent' threshold from \$300 to, at least, \$500. This is arguably a reasonable level that keeps the threshold current.

Recommendation 5.8

The Board also recommends that there be an investigation of the possibility of aligning the FBT year to the income tax year. The Board notes, however, transitional implications and reporting timeframes would need to be considered.

5.84 The Board welcomes the ATO's commitment to consulting with stakeholders to discuss any administrative arrangements that can reduce compliance costs.

Employee share schemes

5.85 Employee share schemes (ESS) are a way in which an employee can share in ownership of the company for which they work through acquiring shares or options in the company.

5.86 In general, where an employee receives an ESS share or option, the difference between its value and any price they paid for it ('the discount') must be included in their assessable income in the income year of acquisition. This is consistent with the general tax principles that all forms of remuneration for work – whether in cash or not – are treated as taxable income.

5.87 There are two broad types of ESS taxation arrangements: taxed-upfront schemes and tax-deferred schemes.

5.88 If the discount on ESS interests is taxed up front, employees with adjusted taxable income of \$180,000 or less are eligible for a tax concession on the first \$1,000 of discounts received each year on eligible ESS interests. However, the ESS must meet a number of criteria.³⁵

5.89 If there is a real risk of an employee forfeiting their discounted shares under the conditions of the ESS, or they are acquired through a salary sacrifice arrangement, then taxation is deferred until the earlier of:

- removal of the risk of forfeiture and the scheme no longer genuinely restricts the disposal of the interest;
- cessation of employment; or
- seven years from acquisition of the interest.

35 These criteria are: the employee is employed by the company offering the interests or by a subsidiary; the scheme is offered to at least 75 per cent of permanent Australian resident employees on a non-discriminatory basis; the employee does not receive more than 5 per cent ownership in the company as a result of the scheme; the interests are not held with a real risk of forfeiture; and the interests are held for at least three years, or until the employee ceases employment.

5.90 An ESS interest is at 'real risk of forfeiture' if a reasonable person would consider that there is a real risk that the employee would lose the interest, or never receive it, other than by selling or exercising it, or through the market value of the ESS interest falling to nil. The meaning of 'real' is 'more than a mere possibility'. The test is intended to deny deferral of tax where schemes create a nominal risk of forfeiture, without complying with the intent of the law. It recognises that the employee may never have a chance to realise economic value in the ESS interest.

5.91 Salary sacrifice under complying schemes is eligible for tax deferred treatment, subject to an annual \$5,000 cap.

Views of Stakeholders

5.92 Stakeholder submissions on ESS drew attention to a number of ways in which the current rules act as impediment to small businesses and start-ups.

5.93 One criticism of the rules relates to the requirement to value an ESS interest at the time of its issue. ACCI, AusBiotech and NSWABC submitted that shares in small companies and start-ups are generally difficult, and therefore costly, to value. This difficulty was seen as being most pronounced for unproven businesses in knowledge-intensive industries.

5.94 Stakeholders also saw a basic unfairness in the requirement, under the ESS rules, for employees to make an upfront payment of tax in advance of receiving a cash benefit from the interest. ACCI, AusBiotech and NSWABC submitted that this has made ESS remuneration unattractive for potential employees and has therefore put smaller companies and start-ups at a competitive disadvantage to their larger, less cash-constrained competitors when seeking to attract and retain staff. NSWABC and IPA were critical that taxpayers who have paid tax on the discount of ESS interests that subsequently lose value are not eligible for a tax refund. This was viewed as a serious disincentive, especially for start-ups given their high failure rate.

5.95 Another criticism of the ESS rules related to the 'ESS deferred taxing point'. One stakeholder (confidential) submitted that, under the current rules, an 'ESS deferred taxing point' can sometimes occur even where the employee is prevented from disposing of the interest to raise funds to pay the tax on the discount. More broadly, they considered that where there is a deferred taxing point for a benefit that has accumulated over a number of years, employees should be entitled to a 50 per cent discount, aligning the tax treatment with gains that are taxable under the CGT provisions.

5.96 Finally, stakeholders noted that other countries offered more generous tax incentives for ESS remuneration creating a risk of Australian entrepreneurs establishing and growing their businesses in other jurisdictions.

Suggested reforms

5.97 The stakeholders who commented on ESS were of the view that taxation of ESS interests should be deferred until their sale, liquidation or other realisation. Two stakeholders, AVCAL and Greenwood & Freehills, went further and stipulated that the deferred tax should be levied under CGT principles, making their holders eligible for the 50 per cent CGT discount.

5.98 It was broadly acknowledged by stakeholders that concessional ESS arrangements should be targeted. It was variously suggested that the arrangements could be confined to:

- all private companies (PwC);
- ‘start-up’ companies – those in existence for less than three years (ACCI);
- entities that meet the small business entity test (ACCI); or
- entities that have, say, 20 or fewer full-time employees in a year (ACCI).

5.99 ACCI and NSWBC considered that, in advance of significant reforms, greater simplification could be achieved by the adoption of simplified valuation methodologies for equity in employer companies.

Board’s Observations

5.100 The Board notes the current work of the Prime Minister’s Taskforce in developing a National Industry Investment and Competitiveness Agenda to make recommendations to the Government. The Taskforce comprises the Treasurer, Industry Minister and Minister for Trade and Investment, and is chaired by the Prime Minister. As part of its work, the Taskforce is examining options to encourage innovation, including employee share schemes.

5.101 The Board suggests that the Taskforce take into account the above discussion and the employee share scheme comments made in submissions to it.

Research and Development

5.102 The current research and development (R&D) tax incentive (the incentive) applies for income years commencing on or after 1 July 2011.³⁶

5.103 The incentive is intended to ‘focus ... assistance on activities that are likely to deliver economy-wide benefits that would not be enjoyed in the absence of public

³⁶ The incentive was established through amendments in the *Tax Laws Amendment (Research and Development) Act 2011*. The rules that give effect to the R&D Tax Incentive are contained in Division 355 of ITAA 1997 and in Part III of the *Industry, Research and Development Act 1986* (IR&D Act 1986).

support' and to 'significantly improve ... the incentive for smaller firms to undertake R&D.'³⁷

5.104 There is no cap on the amount of R&D expenditure that companies can claim. It was also intended to replace the extensive and complex provisions of the former concession, with a new, streamlined incentive.³⁸

5.105 The incentive grants eligible entities a tax offset for expenditure on eligible R&D activities and for the decline in value of depreciating assets used for eligible R&D activities. A minimum expenditure threshold of \$20,000 generally applies.

5.106 The two core components of the incentive are:

- a 45 per cent refundable tax offset (equivalent to a 150 per cent deduction, given the 30 per cent rate of company tax) to eligible entities with an aggregated turnover of less than \$20 million per annum; and
- a 40 per cent non-refundable tax offset (equivalent to a 133 per cent deduction) to all other eligible entities.

5.107 Eligible activities are categorised as either 'core' or 'supporting' R&D activities undertaken in Australia or, in limited circumstances where the activities cannot be undertaken in Australia, overseas.

5.108 Core R&D activities are, with some exclusions, experimental activities that determine unknown outcomes by applying the scientific method, or which are conducted to create new knowledge. Supporting R&D activities are either those directly related to core activities, or in the case of production or activities supporting excluded 'core R&D' activities, undertaken for the dominant purpose of supporting core R&D activities.

5.109 Companies register their eligible R&D activities with AusIndustry in order to claim the tax offset in their company tax return through the ATO.

Recent developments

5.110 The R&D tax offsets are claimed as part of a company's annual income tax assessment. On 15 June 2011, the then Government announced that it would introduce quarterly credits from 1 January 2014 to enhance business cash flow for smaller

37 Explanatory Memorandum to the *Tax Laws Amendment (Research and Development) Act 2011*, paragraph 1.10.

38 Explanatory Memorandum to the *Tax Laws Amendment (Research and Development) Act 2011*, paragraphs 1.3 and 1.5.

companies undertaking R&D.³⁹ On 14 December 2013, the Government announced that it would not proceed with the introduction of the R&D quarterly credits scheme.

5.111 On 14 November 2013, the Government introduced the *Tax Laws Amendment (Research and Development) Bill 2013* to the Parliament. The Bill amends the *Income Tax Assessment Act 1997* to remove access to the incentive for companies with aggregated assessable income of \$20 billion or more for an income year. The Bill is still before the Parliament.

5.112 In the 2014-15 Budget⁴⁰, the Government announced that it will reduce the rates of the refundable and non-refundable tax offsets available under the incentive by 1.5 percentage points, to 43.5 per cent and 38.5 per cent respectively, for all income years commencing on or after 1 July 2014. The reduction is intended to maintain the relative value of the incentive consistent with the Government's commitment to reduce the company tax rate by 1.5 percentage points to 28.5 per cent from 1 July 2015.

Views of Stakeholders

5.113 A number of stakeholders identified the R&D incentive as a key issue for small businesses (including start-ups) in key sectors of the economy. Specific observations from stakeholders in relation to the incentive were:

- The proposed 1.5 percentage point reduction in the R&D tax offsets adversely affects 'pre-revenue' companies that have no tax liability and therefore do not enjoy the benefit of the proposed company tax rate cut: AusBiotech, AVCAL.
- The proposed quarterly tax credits legislation should be reintroduced into Parliament to revitalise private sector investment in innovative small businesses. The proposed credit would provide vital cash flow at a critical phase of a company's development: Deloitte Private and AVCAL.
- The incentive is complex and therefore difficult to access: Business SA.
- Companies conducting R&D are at risk of forfeiting tax losses because of the operation of integrity rules in the tax law: Deloitte Private.

Board's Consideration

5.114 The Board has noted that on 18 December 2013, the Prime Minister announced his chairing of a Taskforce to develop a National Industry Investment and Competitiveness Agenda. The Taskforce is focused on initiatives to promote national

³⁹ Assistant Treasurer, Improving Cash Flow and Helping Small Business Innovate, media release, 18 December 2013.

⁴⁰ 2014-15 Budget, Part 1 — Revenue Measures, Treasury.

competitiveness and productivity, including options to encourage support of R&D.⁴¹ The Board understands that the Taskforce will report to the Government in late-2014.⁴²

5.115 The Board has further noted that when the incentive was enacted, the previous Government committed to a review of it after several years. The Government made an election commitment to use the ‘scheduled 2014 changes to the R&D tax incentive ... to review access to R&D tax support’. Further, the Government committed the Tax White Paper to ‘also give broader consideration to the effectiveness of existing taxation incentives for innovation and industry funded research’ and to ‘develop recommendations for potentially improving the incentive regime for innovation and R&D investment’.

41 Prime Minister, Securing Australia’s Manufacturing Future, media release, 18 December 2013.

42 Prime Minister, \$155 Million Fund to Grow the Jobs of Tomorrow, media release, 30 April 2014.

CHAPTER 6: CGT ISSUES FOR SMALL BUSINESS

Key points

- This Chapter considers a number of issues raised by stakeholders concerning the impact of CGT on small business taxpayers:
 - The impact of CGT on small business restructuring and succession planning.
 - The role of the CGT small business concessions including:
 - : the complexity of eligibility rules;
 - : whether they are appropriately targeted;
 - : whether they support business growth.
- This Chapter goes on to discuss a number of possible CGT reforms to assist the small business sector.

INTRODUCTION

6.1 Before introducing a broad-based CGT regime in 1985, Australia was one of only a few countries in the OECD that had no general tax regime dealing with capital gains. The introduction of the CGT regime sought to align the tax treatment of income from capital gains with the principles of horizontal equity by treating taxpayers equally whether they earned income in the form of ordinary income or from capital growth. The CGT regime also sought to address concerns around vertical equity by recognising that ownership of capital is more heavily concentrated among higher income groups.⁴³

6.2 In setting the scene for the Board's consideration of the impact of the CGT regime on small businesses, it is useful to note some of the key features of the CGT system:

- Generally, CGT is imposed when a CGT asset (such as goodwill in a business) is disposed of.
- CGT does not apply to ordinary business transactions (such as proceeds from the sale of trading stock) or to disposals of depreciable assets. It tends to affect businesses when they conduct unusual or one-off transactions such as the sale or

43 Australian Government, *Reform of the Australian Tax System: Draft White Paper* (June 1985).

restructure of a business, the sale of land, or disposals made to effect family succession.

- The CGT regime contains a number of valuable concessions. For example:
 - Assets acquired before 20 September 1985 (pre-CGT assets) are not subject to CGT.
 - An individual's family home is generally exempt from CGT.
 - Individuals and trusts can generally discount a capital gain by 50 per cent 'CGT discount' if they hold an asset for more than one year.⁴⁴
 - There are a range of generous CGT concessions targeted specifically at small businesses.
- The CGT provisions also contain a number of roll-overs under which the imposition of CGT can be postponed.
 - Some roll-overs relate to business restructuring under which there is a change in the ownership of an asset though the beneficial ownership of the underlying asset remains the same (for example, when a sole trader incorporates).⁴⁵
 - Other roll-overs apply when the circumstances leading to the disposal of an asset are outside the taxpayer's control such as when an asset is transferred to one spouse to another after a marriage or relationship breakdown.

6.3 Another feature of the CGT regime of particular interest to small business stakeholders is the way it applies to deceased estates. Under the provisions, a person's death does not automatically trigger a CGT liability. Instead, when assets pass to a deceased person's beneficiaries, the tax liability is deferred until the beneficiary disposes of the asset.

6.4 Stakeholders saw CGT as a crucial issue for small businesses. Criticisms covered a range of issues including its effect on business structuring and succession planning, the difficulty of accessing small business concessions, and other issues.

44 Prior to the introduction of the CGT discount in 1999, capital gains on assets held for more than 12 months were indexed for inflation. Indexation has some residual operation for assets acquired before 21 September 1999 (particularly for companies as they are ineligible for the discount) but is frozen as at that date.

45 Australian Government, *Reform of the Australian Tax System: Draft White Paper* (June 1985).

The CGT small business concessions

6.5 CGT concessions targeted specifically at small businesses have been a feature of the CGT regime since its introduction in 1985. At that time, small businesses had access to a 20 per cent goodwill exemption. The rate of the exemption was later increased to 50 per cent.

6.6 The CGT concessions have been progressively expanded in recognition of the particular circumstances that often face the owners of small businesses. A key driver is a recognition that small businesses often need to reinvest earnings into their businesses without being able to adequately provide for the retirement of their owners. The roll-over exemption acknowledges that the tax liability relating to a capital gain reduces the amount of capital available to buy replacement assets and seeks to ensure that a lack of capital does not constrain the growth and development of small businesses.

6.7 There are currently four small business CGT concessions:

- **the 15-year exemption**, which provides an exemption for capital gains made on active assets held for at least 15 years and, if the taxpayer is an individual, they must be at least 55 years of age and retire or be permanently incapacitated;
- **the retirement exemption**, which allows a CGT exemption for capital gains made on active assets up to a lifetime limit of \$500,000 per individual – if the individual is aged under 55 years the amount must be paid into a superannuation or similar fund;
- **the 50 per cent reduction for active assets**, which allows a 50 per cent reduction of capital gains made on active assets; and
- **the small business roll-over**, which allows a deferral of capital gains made on active assets if within two years the proceeds are reinvested in another business asset.

6.8 In broad terms, a small business owner is able to access the small business CGT concessions by either satisfying the *turnover test* or the *net asset value test*.

6.9 An entity satisfies the turnover test if it is a small business entity. A small business entity is an individual, partnership, company or trust that is carrying on a business, and has less than \$2 million aggregated turnover. Aggregated turnover is annual turnover plus the annual turnovers of any connected entities or affiliates. Generally, this is tested in the year prior to the year of the capital gain but, where this test cannot be satisfied, an entity may be eligible to use the estimated or actual turnover for the current year.

6.10 An entity satisfies the maximum net asset value test if the net value of CGT assets owned by the entity, its connected entities and affiliates, worked out just before the realisation, is no more than \$6 million.

6.11 The general underlying principle on when a capital gain or capital loss is realised is whether there has been a change in the beneficial ownership of an asset. Relief, in the form of a CGT rollover, is provided in many cases where there was a change in the ownership of an asset though the ownership of the underlying asset remains the same.⁴⁶ An example is the transfer of assets to a company where the sole consideration consists of shares in the company and the original owner of the asset holds all the shares in the company.⁴⁷

6.12 The tax law also provides roll-over relief in certain circumstances where the disposal of an asset is due to circumstances outside the taxpayer's control. For example, where the disposal is due to a marriage breakdown, or due to a compulsory acquisition of an asset by a government. In a similar vein, roll-over relief is provided on an asset passing to a legal personal representative or beneficiary as a result of the death of the owner of the asset.

6.13 On a different policy basis, roll-over relief was also provided for certain types of mergers and acquisitions to encourage takeover activity.⁴⁸

Views of Stakeholders

Small business CGT concessions

6.14 A number of stakeholders, including National Tourism Alliance, Deloitte Private and BDO, acknowledged that the small business CGT concessions are generous but believed the law governing access to the concessions is very complex, has confusing definitions for small business, and is in need of simplification.

The \$2 million turnover test

6.15 There was a general consensus among stakeholders that the current threshold of \$2 million for the turnover test is out of date and needs to be increased with consideration being given to indexing the threshold by the CPI on an annual basis in order to keep the threshold commercially realistic.

6.16 One criticism of the turnover test was that it inappropriately prevents some genuine small businesses from enjoying the concessions. In particular, the test was seen as discriminating against businesses that have high turnovers but low profit margins.

46 Australian Government, *Reform of the Australian Tax System: Draft White Paper* (June 1985).

47 Explanatory Memorandum, *Income Tax Assessment Amendment (Capital Gains) Bill 1986*.

48 The scrip for scrip roll-over was introduced following a recommendation in the Ralph Review: *Review of Business Taxation, A Tax System Redesigned* (July 1999), Recommendation 19.3.

The ability to use the alternative net asset value test assists some, but not all, of the businesses in this category.

6.17 Another concern of stakeholders is that some taxpayers who sell shares in a company or units in a trust must pass the \$6 million net asset value test in order to access the concessions and do not have the ability to access the concessions using the \$2 million turnover test. This will be the case when the shareholder or unit holder is not carrying on a business in their own right. It was proposed that the rules should be expanded to provide shareholders or unit holders with the ability to access the concessions if they are selling shares or units in a company or trust that is classified as a small business entity (that is, carries on a business with aggregated annual turnover of less than \$2 million). It was submitted that providing access to the \$2 million turnover test was preferable for taxpayers because it is easier to apply, provides more certainty, has a lower cost of compliance and is less frequently the subject of disputes.

The \$6 million net asset value test threshold

6.18 Stakeholders identified that the use of market valuations to determine whether a small business entity satisfies the net asset value test can be very costly for a small business and can be an imperfect measure. It was noted during consultation that this area is one of the most litigated and disputed issues.

6.19 The Board is advised that one source of dispute involves taxpayers who assert that the market value of an asset for the purposes of this test just before the disposal is significantly less than its selling price in an arm's length transaction. On the face of it, an entity that sells its net assets to an unrelated party for a sum greater than \$6 million might be expected to fail the net asset value test. However, under the current rules, it is open to such an entity to assert that the buyer paid above market value, and that the true value of assets was significantly less.

6.20 One suggestion was to remove the net asset value test and rely on an improved aggregate turnover test. It was suggested that CGT concessions could be available in full where aggregate turnover is less than a benchmark threshold and then progressively reduce (or taper off) at each threshold above that level. This suggestion was put forward on the basis that the turnover test is easier to comprehend and provides more certainty as opposed to relying on a market valuation of assets (CPA).

6.21 It was also proposed that the \$6 million threshold should be increased as it was last set in 2007.

Grouping rules

6.22 Some stakeholders noted that the grouping rules for calculating an entity's aggregated turnover can give rise to anomalous outcomes. In particular, it has been noted that under the grouping rules, the threshold for control of companies, trusts and partnerships is set at 40 percent. Where a taxpayer holds an interest in an entity of less

than the prescribed control threshold of 40 per cent, no part of the entity's turnover is counted towards the taxpayer's aggregated turnover.

6.23 Conversely, where a taxpayer has a more than 40 per cent interest in an entity, the grouping rules generally require a taxpayer to include 100 per cent of an entity's turnover in the threshold calculation without regard to the proportion of actual ownership or control.

6.24 It was suggested that the grouping rules may deny access to some deserving small businesses and create planning opportunities, allowing the concessions to be accessed by businesses that are not the intended target (including, potentially, very large businesses). Some stakeholders consider that the small business CGT concessions would be significantly better targeted and less open to abuse if aggregated turnover rules were modified to ensure that turnover in controlled entities is based on a pro rata calculation where appropriate so that there is an appropriate reflection of the business wealth controlled by the taxpayer.

Scope of the concessions

6.25 As noted above, stakeholders were critical of the rules governing access to the concessions but generally believed that, once accessed, the concessions themselves were sufficiently generous. However, there were some perceived anomalies with the concessions.

6.26 One concern was that concessions are not available on the disposal of a 'passive asset', such as office premises held in an asset holding entity controlled by a partnership for the use of a partnership, when additional partners are added to the small business. This situation can arise where the addition of a new partner to a partnership results in no partner in the partnership having at least a 40 per cent interest in the asset holding entity causing that entity to cease to be 'connected with' the partnership.

6.27 It was suggested that, to address this issue, the original partners, the additional partners, and the asset holding entity should be deemed to be affiliates and connected entities, provided that each partner holds not less than a 20 per cent control interest in the asset holding entity and the partners collectively not less than a 40 per cent control interest in the partnership. This would provide access to the small business CGT concessions for the 'passive asset' held in the asset holding entity that is used by the partnership.

Restructuring and succession

6.28 Several stakeholders suggested providing comprehensive deferral of CGT (in the form of roll-over relief), whenever there is a change in the legal structure of a small business but no change in the underlying ownership of its assets.

6.29 For example, currently roll-over relief is available for the transfer of an asset by a sole trader to a company where the sole consideration for the transfer is shares in the company and the sole trader is the sole holder of the shares. However, there is no equivalent relief from CGT for the reverse transaction, even where there is no change in beneficial ownership of the underlying asset. It would be consistent with the underlying fundamentals of the existing CGT regime to provide for such relief from CGT.

6.30 It was suggested that an incomplete set of CGT roll-over relief options can disadvantage small business operators who commence a small business as a sole trader or other legal structure that subsequently proves to be inappropriate or inefficient, perhaps after obtaining professional advice. It was submitted that such a business should be able to restructure without triggering tax liabilities. For example, transferring assets to a discretionary trust is not catered for by the current roll-over provisions.

6.31 In light of these concerns, it was submitted that it would be of significant benefit if new small businesses were given access to a one-off roll-over relief for restructuring undertaken reasonably soon after the business commences. Such a roll-over would not be confined to restructures involving maintenance of the same economic ownership structure and might therefore allow interests in assets to be transferred, for example, to spouses under a newly-formed partnership arrangement or to a family trust. The Board understands that the family trust is the vehicle of choice in small business structuring based on a range of tax and non-tax considerations.

6.32 An advantage of this approach is that it would free up new small businesses to focus on conducting the business, and defer the question of structuring to a more appropriate time in the business life cycle. It was suggested that a suitable cut-off date for accessing the concession would be three years from the commencement of the business.

Broader CGT roll-over relief for small business (succession planning)

6.33 Several stakeholders suggested roll-over relief for small businesses should be available as part of a small business owner's succession planning or more broadly in allowing small businesses to sell assets without restriction, such as those contained in the small business CGT concessions.

6.34 It was suggested by some that providing roll-over relief for succession planning would be a similar policy to the current CGT roll-over relief for the passing on of assets as part of winding up a small business owner's deceased estate.

Board's Observations

6.35 CGT is an issue of particular importance for small businesses. Small businesses are often exposed to greater risk than larger businesses, and there is an argument that, to compensate for this risk-taking, successful small business people should be allowed

to keep a larger proportion of the gains from selling a successful business. In particular, the rules governing eligibility for the small business CGT concessions are exceedingly complex and difficult for small businesses to navigate.

6.36 The hard cut-off for the tests, which means some businesses are able to access the concessions while slightly larger or less-advised entities receive no concession, creates boundary tensions. These boundary tensions can create significant litigation regarding access to the concessions.

6.37 The hard cut-off also encourages significant tax-planning activity to ensure access to the concessions, and may even encourage some owners to limit the growth of their business. This appears to work against some policy objectives of the concessions (particularly the small business roll-over) to provide small business owners with access to funds for the expansion of their business.

6.38 In the previous chapter, the Board recommended that the Government increase the small business entity turnover threshold to at least \$3 million and investigate the feasibility of an increase to \$5 million. It was noted that such an increase would provide a significant number of small businesses with more certain access to a range of important concessions, including the CGT small business concessions.

6.39 In the event that the Government decides against raising the turnover threshold for general small business entity purposes (or raises it to a different amount), the Board would recommend that consideration be given to raising the threshold solely for the purposes of the small business CGT concessions.

Longer term options for reform

6.40 The Board acknowledges that raising thresholds is an incremental reform and will not address the structural issues with the CGT system as it applies to small businesses. The Board has noted a number of suggestions of stakeholders for improving the current legislative framework. In the time allowed for this review, the Board has not been able to fully evaluate these suggestions. The Board considers that submissions highlight the importance of CGT to small businesses and merit further Government consideration.

6.41 In particular, the Board suggests further consideration of reforms to the CGT small business concessions to better target the concessions and to eliminate the disincentives and unfairness associated with the current rules.

6.42 The Board considers that further analysis could be undertaken to identify circumstances in which eligibility under the turnover test should be based on a pro rata calculation, reflecting the extent to which an entity is controlled by a taxpayer. In the context of that exercise, consideration could also be given to extending access to the turnover test to taxpayers who, for practical reasons, are required to determine eligibility using the net asset value test.

6.43 It is noted that a pro rata rule would represent a departure from existing policy, under which a controlling shareholder is taken to have access to all of the wealth of an entity. It may also involve additional complexity.

6.44 The submission that concessions should be 'tapered' off when thresholds are exceeded, rather than being forfeited completely, may partly address hard cut-off issues but may be complex and difficult to implement.

6.45 The Board is also attracted to the suggestion that the CGT rules should be sufficiently flexible to permit newer small businesses to restructure without undue tax cost. Subject to addressing integrity concerns, the Board considers that further consideration should be given to providing roll-over relief to business restructures that occur early on in the business life cycle. The aim of such a roll-over would be to put such a business in the position it would have been in had it been structured appropriately at its commencement.

6.46 One way of helping to address integrity concerns would be to make the roll-over relief contingent on the existing test for small business CGT concessions. In effect, this would make the new roll-over an additional small business CGT concession subject to the same gateway eligibility criteria. However, a possible disadvantage of this approach is that it would deny relief to very successful start-ups that exceed the eligibility thresholds in the first three years of operation.

6.47 An advantage of a 'new business' roll-over is that it would address a longstanding criticism of the existing concessions, that they are too focussed on the end stages of the business life cycle, rather than at the start-up phase. To provide meaningful assistance, the roll-over should require a degree of continuity of ownership but should not insist on strict maintenance of underlying economic ownership. For example, roll-over could be extended to transfers of active assets to a family-owned company or to a family discretionary trust for which a family trust election has been made. The Board acknowledges that this would represent a very significant departure from the current policy framework for CGT roll-overs and have revenue consequences that would need to be taken into account.

6.48 The introduction of a new business roll-over may also raise complex issues of design and implementation. For example, it would be necessary to include rules specifying the appropriate degree of continuity in ownership to qualify for roll-over. Another issue would be whether roll-over should be available only to sole traders or should permit the unwinding of other business structures, thereby requiring more complex rules. Irrespective of that choice, complex rules may be required to ensure the appropriate treatment of losses incurred in the pre-structure period. A consideration of these issues may well lead to integrity measures and complexities that make the concept undesirable.

6.49 Another proposal for reforming the small business CGT concessions would involve removing the current threshold eligibility requirements and allowing all individuals to receive all capital gains made on active assets free of CGT up to a prescribed cap. The cap could apply to capital gains realised over a person's lifetime or for a shorter period of, say, ten years.

6.50 The Board considers that there are a number of potential advantages to the use of a lifetime cap. Removing complex eligibility criteria could make the system significantly simpler. It would remove the perceived inequity of treatment between a business that is just under the current eligibility cap and a slightly larger business that exceeds the cap. It could also remove the anomalies and integrity risks associated with the current rules.

6.51 Importantly, by eliminating the existing bright line test for eligibility, this option could also remove the disincentive for businesses to grow their business and risk forfeiting extremely valuable concessions.

6.52 The lifetime cap approach would not only be available to proprietors of small businesses. It could potentially be accessed by wealthy taxpayers who realise capital gains from active assets. Accordingly, the proposal is open to the criticism that it might be inappropriately targeted. Depending on where the cap is set, some small businesses may receive less concessions than at present. Grandfathering of existing businesses may be appropriate, adding to the complexity of the system.

6.53 The Board acknowledges that implementing an ambitious reform such as a lifetime cap may also involve some trade-offs. However, if the introduction of a capped concessions can achieve greater simplicity, this might be seen as a reasonable compromise, especially, given that under the current regime, uncapped concessions appear already to be available to large business owners.

6.54 The Board also notes that a lifetime cap may raise its own integrity issues that would need to be properly managed. There would be a need to ensure that the system is designed to remove the risk of taxpayers duplicating caps. One issue for testing would be whether a system could be designed that would allow the ATO to monitor when the cap has been exhausted for a given individual. This may represent a significant administrative challenge, particularly if the cap is in place for a taxpayer's lifetime. A shorter period may be more administratively feasible but increase the cost to revenue.

6.55 The Board considers that this proposal would be a longer term reform option but is one that merits further consideration.

CHAPTER 7: OTHER POTENTIAL REFORMS

Key Points

This Chapter reports on stakeholder comments concerning taxation issues that are out of scope for this review, for example:

- State taxes; and
- Issues having broad application across the business sector.

Other issues in the Chapter are more complex reform matters that are unlikely to be resolved in the short or medium term, may be subject to other current or future processes or are major structural reforms. These include:

- Taxation of trusts;
- Rounding of thresholds in the tax law;
- FBT regime;
- Capital expenditure write-off;
- Division 7A;
- The tax treatment of losses; and
- A new small business entity.

The Board discusses the issues raised and provides its observations in relation to some of the issues.

OVERVIEW

7.1 This Chapter reports on stakeholder comments concerning taxation issues that appear out of scope for this review such as issues involving state taxes and issues having broad application across the business sector.

7.2 Other issues in this Chapter are more complex reform matters that are unlikely to be resolved in the short or medium term. Some of these issues could be considered as part of other processes including, potentially, the Government's Tax White Paper, the Federation White Paper, or any other broader tax or fiscal reform process.

State taxes

7.3 AMIF submitted that impediments facing small businesses cannot be properly examined purely from a Commonwealth perspective. It noted that:

It is not only the existence of taxes, but significant variations between jurisdictions on how they are applied. This is not only impacting growth, but also arguably distorting markets and reducing competitiveness.

7.4 AMIF considered that the Tax White Paper should examine the relationships between the Commonwealth and State and Territory tax systems and their combined contribution to impeding small businesses.

Payroll tax

7.5 A number of submissions to the review raised payroll tax as a very significant impediment to the growth of small businesses. In particular, the AFGC stated that 'payroll tax is by far seen as the worst tax in terms of complexity, cost and disincentive to growth', particularly for businesses operating across jurisdictions.

7.6 ACCI, NSWBC, CCIWA, Pharmacy Guild of Australia, AVCAL, Business SA and CPA also saw payroll tax as an impediment. Business SA (SA CCI) considered that 'payroll tax remains the tax that most limits small businesses ability to expand'. CPA noted that 'payroll tax is a significant handbrake on small businesses employing more people that will trigger a payroll tax liability.'

7.7 Some stakeholders proposed that payroll tax be abolished with AB Network and BDO suggesting that this could be funded by a broadening of the GST base.

7.8 In this context the Board has noted the AFTS finding that State payroll taxes should eventually be replaced with revenue from more efficient broad-based taxes.⁴⁹ However, it was also noted in AFTS that existing payroll taxes are more complex and less efficient than they could be because of tax-free thresholds and other exemptions that vary between jurisdictions.⁵⁰

7.9 ACCI, NSWBC, CCIWA and CCIQ suggested that harmonising rates and thresholds, and indexing thresholds, are important interim measures for reducing complexity.

7.10 A number of stakeholders suggested that consideration be given to having one central administrator for payroll tax and that this could be a role for the ATO.

⁴⁹ AFTS, Report to the Treasurer – Part Two: Detailed Analysis (December 2009), Recommendation 57.

⁵⁰ *Ibid*, 293.

Board's Observations

7.11 The Board strongly supports the harmonisation of the payroll tax rates and thresholds across the states and territories. This would significantly reduce compliance costs. The Board notes, however, that this is a matter for the States and Territories to consider.

7.12 The Board considers that a central administrator for payroll taxes is worthy of consideration on the basis that it could significantly reduce compliance costs, especially for businesses operating across jurisdictions. Again, this is an issue for Commonwealth-State processes.

7.13 The Board has noted that the States and Territories and the ATO have entered into an agreement in relation to the GST, whereby the ATO collects, administers, conducts audits on behalf of the States and Territories who agree to pay the costs of those services.

Stamp duty

7.14 A number of stakeholders stated that stamp duties are inequitable and inefficient. This accords with the finding of AFTS that:

stamp duties on conveyances are inconsistent with the needs of a modern tax system. While a significant source of State tax revenue, they are volatile and highly inefficient and should be replaced with a more efficient means of raising revenue.⁵¹

7.15 CCIQ considered that stamp duty on insurance deters small businesses from adequately protecting their assets. CPA noted that 'transaction taxes such as stamp duty on transfer of real property are a disincentive to buying and selling property which impacts on turnover, labour mobility and general economic activity.'

7.16 AB Network noted that stamp duty can significantly add to the cost of restructuring. It asserted that stamp duty is a growth-inhibiting tax which deters investment and should be abolished. Failing that, AB Network considered that stamp duty exemptions on business assets and reorganisations/restructures should be consistent with the exemptions that currently exist in the CGT law.

51 *Ibid*, 247.

GST

7.17 A number of suggestions were made for the reform of GST including:

- extending the ability to issue Recipient Created Tax Invoices (RCTI);
- removing the distinction between GST Free and Input tax supplies;
- extending the use of the deferred GST Scheme for imports; and
- removing or reducing the GST import threshold.

Recipient created tax invoices

7.18 A RCTI is a tax invoice created by the recipient rather than the supplier. Businesses need to be covered by a legislative determination in order to issue RCTIs.

7.19 The Commissioner has made 59 legislative determinations authorising the use of RCTIs for three general situations as well as for a number of more specific industry transactions. The ATO occasionally receives private ruling requests or correspondence asking if RCTIs can be issued by particular taxpayers under the current determinations, or asking for new determinations to be made. There have been several hundred requests since the start of GST. There have been 86 private ruling requests related to RCTIs since July 2012.

7.20 The three broad classes of RCTIs are detailed in GSTR 2000/10:

- Supplies of agricultural products made to registered recipients who determine the value of the products after a qualitative or quantitative analysis. This applies to viticulture, horticulture, pasturage, apiculture (bees), poultry farming and dairy farming and other operations connected with cultivation, crop gathering or livestock rearing.
- Supplies made to registered government entities such as department, branch or other approved bodies.
- Supplies made to registered recipients that have a turnover of at least \$20 million. If the recipient is a member of a group that meets the requirements of a GST group – even though the group is not registered as such. It is sufficient that one of the members of the GST group has a GST turnover of at least \$20 million. If the recipient is the operator of a GST joint venture it will be sufficient that one of the participants has turnover of at least \$20 million, or is a member of a qualifying group.

7.21 For RCTIs to be effective in any of these situations, various additional requirements must be satisfied. For example, both parties must be registered and there must be a written agreement between the buyer and the seller to issue a RCTI. Tax

invoices within these three classes can be issued by recipients without notifying or applying to the Commissioner.

Stakeholder comments

7.22 Indirecttax.net noted that RCTIs cannot be issued for many transactions by small businesses where it would be practical for them to use them. It suggested that the Commissioner exercise his discretion to allow all recipients to issue RCTIs provided they have an agreement in writing with the supplier to do so.

ATO comments

7.23 Some submissions to the Board of Taxation's 2008 Review of the Legal Framework for the Administration of the Goods and Services Tax noted that complying with the RCTI provisions is very onerous⁵². The Board also noted the industry view that '[t]he requirement for whole industries refraining from using RCTIs until the Commissioner issues an RCTI determination is cumbersome and unnecessary'.⁵³ However, in the report it was noted that the ATO had informed the Board that it was currently consulting with industry to find solutions for these issues. The Board stated that, in its view, it is appropriate that this process be completed before any consideration is given to whether the law needs to be amended.⁵⁴

7.24 Following the Board of Taxation review recommendations, changes were made to the GST law relating to tax invoices and RCTIs, making it easier to comply with the law and relaxing some of the restrictions. However, the changes did not include changing the RCTI requirement for legislative determinations. The ATO also produced a new public ruling on tax invoices.

7.25 The tax invoice is a key element of the GST system and one which the ATO is heavily reliant upon in ensuring compliance. The ATO's view is to leave the existing requirement for RCTI determinations as it helps maintain the integrity of the GST system and means there is an objective standard in the law.

7.26 There is a risk to revenue in allowing all recipients to issue RCTIs. Such a change would make it easier for taxpayers to incorrectly claim input tax credits, or to 'double dip' when using RCTIs. It is also more difficult for the ATO to identify false or incorrect RCTIs rather than normal tax invoices.

7.27 As a result of the concerns raised by stakeholders in this review, the ATO will undertake a review on how the process of the creation of RCTI determinations can be improved, within legislative parameters.

52 The Board of Taxation, *Review of the Legal Framework for the Administration of the Goods and Services Tax*, A report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, December 2008, 43.

53 *Ibid*, 44.

54 *Ibid*, 47.

7.28 This will include ensuring that ATO external webpages and other information products as appropriate are updated to make it clear that registered recipients, and not just industry associations, are able to ask the Commissioner make a legislative instrument in respect of other classes of tax invoices and also the information required by the Commissioner in making a decision whether to create a legislative instrument in the circumstances.

7.29 The review will also consider the process from the time when a registered recipient makes a request to when a decision is made to proceed with the creation of a legislative instrument and how this can be improved.

Board's Observation

7.30 The Board notes that this issue applies broadly across businesses with turnovers of less than \$20 million and is not of particular relevance to small businesses. However, the Board supports the ATO's undertaking that it will review how the process of the creation of RCTI determinations can be improved.

GST Import threshold

7.31 The low value threshold currently exempts imports of goods valued at \$1,000 or less from GST. The threshold was considered by the Productivity Commission in 2011. The Productivity Commission found that there was strong in-principle grounds for the threshold to be lowered significantly on the basis of tax neutrality for goods sourced overseas and those sourced domestically. However, the Productivity Commission recommended against lowering the low value threshold until it is cost-effective to do so.⁵⁵

Views of Stakeholders

7.32 A number of submissions commented on this threshold including the National Retail Association who suggested for physical parcels the threshold should be reduced to the nominal level of \$20.

7.33 The SBAA suggested that the threshold should be abolished as it provides an advantage to foreign businesses to the detriment of Australian businesses.

7.34 As all GST revenue is paid to the States and Territories, who are also responsible for meeting the administration costs of collecting the GST, any change to the threshold would require the agreement of the States and Territories under the Intergovernmental Agreement on Federal Financial Relations.

7.35 At the meeting of the Council on Federal Financial Relations (CFFR) held on 28 March 2014 the Treasurer agreed to a request from the States and Territories

⁵⁵ Productivity Commission, *Economic Structure and Performance of the Australian Retail Industry* (November, 2011), 169.

collectively to further explore options around lowering the value at which GST is applied to the importation of goods into Australia. A joint Working Group of Commonwealth, State and Territory officials subsequently met on 29 and 30 May 2014 to examine the options. The issue will be discussed with the States and Territories again at the next CFFR meeting, which is expected to occur in September 2014.

Board's Observations

7.36 The Board notes that this issue has been raised in a number of different forums and is currently being considered by the CFFR.

Deferred GST

7.37 The deferral of GST on imported goods until the time of the next BAS period is a scheme that provides compliance cost savings and cash flow benefits. Outside this scheme, GST is paid on entry of the goods into Australia. Under the deferral scheme an importer is generally liable to pay GST at the same time that the relevant input tax credit can be claimed.

7.38 In order to register for the scheme, there are a number of conditions that must be satisfied including:

- It is necessary to lodge BAS monthly even if the entity would be entitled to lodge less frequently;
- Lodgements must be electronic; and
- The applicant must have a good compliance record.

Stakeholder comments

7.39 Indirecttax.net noted that in relation to the Deferred GST Scheme for imports the requirement to lodge monthly eliminates much of the benefit of the scheme for SMEs. It recommended that small businesses operating as companies and trusts should be entitled to continue to lodge BAS and pay GST quarterly where they apply to use the scheme.

ATO comments

7.40 Proposals to extend the GST deferral scheme to quarterly remitters have been examined on two occasions in the past five years.

- In 2008 the Board of Taxation in its final report recommended the GST deferral scheme should be extended to small business taxpayers that are eligible to lodge quarterly. The then Government did not accept the recommendation.
- In 2012 the Low Value Parcel Processing Taskforce in its final report recommended that the option of deferral of payment of GST for all GST registrants, while not supported at the time, should be considered further going forward. The then Government agreed to consider an expansion of the GST

deferral scheme should there be any significant reduction in the threshold, and noted that in developing its view it will take into account the potential consequences for the revenue.

7.41 There is a mix of risk, cost and benefit issues associated with proposals to expand the GST deferral scheme.

7.42 The ATO and Australian Customs and Border Protection Service (ACBPS) as administrators of the scheme have previously identified an increased revenue risk associated with the expansion of the scheme unless the ATO maintains key tests applied as part of the registration process in determining a good compliance record. However, maintaining current administrative approaches would significantly increase the cost of such an expansion. There may be a transitional revenue impact through an extension to quarterly BAS lodgers.

7.43 Businesses that could potentially access an expanded scheme may derive a cash-flow benefit or compliance cost savings. However, the overall benefit may be marginal if the proportion of their business is less import oriented, compared to those businesses that have large exposure and operate within the current monthly lodgement framework.

Board Observations

7.44 The Board notes that the issue of extending the GST deferral scheme to quarterly remitters was considered in detail in 2012. The then Government response was that this issue should be considered further going forward in the context of other changes being considered including in relation to potential changes to the GST Import threshold. The Board therefore recommends no change at this time.

GST Classification

7.45 Most basic foods, some education courses and some medical, health and care products and services are GST-free. Exports and businesses sold as a going concern are also GST-free. Sales of these supplies are GST-free. Input tax credits are available for the GST included in the price of purchases used to make GST-free sales.

7.46 To account correctly for GST it is necessary to determine which supplies are GST-free, which ones are taxable and which ones are not reportable. This can add to compliance costs.

7.47 GST simplified accounting methods were introduced to reduce the compliance burden for small food retailers with inadequate or non-existent point of sale equipment by making it easier to account for GST. They were introduced when GST was first implemented in 2000.

7.48 Many small food retailers buy and sell products that are taxable, as well as products that are GST-free. Others buy taxable and GST-free products and sell only

taxable products. Depending on the point-of-sale equipment they use, accurately identifying and recording GST-free sales separately from those that are taxable can be difficult, which makes accounting for GST more complicated.

Stakeholder comments

7.49 Indirecttax.net noted that considerable costs are incurred in classifying goods and services for GST purposes and that the Tax White paper review process should consider the cost of compliance that GST imposes on small businesses.

ATO comments

7.50 The ATO has consulted widely with business over a number of years to develop a wide range of products, guides, determinations and tools (including the food classification decision tool) that are available to the whole business community. Through its consultation framework the ATO continues to engage with and address the needs of the community.

GST base and rate

7.51 A number of stakeholders, including the AB Network, called for changes to the GST base and/or rate including linking an increase in rate or broadening the base to, for example, abolition of payroll tax.

7.52 A number of stakeholders, including R&CA, AB Network, CCIQ and Regional Australia Institute (RAI), submitted that the significant compliance burden of the GST could be reduced by removing exemptions to the GST. For example, R&CA noted that the GST base should be broadened to include fresh food and produce which would reduce the burden for restaurants and cafes who need to determine if each product used is GST-free or not.

Board's Observations

7.53 The concerns raised by stakeholders in relation to the GST rate and base are significant policy issues for the taxation system broadly and are matters for the Commonwealth and States jointly. It is also an issue that has broad application across the business sector.

Taxation of Trusts

7.54 A number of stakeholders commented on the taxation of trusts noting that they are a common vehicle for small businesses. The CAANZ noted that the rules for the taxation of trusts need to be updated and rewritten to reduce complexity. There were a number of specific issues raised including flexibility for trusts to restructure, a new definition of fixed trusts, family trust elections and trustee resolutions. These are discussed briefly below.

7.55 The CAANZ stated that:

For small business in particular, greater flexibility for trusts to restructure their business affairs within a family group without triggering tax liabilities would be achieved by extending tax roll-over relief.

7.56 CPA proposed that a simplified taxation of trusts regime could be achieved by developing separate rules for fixed trusts, non-fixed trusts carrying on investment and non-fixed trusts carrying on a business, rather than trying to subject such differential trusts to a single set of rules. Similarly, BDO noted that the 'practical impossibility to have a fixed trust' and submitted that 'a new and achievable "fixed trust" definition is essential.

7.57 The CAANZ stated that there should be a review of the tax compliance and complexity that currently arises from the making of a family trust election and interposed entity election. Such elections are commonly made by small businesses and there is a general view within the tax practitioner community that the risk to revenue has been addressed by measures which are unduly complex and difficult to apply in practice.

7.58 BDO stated trusts and their beneficiaries should be able to elect to be taxed in a manner analogous to a company and its shareholders. Similarly, Cleary Hoare considers that businesses conducted through trusts operate at a disadvantage relative to companies.

7.59 Cleary Hoare also drew attention to the importance of trust taxation to the small business sector. It was critical of the removal of 'trust cloning' exceptions to the CGT provisions, which had previously facilitated estate/succession planning and restructuring. Similarly, PwC noted that trusts are a safer, more predictable option for passing business assets (for example, farms) down through generations.

7.60 PwC and IPA identified trustee resolutions as an issue that has caused compliance issues for a large number of their clients and members. Since 30 June 2012, there has been a requirement for trustees to complete trustee distribution resolutions by 30 June each year. This change was brought about by the ATO on 1 September 2011 when it withdrew its longstanding practice of allowing trustees an additional two months to prepare trust distribution resolutions. This administrative practice had been in place since 1966 and recognised the practical difficulties faced by trustees and their advisors in making trustee resolutions prior to the end of the income tax years. PwC suggested that, where a family trust election is in place, the due date for trustee resolutions should be extended to the due date for lodgement of the trust's income tax return.

Board's Observations

7.61 The Board considers that, although trust issues have broad application across the business sector, they present particular challenges for small businesses. The Board has recently noted some of these challenges in its review of Division 7A.

7.62 While it emphasises the importance of trust taxation to small businesses, the Board considers that these issues raise significant policy matters that would need to be considered in the context of a broader review.

Rounding and aligning thresholds — for example the Car Limit (for income tax depreciation and luxury car tax)

7.63 The car limit for income tax depreciation and GST credits are currently aligned at \$57,466. This limit is different to the luxury car tax (LCT) threshold.

7.64 LCT is a tax of 33 per cent on luxury cars sold or imported where the value of a car exceeds the threshold. LCT only applies to the amount above the LCT threshold. The LCT threshold is reviewed each financial year and may change. There is a different LCT threshold for fuel-efficient cars (referred to as the 'fuel efficient car limit'). These thresholds are different to the car depreciation limit (car limit) which is used to work out depreciation deductions for income tax purposes.

7.65 For the 2014-15 financial year, the LCT threshold is \$75,375 for fuel efficient vehicles, and \$61,884 for other vehicles. The thresholds are indexed each year and are therefore not round numbers.

7.66 When acquiring a vehicle, a taxpayer needs to consider the car limit to determine their depreciation and input tax credit entitlements, and then consider whether there are any LCT impacts resulting from the LCT threshold. The lack of alignment is made more pronounced for fuel efficient vehicles.

Views of Stakeholders

7.67 Indirecttax.net saw the luxury car limit for income tax depreciation and luxury car tax purposes as a clear source of unnecessary complexity in the system, adding to compliance costs. It recommended making the limit a round number (for example, \$57,000 or even \$55,000) and leaving it unchanged until the underlying index compels change to say \$58,000 (or even \$60,000).

ATO comments

7.68 The alignment of the GST and depreciation cost limits with the LCT threshold, and indexing thresholds by the same factor, may result in some compliance cost savings for taxpayers.

7.69 It is considered that rounding up the car limit to the nearest thousand, for example from \$57,446 to \$58,000, is unlikely to lead to any significant savings in compliance costs for small business. This is because as the threshold is indexed,

taxpayers will still need to seek out the current threshold figure. The rounding of a figure to the nearest thousand will not obviate the need to spend time confirming the current threshold limit.

7.70 Further, it is generally the case that businesses and other organisations registered for GST will pay LCT when they sell or import a luxury car.

Board's Observations

7.71 This issue has broad application across the business sector and would require consideration as part of a broader process.

FBT

7.72 Stakeholder submissions raised concerns about the FBT compliance burden on small business employers including administration proposals, increasing exemptions as well as structural changes to the FBT system. Suggested improvements to administrative arrangements and increased exemptions are discussed in Chapter 5. This section outlines the significant structural proposal that fringe benefits be assessed to employees.

7.73 The AFTS Report⁵⁶ noted that:

Australia's fringe benefits tax system is complex, like those of many other countries. There are, however, some differences in the way in which Australia taxes fringe benefits. While the FBT system has the same broad tax base as other countries, it relies on a higher number of statutory valuation rules and a greater number of concessions and exemptions. The complexity of Australia's FBT system is exacerbated by the taxation of fringe benefits in the hands of employers, which has required the introduction of a large number of supplementary rules to ensure that fringe benefits are factored into means tests in the tax and transfer systems.

FBT on employees

7.74 BDO submitted that fringe benefits should be assessed to employees noting that collection would be facilitated by the PAYG system and much of the necessary work is already undertaken in the collection and reporting of data in respect of 'reportable fringe benefits'. It was, however, recognised that this may raise timing difficulties for employers in being able to collate all fringe benefits to be included in the employee's payment summary by the 14 July deadline.

7.75 IPA and Deloitte Private noted that the taxation of fringe benefits in the hands of employees would alleviate the inequitable application of the top marginal tax rate to fringe benefits, which is currently applied irrespective of the income of the employee.

56 AFTS page 41.

7.76 These stakeholder views are consistent with the AFTS recommendation (see AFTS recommendation 9) that where fringe benefits are readily valued and attributable to individual employees, they should be taxed in the hands of employees through the PAYG system.

7.77 IPA noted that, as a matter of general principle relevant to all businesses, FBT is an inefficient tax intended as a disincentive rather than a source of revenue and that FBT incurs the highest compliance cost relative to the revenue generated.

Board's Observations

7.78 It has been consistently raised that FBT imposes a disproportionate burden on small businesses and in that context, administrative proposals to reduce that burden for small businesses are discussed in Chapter 5. These concerns are significant policy issues that would need to be considered in the context of a broader review. They also have broad application across the business sector. The Board notes stakeholders concerns noted that in practice FBT regime imposes a disproportionate burden on small businesses.

Capital Expenditure write-off

7.79 Australia's tax system does not provide an immediate deduction for most capital expenditure. However, under the capital allowance rules, business taxpayers are entitled to a deduction for the decline in value of depreciating assets.

7.80 There are two parallel regimes governing capital allowances: a 'uniform capital allowances' regime that is open to all taxpayers, and 'simpler depreciation' for businesses with an aggregated turnover of less than \$2 million.

7.81 Under the uniform capital allowances regime, the decline in value deduction is calculated on the basis of an asset's effective life, that is, how long it can be used to produce income. The deduction can be calculated using either a straight line method in which the asset's value is assumed to decline uniformly or a 'prime cost' method in which the rate of decline is assumed to lessen over time. The uniform capital allowances regime also has some concessions for low cost and low value assets.

7.82 Under the simpler depreciation rules for small businesses with aggregated turnover of less than \$2 million, eligible taxpayers are entitled to:

- an immediate write off for most depreciating assets costing less than \$6,500 (\$1,000 prior to 1 July 2012);
- pool most other depreciating assets in the 'general small business pool' and claim a 30 per cent deduction for them (irrespective of their effective life); and

- claim a deduction for most assets that were newly purchased or acquired at 15 per cent in the first year, regardless of when they were purchased or acquired during that year.⁵⁷

7.83 In addition, small businesses may be able to claim up to \$5,000 as an immediate deduction for new or used motor vehicles which cost \$6,500 or more acquired on or after 1 July 2012. The remainder of the motor vehicle's cost will be depreciated in the general small business pool.

7.84 The immediate write off for assets costing less than \$6,500 and for the first \$5,000 on a motor vehicle were introduced as part of a package that included the minerals resource rent tax (MRRT). The Government has introduced legislation into Parliament to repeal the MRRT and associated spending measures.⁵⁸ The accelerated initial deduction for motor vehicles is proposed to be repealed and the asset write-off threshold reduced to its previous level of \$1,000. Assets costing \$1,000 or more will need to be depreciated in the general small business pool.

Views of Stakeholders

7.85 A number of stakeholders saw the availability of enhanced deductibility for capital expenditure as an important initiative for small businesses. The ACCI and the CAANZ recommended that the Government adopt the recommendation made in AFTS to increase the threshold for determining a low-value asset for small businesses to \$10,000. The ACCI noted that current arrangements are complex and uncertain due to the differential treatment of different types of assets.

7.86 CCIQ and PwC opposed the repeal of the small business capital expenditure measures. CPA believes the Government should consider restoring the instant asset threshold to \$6,500 when fiscal circumstances permit. It also submitted that, in light of delays in the repeal legislation, to avoid confusion the change to the write-off threshold should take effect from 1 July 2014 and not 1 July 2013 as announced.

Board's Observations

7.87 The Board notes stakeholder views that the ability to immediately write off capital expenditure is of significant benefit to small businesses. However, this issue is subject to other/parliamentary processes.

57 Certain depreciating assets are excluded from the simpler depreciation rules: assets rented or leased to others, assets allocated to a low value pool, horticultural plants including grapevines, capital works, investment in Australian films, and R&D.

58 The *Minerals Resource Rent Tax Repeal and Other Measures Bill 2013 [No. 2]* is before Parliament at the date of this report.

Division 7A

7.88 Division 7A is an integrity regime designed to prevent shareholders of private companies (or their associates) from inappropriately accessing the profits of those companies in the form of loans, payments, the private use of company assets and debt forgiveness.

7.89 Under Division 7A, where shareholders or associates are taken to have inappropriately accessed company profits, they are taxable on an unfranked deemed dividend. This can cause a significant tax impost for taxpayers who inadvertently trigger the provisions. Generally, a shareholder or associate can avoid the operation of the Division by ensuring that dealings be placed on a commercial footing.

7.90 The most common application of Division 7A is to loans from the company to a related party. Under the Division, loans to shareholders and associates are required to be supported by a 'complying loan agreement' under which the borrower undertakes to make minimum yearly repayments of interest and principal over a 7-year term (for unsecured loans) or 25-year period (for loans secured by real property).

Views of Stakeholders

7.91 The impact of Division 7A on small businesses attracted comment by a number of stakeholders: the Australian Motor Industry Federation, BDO, Business SA, CPA, Deloitte Private, CAANZ, IPA and PwC. It was submitted that the provisions are complex, not well understood, and involve a high cost of compliance that disproportionately affects smaller businesses.

7.92 Three stakeholders, BDO, ICA and IPA, noted that, while Division 7A is primarily a company tax regime, it has a particular impact on small businesses that operate through trusts. They submitted that that Division 7A represents a significant impediment for trading trusts that seek to retain business profits as working capital by making a notional distribution to a corporate beneficiary but retaining the funds in the form of an unpaid present entitlement (UPE). This is said to be a common financing technique for small businesses that gives trusts the ability to reinvest profits without suffering an undue tax burden. This issue is seen as being particularly pressing for businesses that lack ready access to external finance.

Board's Consideration

7.93 The Board of Taxation is conducting a post-implementation review of Division 7A that is due to report to Government by 31 October 2014. In conducting that review, it has noted that Division 7A can apply to a wide range of transactions and arrangements commonly undertaken by small businesses. It extends from individuals carrying on a small business through one private company to groups of entities with

multiple businesses and investment activities.⁵⁹ It has also noted that there are a number of administrative and interpretational difficulties with the provisions.⁶⁰

7.94 Another focus of the Board's review of Division 7A is the interaction of the Division with other parts of the tax system. In this context, the Board is examining the application of the provisions to business structures that combine trusts and companies. The problems associated with trading trusts financing the operations through UPEs are receiving particular attention.

Board's Observation

7.95 As mentioned above, this issue is the subject of a separate Board of Taxation review.

The tax treatment of losses

7.96 Tax losses arise when a business's allowable deductions exceed its assessable income for a given income year. The reasons a business may be reporting tax losses are varied. It may indicate that the business is in permanent decline, that it is undergoing a temporary setback from which it can recover, or it is in start-up phase, not having yet achieved profitability. Tax losses may also be reported by a successful business that has undertaken significant expenditure to expand or modernise.

7.97 The tax treatment of losses, and its impact on business activity also received significant attention in 2009 by Australia's Future Tax System review and again by the Business Tax Working Group (BTWG) which was established by the then Government to consider structural changes to the tax system to support Australia's future growth. Both reviews found that the treatment of losses 'penalises' investments that have a high risk of failure, influencing the types of investments undertaken and how much investment occurs.⁶¹

7.98 The BTWG identified a number of ways in which the tax system 'penalises' risk-taking through its treatment of tax losses. It noted that tax losses are able to be carried forward and offset against future income but not offset against prior years' income. Further, tax losses can be carried forward at their nominal value meaning their 'real' value erodes over time. Finally, the tax law contains a range of integrity rules that can prevent an entity from deducting tax losses if there has been a significant change in its underlying ownership (the continuity of ownership test) and cannot demonstrate that it is carrying on the same business as the one previously carried on (the same business test). These integrity rules are variously designed to prevent 'loss trafficking'

59 Board of Taxation, *Post-implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936: Discussion Paper* (December 2012).

60 *Ibid*, 29.

61 Business Tax Working Group, *Final report on the tax treatment of losses* (2012); AFTS, *Report to the Treasurer – Part One* (2009), 41.

or to ensure that the benefit of losses is only enjoyed by persons economically associated with the loss.

7.99 From the 2012-13 income year, companies were given tax relief allowing them to carry-back tax losses to receive a refund against previously paid tax. The Government has announced that it intends to repeal the loss carry-back tax refund for the 2013-14 income year and later income years. Legislation was tabled in Parliament on 23 June 2014⁶².

7.100 A further aspect of the tax treatment of losses that affects some small businesses is the non-commercial loss rules. These rules limit the ability of individuals to offset losses from business against income from other sources, such as wages. It applies to individuals who conduct business as sole traders or in partnership. The rules are targeted at high income earners.⁶³

7.101 Under these rules, an individual can offset a loss from a business against other income if their income for non-commercial loss purposes is less than \$250,000 and the business passes one of these tests:

- It produces assessable income of at least \$20,000.
- It has produced a profit in three of the past five years (including the current year).
- It uses, on a continuing basis:
 - real property or an interest in real property worth at least \$500,000; or
 - other assets worth at least \$100,000.

Views of Stakeholders

7.102 The tax treatment of losses was identified as an impediment for small businesses in a number of submissions.

7.103 BDO and CPA submitted that when fiscal circumstances permitted, the Government should consider the reintroduction of loss carry-back. IPA and AFGC were also in favour of its reintroduction.

7.104 ACCI supported the introduction of loss carry-back for capital losses, on the basis that it would help businesses manage volatility and improve cash flow in times of volatility.

62 *Minerals Resource Rent Tax Repeal and Other Measures Bill 2013 [No. 2]*.

63 *Explanatory Memorandum to Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009*.

7.105 Two stakeholders believed that the integrity rules for carrying forward losses had a negative effect. Deloitte Private noted that smaller companies that invest in R&D often need to raise share capital while in the innovation phase thereby failing the continuity of ownership test. These companies may be unable to satisfy the same business test when they seek to commercialise the R&D. The effect is that tax losses can be forfeited.

7.106 TTI submitted that, although not strictly limited to small businesses, the complexity of the loss integrity rules makes them difficult to apply when seeking to utilise losses.

7.107 One stakeholder, the Regional Australia Institute, was critical of the non-commercial loss regime. It submitted that the design and drafting of the law has resulted in a regime that is highly complex, resulting in a high compliance burden.

Board's Observation

7.108 The Board notes the support for loss carry-back and acknowledges that, if properly designed, loss carry-back can advantage small businesses by providing additional cash flow during periods of temporary downturns. It can also create an incentive for businesses to undertake capital expenditure programs which may result in losses in the short term but enhance a business's profitability in the longer term.

7.109 The Board also notes that loss carry back has a significant cost to revenue. For example, according to Treasury estimates, the proposed discontinuation of the current company loss carry-back measure will generate savings of \$950 million over the forward estimates period⁶⁴.

7.110 The Board also observes that one potential criticism of the current loss carry-back measure is that, because it applies only to companies, it does not reduce tax impediments for the large number of businesses that operate as sole traders, in partnership or through trusts. However, a more broadly based carry-back mechanism is likely to significantly increase the cost to revenue and may involve significant complexity.

7.111 The Board agrees that the issue of whether the same business test is overly restrictive is worthy of further consideration.

STRUCTURAL REFORM OF SMALL BUSINESS TAXATION

7.112 Stakeholders raised issues involving structural reform of the taxation of small businesses. These issues cannot be resolved in the short or medium term but could be considered by the Government, for example, as part of its White Paper process.

⁶⁴ Explanatory Memorandum to *Mineral Resource Rent Tax Repeal and other measures Bill 2013*, 7.

New small business entity

7.113 A number of stakeholders suggested a new structure or taxation arrangements should be examined for small businesses.

7.114 BDO suggested that a new tax regime for small business entities combining attributes of companies, trusts and partnerships should be created. Similarly, CAANZ consider that a new small business entity should be created noting that tax outcomes vary depending on structure chosen to conduct a business. Small Business Development Corporation WA pointed out that a new low cost hybrid small business entity could eliminate the complexity of tax planning and reporting associated with operating under a company structure.

7.115 Reference was also made to the US system with CPA stating that the Tax White Paper should explore introduction of a US 'S corp' style entity as a vehicle through which an SME can carry on a business in Australia.

7.116 IPA suggested that there should be a simplification of the small business taxation system through the application of a structure which eliminates the need for multiple structures. It proposes that a separate type of entity be established specifically for small businesses 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 a uniform corporate tax rate as other entities are able to reinvest at least 70 cents of each dollar of profit back into the business.

7.117 RAI went further, suggesting not only that consideration be given to the creation of a new small business entity or structure for taxation purposes, but that such an entity could be extended for other purposes such as workplace relations. From a tax perspective such an entity could provide access to the CGT small business concessions, GST simplified reporting and relief from FBT. The flow through of income could be allowed and a differential entity tax rate could be considered.

7.118 A number of stakeholders supported the concept of entity flow-through, including The Law Council of Australia who submitted that there should be further consideration of a 'flow-through' election option for SME companies. TTI was broadly supportive of elective flow-through of losses although it is cognisant that such a change will raise integrity concerns that may also need to be countered. The CAANZ and Deloitte Private propose that business income should be taxed when it flows to the owners of the business rather than in the businesses itself – entity flow-through.

Board's Observations

7.119 This is a significant policy issue that would need to be considered in the context of a broader review and has broad application across the business sector.

CHAPTER 8: PRIORITIES

8.1 The purpose of this Chapter is to prioritise the Board's recommendations having regard to ease of implementation and how long they are likely to take to implement. This Chapter is not a comprehensive list of the issues raised by stakeholders. The Board's consideration of issues where no formal recommendation is made, are addressed through the substantive chapters.

8.2 A number of systemic taxation issues consistently raised by stakeholders are noted in the medium to longer term reforms section below. These are complex areas. While they are not the subject of formal recommendations, the Board is of the view that further consideration of them is warranted.

8.3 The priority of the Board's recommendations and a number of observations are discussed in the following broad categories.

SHORT TERM ADMINISTRATIVE RECOMMENDATIONS

8.4 These recommendations can be implemented administratively by the ATO, and some are already being implemented. In this category, short term is considered to be around 12 months.

Australian Business Number — Recommendations 4.1 and 4.2

- The Board recommends that the ATO revise Miscellaneous Taxation Ruling MT 2006/1 and other guidance material to include activities which will evidence an applicant is *intending* to carry on an enterprise and can therefore be eligible for an ABN.
 - The additional activities should be typical of the kinds of things, from a practical perspective; a person may do prior to actually carrying on an enterprise but are not currently within the guidance material.
 - Further, the activities should be able to be selected from a list as part of the ABN application process.
 - Specifically, the Board recommends the online ABN application tool ask whether the applicant intends to carry on an enterprise, followed by a 'drop down' menu with the extended list of activities that confirm an applicant's eligibility for an ABN.

- The Board also recommends that the ATO provide a 'hotline' so that where an application has not issued in circumstances where it is important to the applicant it be issued urgently, or is rejected, there is access to the ATO for assistance.
- The Board endorses the ATO's approach to reviewing the disclaimer on the ABN Lookup tool so that users of the tool acting in good faith can rely on the result of an ABR search to evidence the validity of an ABN.

Employee/contractor tool — Recommendation 4.3

- The Board recognises that the complexities faced by some small businesses in deciding whether an employment or contractor relationship exists in particular circumstances. The Board endorses the ATO review of the tool and commends the ATO for its responsiveness to the stakeholder concerns.
- The Board recommends, as part of its review of the operation of the tool, the ATO considers how the tool could better reflect or provide guidance in circumstances where a person is working through an interposed entity (company or trust).
- In addition, the Board recommends that the ATO consider incorporating into the tool its guidance on who is an 'employee' for SG purposes to provide more certainty for employers in respect of their SG obligations.

Director Penalty Notices (Observations) — Paragraphs 4.84 — 4.85

- The Board considers that there is scope for improving administrative processes to provide greater comfort to directors that they will not receive a DPN without warning.
- The ATO has undertaken to modify the 'Firm Action Warning letter' sent to the authorised tax representative of a company to incorporate information about the impending DPN. Further, the notice should make it clear that the authorised representative should be communicating with all the directors to resolve the issues. The Board endorses these proposed changes.

Activity Statements — Recommendation 4.6

- The Board recommends that the ATO, and its relevant advisory groups, review whether the quarterly reporting obligations for small businesses could be significantly simplified including whether at the end of each financial year businesses could complete a combined Income Tax Return and Annual Business Activity Statement based on the same data.

Recipient Created Tax Invoices (RCTI) (Observation) — Paragraph 7.31

- The Board notes that this issue applies broadly across businesses and is not only relevant to small businesses. However, the Board supports the ATO's undertaking that it will review how the process of the creation of RCTI determinations can be improved.

MEDIUM TERM ADMINISTRATIVE RECOMMENDATIONS

Personal Services Income (PSI) — recommendations 4.4 and 4.5

- The Board commends the steps already undertaken by the ATO to develop a prototype on line decision tool and recommends that the ATO continues to develop it. The tool should go further than just working through the PSI tests; it should where possible incorporate material that clarifies what the result means for the taxpayer. Furthermore, where the PSI tool is used in good faith the tool should provide a decision that will provide protection from the imposition of penalties where the user relies on the outcome.
- Stakeholders' comments to the Board suggest that the current ATO guidance material can be disjointed and that any changes to improve understanding should be comprehensive. As such the Board also recommends that, given the uncertainty and complex nature of the PSI rules, that as well as the decision tool the ATO examine ways to better explain the PSI rules and how they apply.

Transfer pricing compliance obligations — Recommendation 4.9

- The Board recommends that the ATO develops guidance for small businesses to provide some certainty as to documentation requirements for transfer pricing transactions.
- In particular, the ATO should take into account stakeholders' comments that the most significant compliance costs for small businesses relate to benchmarking data which can be hard to establish and/or costly to obtain from a third party.
- It would reduce compliance costs if the ATO could outline its expectations for small businesses when they are sourcing benchmarking data to support transfer pricing transactions, such as whether the use of ABS data or ATO statistics may be acceptable.
- In undertaking this work, consideration needs to be given to the transfer pricing work being completed by the OECD as part of the international project on Base Erosion and Profit Shifting (BEPS).

SHORT TO MEDIUM TERM LEGISLATIVE RECOMMENDATIONS

Superannuation Guarantee (SG) — recommendations 5.2 to 5.6

- The Board recommends allowing employers to assess superannuation obligations for employees against a quarterly threshold of \$1,350. Employers who do not wish to change their current systems and processes will still meet their superannuation obligations if they continue to test on a monthly basis.

- The Board recommends that the SG charge be calculated on the basis of OTE rather than salary and wages to align it with the way that superannuation contributions are calculated. While OTE is a more complex definition it would mean no change to employers' current calculations.
- The Board recommends that the calculation of the SG Charge components be redesigned by legislation. In this respect, it is noted that the SG Charge and interest components are distributed to employees' superannuation funds representing the superannuation contributions they are entitled to and interest. In relation to other penalties, such as the Part 7 penalty and the administrative component (\$20 per employee per quarter), these should be replaced with the administrative penalties provided for under the TAA.
- The Board also considers that the non-deductibility of the SG Charge is unreasonable. The Board recommends that the SG Charge and any employer contributions paid to a superannuation fund that are used to offset the SG Charge payable should be deductible to the employer when the amounts are paid.
- In relation to the SG Charge reporting requirements, the Board recommends the removal of the automatic requirement on employers to lodge an SG Charge statement (and the associated documentation) with the ATO when they become liable to the SG Charge. The employer instead should be required to pay the late superannuation contribution and the associated interest directly to the superannuation fund. An employer would be required to provide the details contained in the SG Charge statement if requested by the ATO or if ATO compliance activity was initiated. It should not be an automatic requirement by operation of the law any time an employer is more than one day late with superannuation contributions.

Small Business Entity test (including for CGT concessions) — Recommendation 5.1

- Based on an analysis of business population data, the Board recommends that the small business entity turnover threshold be increased to at least \$3 million and investigate the feasibility of an increase to \$5 million.

FBT — Recommendations 5.7 and 5.8

- The frequency with which FBT issues were raised by stakeholders suggests FBT creates a significant and disproportionate compliance burden for small businesses. A number of options to relieve some of this burden were suggested.
- One suggestion is to raise the minor and infrequent threshold which is currently \$300. This threshold was increased from \$100 to \$300 on 1 April 2007. The Board recommends an increase to the 'minor and infrequent' threshold from \$300 to, at least, \$500. This is arguably a reasonable level that keeps the threshold current.

- The Board also recommends that there be an investigation of the possibility of aligning the FBT year to the income tax year. The Board notes, however, transitional implications and reporting timeframes would need to be considered.
- The Board welcomes the ATO's commitment to consulting with stakeholders to discuss any administrative arrangements that can reduce compliance costs.

Taxable Payments Reporting System — Recommendations 4.7 and 4.8

- The Board recommends the alignment of the 21 July TPRS reporting date with the 28 August BAS lodgement date to the latter date.
 - The Board understands that a later reporting date will have implications for pre-filing income tax returns for contractors in the building and construction industry. However, on balance the Board considers that the reduction in compliance costs for small businesses outweighs the delay in the ATO's ability to pre-fill.
 - : It is expected that only taxpayers who want to lodge their tax returns early will be impacted by the inability of the ATO to pre-fill their returns.
 - : In addition, taxpayers who want to lodge early will have their own business records to complete their return.
 - : It is also noted that reported payments in respect of taxpayers may not capture all payments a taxpayer has received therefore requiring adjustment to pre-filled data.
- The Board also recommends that a full analysis of the effectiveness of this reporting system be undertaken once complete data is available.

MEDIUM TO LONGER TERM REFORMS

8.5 Chapter 6 discusses the small business CGT concessions; in particular, noting the significant concerns raised by stakeholders about the complexity and compliance costs of the concessions. As discussed in that Chapter, the Board identified some incremental options including raising the turnover threshold, and considering a tapered reduction in concessions rather than the current 'bright line' test.

8.6 However, the Board considers a more fundamental review of the Small Business CGT concessions is warranted given the potential for significant simplification and reduction in compliance costs.

8.7 Chapter 7 reports on stakeholder comments concerning taxation issues that are out of scope for this review, for example, issues involving state taxes and issues having broad application across the business sector.

8.8 There are also a number of issues that would require consideration by different Commonwealth agencies and different levels of government in order to address stakeholder concerns. Of the issues in this category, a key one is the different definitions of 'small business' (discussed in Chapter 5). The Board considers that this issue should be reviewed as consistency would significantly reduce small business compliance costs.

8.9 Chapter 7 also includes a discussion of more complex areas that are unlikely to be resolved in the short or medium term. Some of these issues could be considered as part of other processes including potentially as part of the Tax White Paper or the Federation White Paper, or any other broader tax or fiscal reform process.

8.10 An issue that falls within this category is whether tax treatment should be consistent regardless of business structure or entity type. Recognising that this would be a very difficult and complex review, the Board considers it should be reviewed given the substantial benefits it could provide. A related issue is the taxation of trusts which, although is relevant across the business sector, presents particular challenges for small businesses as it is a common entity used by them.

APPENDIX A: SUMMARY OF RECOMMENDATIONS

Recommendation 4.1

The Board recommends that:

- The ATO revise Miscellaneous Taxation Ruling MT 2006/1 and other guidance material to include activities which will evidence that an applicant is *intending* to carry on an enterprise and is therefore eligible for an ABN.
 - The additional activities should be typical of the kinds of things, from a practical perspective; a person may do prior to actually carrying on an enterprise but are not currently within the guidance material.
 - Further, the activities should be able to be selected from a list as part of the ABN application process.
 - Specifically, the Board recommends the online ABN application tool ask whether the applicant intends to carry on an enterprise, followed by a ‘drop down’ menu with the extended list of activities that confirm an applicant’s eligibility for an ABN.

Recommendation 4.2

The Board also recommends that the ATO provide a ‘hotline’ so that where an application has not issued in circumstances where it is important to the applicant it be issued urgently, or is rejected, there is access to the ATO for assistance

Recommendation 4.3

The Board recognises the complexities faced by some small businesses in deciding whether an employment or contractor relationship exists in particular circumstances. The Board endorses the ATO review of the tool and commends the ATO for its responsiveness to the stakeholder concerns

The Board recommends, as part of the ATO’s review of the operation of the tool:

- it considers how the tool could better reflect or provide guidance in circumstances where a person is working through an interposed entity (company or trust); and
- it considers incorporating into the tool its guidance on who is an ‘employee’ for SG purposes to provide more certainty for employers in respect of their SG obligations.

Recommendation 4.4

The Board commends the steps already undertaken by the ATO to develop a prototype on-line decision tool and recommends that the ATO continues to develop it.

The Board recommends that:

- The tool should go further than just working through the PSI tests; it should where possible incorporate material that clarifies what the result means for the taxpayer.
- Furthermore, where the PSI tool is used in good faith the tool should provide a decision that will provide protection from the imposition of penalties where the user relies on the outcome.

Recommendation 4.5

Stakeholders' comments to the Board suggest that the current ATO guidance material can be disjointed and that any changes to improve understanding should be comprehensive.

As such the Board recommends that, given the uncertainty and complex nature of the PSI rules, that as well as the decision tool the ATO examine ways to better explain the PSI rules and how they apply.

Recommendation 4.6

The Board recommends that the ATO, and its relevant advisory groups, review whether the quarterly reporting obligations for small businesses could be significantly simplified including whether at the end of each financial year businesses could complete a combined Income Tax Return and Annual Business Activity Statement based on the same data.

Recommendation 4.7

The Board recommends the alignment of the 21 July TPRS reporting date with the 28 August BAS lodgement date to the latter date.

- The Board understands that a later reporting date will have implications for pre-filing income tax returns for contractors in the building and construction industry. However, on balance the Board considers that the reduction in compliance costs for small businesses outweighs the delay in the ATO's ability to pre-fill.
 - It is expected that only taxpayers who want to lodge their tax returns early will be impacted by the inability of the ATO to pre-fill their returns.
 - In addition, taxpayers who want to lodge early will have their own business records to complete their return.

Recommendation 4.7 (continued)

- It is also noted that reported payments in respect of taxpayers may not capture all payments a taxpayer has received therefore requiring adjustment to pre-filled data.

Recommendation 4.8

The Board recommends that a full analysis of the effectiveness of this reporting system be undertaken once complete data is available.

Recommendation 4.9

The Board recommends that the ATO develops guidance for small businesses to provide some certainty as to documentation requirements for transfer pricing transactions.

- In particular, the ATO should take into account stakeholders' comments that the most significant compliance costs for small businesses relate to benchmarking data which can be hard to establish and/or costly to obtain from a third party.
- It would reduce compliance costs if the ATO could outline its expectations for small businesses when they are sourcing benchmarking data to support transfer pricing transactions, such as whether the use of ABS data or ATO statistics may be acceptable.
- In undertaking this work, consideration needs to be given to the transfer pricing work being completed by the OECD as part of the international project on Base Erosion and Profit Shifting (BEPS).

Recommendation 5.1

Based on an analysis of business population data, the Board recommends that the small business entity turnover threshold be increased to at least \$3 million and investigate the feasibility of an increase to \$5 million.

Recommendation 5.2

The Board recommends allowing employers to assess superannuation obligations for employees against a quarterly threshold of \$1,350. Employers who do not wish to change their current systems and processes will still meet their superannuation obligations if they continue to test on a monthly basis.

The Board recognises that this may exclude some low income earners from superannuation coverage. However, it will reduce compliance costs for small businesses, particularly for those with a large number of short-term casual employees.

Recommendation 5.3

The Board recommends that the superannuation guarantee charge be calculated on the basis of OTE rather than salary and wages to align it with the way that superannuation contributions are calculated. While OTE is a more complex definition it would mean no change to employers' current calculations.

Recommendation 5.4

The Board recommends that the calculation of the SG Charge components be redesigned by legislation.

In this respect, it is noted that the SG Charge and interest components are distributed to employees' super funds representing the superannuation contributions they are entitled to and interest.

In relation to other penalties, such as the Part 7 penalty and the administrative component (\$20 per employee per quarter), these should be replaced with the administrative penalties provided for under the TAA.

Recommendation 5.5

The Board considers that the non-deductibility of the SG Charge is unreasonable. The Board recommends that the SG Charge and any employer contributions paid to a superannuation fund that are used to offset the SG Charge payable should be deductible to the employer when the amounts are paid.

Recommendation 5.6

In relation to the SG Charge reporting requirements, the Board recommends the removal of the automatic requirement on employers to lodge an SG Charge statement (and the associated documentation) with the ATO when they become liable to the SG Charge.

Recommendation 5.6 (continue)

The employer instead should be required to pay the late superannuation contribution and the associated interest directly to the superannuation fund. An employer would be required to provide the details contained in the SG Charge statement if requested by the ATO or if ATO compliance activity was initiated. It should not be an automatic requirement by operation of the law any time an employer is more than one day late with superannuation contributions.

Recommendation 5.7

The frequency with which FBT issues were raised by stakeholders suggests FBT creates a significant and disproportionate compliance burden for small businesses. A number of options to relieve some of this burden were suggested.

One suggestion is to raise the minor and infrequent threshold which is currently \$300. This threshold was increased from \$100 to \$300 on 1 April 2007. The Board recommends an increase to the 'minor and infrequent' threshold from \$300 to, at least, \$500. This is arguably a reasonable level that keeps the threshold current.

Recommendation 5.8

The Board also recommends that there be an investigation of the possibility of aligning the FBT year to the income tax year. The Board notes, however, transitional implications and reporting timeframes would need to be considered.

APPENDIX B: LIST OF PUBLIC SUBMISSIONS

APL Financial Chartered Accountants

Australian Chamber of Commerce and Industry

The Association of Superannuation Funds of Australia

AusBiotech

Australian Bookkeepers Network

Australian Food and Grocery Council

Australian Motor Industry Federation

Australian Taxi Industry Association

Australian Trucking Association

Australian Private Equity & Venture Capital Association Limited

BDO

Business SA

Chamber of Commerce and Industry Queensland

Chamber of Commerce and Industry of Western Australia

Chartered Accountants Australia and New Zealand
(formerly the Institute of Chartered Accountants in Australia)

Cleary Hoare

Combined Small Business Alliance of WA

Cooperative Research Centres Association

CPA Australia

Deloitte Private

Enterprise Network for Young Australians

Greenwood & Freehills

Independent Contractors Australia

Indirecttax.net

Inside This World Pty Ltd

Institute of Public Accountants

Launceston Chamber of Commerce

Law Council of Australia

Master Builders Australia

McEwan, Chris

National Retail Association

National Tourism Alliance

NSW Business Chamber

NSW Small Business Commissioner

Pharmacy Guild of Australia

PwC

Regional Australia Institute

Restaurant and Catering Australia

Small Business Association of Australia

Small Business Development Corporation (Government of Western Australia)

The Tax Institute

APPENDIX C: FINDINGS OF THE BOARD'S 2007 SCOPING STUDY OF SMALL BUSINESS TAX COMPLIANCE COSTS⁶⁵

Finding 1

The vast majority of Australian businesses are small businesses. Around 93 per cent of all Australian businesses by number have turnover of less than \$2 million per year.

Finding 2

Small businesses are very important to the Australian economy. They produce around 39 per cent of Australia's industry value added and employ almost half the non-agricultural workforce. Most are engaged in the property and business services, agriculture, construction and retail sectors.

Finding 3

While not-for-profit organisations are not generally established for business purposes, in some respects they may experience similar compliance issues to small businesses.

Finding 4

Compliance costs have a more significant impact on small businesses than on larger businesses. They are regressive, with a given cost imposing a proportionately higher impost, the smaller the business.

Finding 5

Governments, both in Australia and internationally, have recognised that small businesses have proportionately higher tax compliance costs and have introduced initiatives to try to reduce these costs.

Finding 6

Compliance costs can be both financial and non-financial. In some cases, non-financial compliance costs, such as stress and time lost, can be just as significant, if not more so, than the financial compliance costs. Many small businesses choose to replace stress and time costs with financial costs by paying tax agents and bookkeepers to assist in meeting their tax compliance obligations.

⁶⁵ Board of Taxation, Scoping study of small business tax compliance costs: A report to the Treasurer (December 2007).

Finding 7

Small businesses may become confused about what tax compliance costs are. They do not always distinguish between tax compliance costs and either the amount of tax they have to pay or the general accounting and record keeping costs that are an essential part of running an effective business.

Finding 8

Tax compliance may provide benefits to businesses by imposing a discipline that allows them to better monitor and understand their business dealings and cash flow. Tax agents are often more likely to recognise these benefits than small businesses themselves.

Finding 9

The small business sector is extremely diverse and the compliance costs of small businesses are influenced by a range of factors. As a result, the experience of both tax and non-tax compliance costs can vary significantly from business to business. For some businesses, tax compliance costs will dominate, but for others, non-tax compliance costs will be more significant.

Finding 10

Size, turnover and business structure influence the compliance costs of small businesses. New businesses tend to start with low turnover and simple business structures, and generally have lower compliance costs. As the business becomes more successful over time and turnover grows, owners tend to move to more complex business structures, for example companies and trusts, to minimise risk and tax. This can increase both tax and non-tax compliance costs.

Finding 11

Small businesses may not always be fully aware of the tax and non-tax compliance cost implications of establishing their own business and changing from simple to more complex business structures such as a company and/or trust.

Finding 12

Employment of staff imposes significant regulatory compliance costs, many of which are not tax related.

Some business operators choose not to grow beyond a certain size so that they can avoid additional risk, complexity and administrative burdens.

Finding 13

Industry sector can influence both the level of compliance costs and whether tax or non-tax compliance costs are more significant. Businesses that operate in the construction, restaurant and catering, agricultural and mining industries, in particular, appear to experience significant non-tax regulatory compliance costs.

Finding 14

The skills, attitudes, efficiency and confidence of the small business proprietor are significant determinants of whether they are likely to be concerned about tax compliance obligations.

Finding 15

Businesses with computerised recording and reporting systems tend to manage their compliance costs better.

Finding 16

A significant number of small businesses outsource their tax compliance obligations, particularly to tax agents and bookkeepers. Key factors determining whether businesses outsource their tax compliance obligations include the size and complexity of the business, the cash flow, the proprietor's understanding of their record keeping and reporting obligations, and the prioritisation of their time.

Finding 17

Some progress has been made in standardising the definition of 'small business' in tax law, but different definitions are still used in other parts of the law, making it difficult to define clearly the boundaries of the small business sector. There would be merit in exploring the broader application of a standard definition across all legislation.

Finding 18

Inconsistent definitions and thresholds for concepts such as 'employee' and 'salary and wages' cause complexity in the law and uncertainty for small businesses, potentially adding to their compliance costs.

Finding 19

Businesses that have to comply with regulations imposed by several jurisdictions because they operate across state and territory borders experience higher regulatory compliance costs than those that operate within one State or Territory. Trading across national borders is likely to increase compliance costs further, with nearly half of all Australian exporters being small businesses.

Finding 20

Use of the tax system to achieve social and other broader policy objectives can increase the complexity and pace of change of the law. This can influence perceptions of compliance costs and may in some cases increase actual compliance costs.

Finding 21

The provision of a range of choices, concessions and thresholds for small business in the tax system adds to complexity and encourages small businesses to seek professional advice, which increases their financial compliance costs.

Finding 22

Achieving both certainty and simplicity is a key challenge for all participants in the tax system. While taxpayers' desire for certainty from the tax system is being met by the ATO offering to tax agents a range of public and private rulings, determinations, practice statements and other supporting materials, these can increase the overall complexity of the system.

Finding 23

Change to the tax system can increase compliance costs as both taxpayers and tax agents seek to understand new arrangements. However, change is also necessary to address concerns about compliance costs. Mandatory compliance cost assessments will assist in determining whether particular changes will increase or reduce compliance costs.

While individual changes may be justified, they need to be considered in the context of other changes that are being made. The cumulative impact of all changes on compliance costs also needs to be considered.

Finding 24

The complexity of the tax system and recruitment difficulties are placing significant pressure on the tax agent industry.

Finding 25

Consultation with small business is important to ensure that the design of tax policy, legislation, administrative systems and supporting materials suits the needs of small business.

Finding 26

Education of taxpayers and tax agents can assist in reducing tax compliance costs. There are roles for the ATO, the tax profession and other private sector organisations in providing education, and small businesses themselves need to seek out those services that best meet their needs.

Finding 27

There is no single, precise aspect of the tax system that appears to be driving the tax compliance concerns perceived by small businesses. Rather, changes to and the accumulation of regulation at all levels of government appear to be the problem. Consequently, there is no simple 'quick fix', and improvements are only likely to be achieved through concerted effort by governments across jurisdictions.

Finding 28

While concerns about completing Business Activity Statements appear to be gradually decreasing over time as businesses become familiar with the requirements, the BAS is still regarded as the most annoying and time consuming tax compliance requirement for small businesses. The degree of the concern varies from business to business.

Ongoing education of small businesses about BAS requirements is likely to assist in easing the compliance burden.

Finding 29

While changes have been made recently to improve the operation of the small business capital gains tax concessions, the complexities of capital gains tax legislation still make it difficult for small businesses to comply easily.

Finding 30

While very few small businesses pay fringe benefits tax, some small businesses undertake considerable compliance activities in order to avoid being included in the FBT system.

Finding 31

Many small businesses are experiencing significant tax compliance costs in attempting to manage intergenerational transfer of business assets. The lack of a comprehensive regime across all levels of government to deal with succession planning issues appears to contribute to this cost.

APPENDIX D — AUSTRALIA’S FUTURE TAX SYSTEM REVIEW — SMALL BUSINESS RECOMMENDATIONS

AFTS RECOMMENDATION	IMPLEMENTATION STATUS
Recommendation 17	
<p>The capital gains tax regime should be simplified by:</p> <p>(a)...</p> <p>(b) rationalising and streamlining the current small business capital gains tax concessions by:</p> <ul style="list-style-type: none"> - removing the active asset 50 per cent reduction and 15-year exemption concessions; - increasing the lifetime limit of the retirement exemption by permanently aligning it with the capital gains tax cap for contributions to a superannuation fund; and - allowing taxpayers who sell a share in a company or an interest in a trust to access the concessions via the turnover test. <p>(c) removing current grandfathering provisions relating to assets acquired before the commencement of capital gains tax, with a market value cost base provided for those assets when the exemption is removed, or before the end of previous indexation arrangements. A relatively long lead-time should be provided before these removals take effect; and</p> <p>(d) rewriting the capital gains tax legislation using a principles-based approach that better integrates it with the rest of the income tax system.</p>	<p>Not adopted by government.</p>

Recommendation 29	
<p>The capital allowance arrangements for small business should be streamlined and simplified, by:</p> <p>(a) allowing depreciating assets costing less than \$10,000 to be immediately written off; and</p> <p>(b) allowing all other depreciating assets (except buildings) to be pooled together, with the value of the pool depreciated at a single declining balance rate.</p>	<p>Enacted in part – Adopted with modification: \$5,000 instant asset write-off from the 2013-14 financial year.</p> <p>Pooling at 30 per cent depreciation rate.</p>
Recommendation 30	
<p>The small business entity turnover threshold should be increased from \$2 million to \$5 million, and adjustments to the \$6 million net asset value test should be considered.</p>	<p>Not adopted by government.</p>
Recommendation 127	
<p>The government should assist small businesses to be 'business ready' when they begin business. This could be achieved through education and financial assistance, which may include assistance to small business to get ready for Standard Business Reporting (SBR).</p>	<p>SBR has been available for business use since mid-2010. While business use of SBR was initially constrained by the limited availability of SBR-enabled software in the market, business use of SBR has increased sharply in the past 18 months with increasing availability of software.</p> <p>The small to medium business sector has been the strongest adopter of SBR.</p> <p>A range of administrative mechanisms are in place to support business adoption of SBR, including technical assistance and free tools for software developers to support the development of SBR-software for business use; and the SBR program's ongoing work with its Business Advisory Forum to support business adoption.</p>

Recommendation 128:	
<p>Common information standards, leveraging from the standards and governance put in place by the SBR Program, be developed and adopted to support system interoperability between tax and transfer agencies, and between those agencies and third parties, such as employers.</p>	<p>Since its launch in mid-2010, the availability of SBR for business reporting has been limited to financial and payroll matters. However, the SBR Program is working with multiple agencies, including the Department of Human Services, to expand its scope to include a broader range of reports and informational transactions.</p> <p>The SBR taxonomy (a common dictionary of reporting terms) has been endorsed as a national standard under the National Standards Framework (NSF). Work is also underway to progress SBR's messaging profile, ebMS3, for consideration as a government standard under the NSF, for use in business to government and government to government interactions, as appropriate.</p> <p>Under the SuperStream reforms, SBR's data and messaging standards are being progressively introduced as the standard platform for rollovers between superannuation funds from 1 July 2013, and for member contributions for large and medium-sized employers from 1 July 2014 and smaller employers from 1 July 2015.</p>

