REVIEW OF TAX IMPEDIMENTS FACING SMALL BUSINESS

CPA Australia's submission to the Board of Taxation's review of the tax impediments facing small business

May 2014

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CPA AUSTRALIA

Introduction

We are of the view that Australia and Australian businesses are at a tipping point. The global economy, and the high cost of doing business in Australia is hampering our international competitiveness. We all share the challenge to identify and remove obstacles to business growth to unlock our future economic potential. Against this background, we welcome the opportunity to contribute to the Board of Taxation's review of impediments in the tax system that are currently hindering or preventing small businesses from reaching their commercial goals.

Our comments are inevitably somewhat limited given the short timeframe in which to provide a considered response. Notwithstanding this limitation we provide the following comments and recommendations in good faith to help the Board focus on those tax issues which are most impeding the productive capacity of small business.

As an overarching comment, we believe that many of these issues can be appropriately addressed by moving the tax system to a regime where business income is taxed on the same basis regardless of the legal entity through which the business is operated. Such an outcome should also provide trading entities with the option of accumulating after-tax profits which can be re-invested into working capital to improve their productivity and capacity to grow.

We appreciate that many of our suggestions will be subsumed into the Government's proposed Tax White Paper later this year. Again this will provide us with a further opportunity to comment. However, what business really needs is action – and outcomes that will remove or reduce impediments to business growth and success.

About CPA Australia

CPA Australia is one of the world's largest accounting bodies with a global membership of more than 150,000 members working in 120 countries around the world, with more than 25,000 members working in senior leadership positions.

We have a history that stretches back to 1886, and have been actively involved in Asia since the early 1950's. We currently have nine offices in Asia and more than 36,000 members working in the region.

CPA Australia is committed to a creative engagement with governments and their agencies on behalf of members and in the broader public interest to encourage the adoption of economic and social policies that foster improvements in Australia's productivity and global competitiveness.

Review of impediments facing small business

CPA Australia is of the view that the following features of the tax system are of the greatest hindrance to a broad cross section of small businesses from pursuing and achieving their commercial goals. Many of these issues are caused by the differential tax rules that apply to the various different legal structures (or combination of structures) in which a business may be carried on. Further specific detail on these issues and recommendations are detailed below:

1. Private company loan rules - Division 7A
2. Trusts
3. Small business capital gains tax concessions
4. Trust losses
5. Personal services income
6. Lack of safe harbours for SMEs in the tax law
7. Consolidations regime
8. Over-reliance on specific anti-avoidance rules to tackle issues that could be dealt with using general anti-avoidance provisions
9. The proposed reduction in the small business instant asset write from $6,500 to $1,000
10. The proposed repeal of the loss-carry back provisions
11. Innovation and R&D tax incentives in Australia
12. Recalibrating certain tax thresholds concessions and caps
13. State taxes including payroll tax, and transaction taxes on real property

1. Private company loan rules - Division 7A

CPA Australia lodged a submission with the Board of Taxation dated 20 May 2014 in respect of the Board's second Discussion Paper of its Post-Implementation review of Division 7A of the Income Tax Assessment Act (1936) (the ITAA (1936)). Below is a summary of the key points from our submission.

A new, simplified regime to replace the existing provisions relating to complying loans

We concur with the Board's view that the existing rules relating to exempt complying secured 25 year loans and unsecured 7 year loans has become unnecessarily complex including the inflexible requirement to make annual minimum yearly repayments of principal and interest under such loans. These rules become even more complicated where a loan is refinanced and changes from being secured to unsecured or from unsecured to secured.

Accordingly, CPA Australia supports the proposed design features of the single 10 year complying loan exemption as detailed in Chapter 6 of the Discussion Paper as it will remove much of the complexity associated with the current differential rules applying to secured and unsecured loans. This measure would also strike an appropriate balance between ensuring that shareholders or associates repay private company loans over a reasonable period (regardless of whether the loans are secured or not) at an appropriate arm's length interest rate whilst providing some flexibility for interest and principal repayments over the loan term.

A limited exclusion from the application of Division 7A to UPEs owed by trusts that nominate to 'tick the box' and forgo access to the CGT discount on disposal of assets

We are of the opinion that the current administrative practice under Practice Statement PSLA 2010/4 of excluding unpaid present entitlements held on a sub-trust from being regarded as a deemed dividend for Division 7A purposes is not sustainable and can lead to various anomalous outcomes.

Hence, we support the proposed introduction of an irrevocable 'tick the box' election which will allow a trading trust to exclude loans (including unpaid present entitlements) from the scope of Division 7A as set out in Chapter 6 of the Discussion Paper.

This initiative will allow trading trusts to reinvest their after-tax profits into their working capital thereby improving their self-sufficiency and productivity. As a corollary it will also significantly reduce compliance costs associated with satisfying the requirements of Practice Statement PSLA 2010/4, and ensure that trusts used to carry on a business are not faced with the prospect of having to sell assets to fund the repayment of loan principal at the end of a loan term as may be the case in respect of unpaid entitlements which are subject to Options 1 and 2 of Practice Statement PSLA 2010/4.

Given that the amount of such contingent principal repayments on unpaid present entitlements held on a sub-trust under Options 1 and 2 of Practice Statement PSLA 2010/4 has often progressively grown each year since the issue of the Practice Statement it is also imperative that some meaningful transitional rules be introduced to address this growing tax exposure. In our view the most appropriate transitional relief would be for a trading trust to be provided with an irrevocable option that it can elect to be treated as a company in respect to any past, current and future loans (including unpaid present entitlements) in return for permanently foregoing its entitlement to any 50 per cent CGT discount on disposal of CGT assets.

A mechanism to allow taxpayers to self-correct mistakes or omissions

There is considerable uncertainty associated with the exercise of the Commissioner's discretion under section 109RB to not treat a payment, loan or debt forgiveness as a deemed dividend. This significantly increases the compliance burden borne by taxpayers, their advisers and the Australian Taxation Office (ATO).

CPA Australia believes that a legislative self-correction exception as canvassed in Chapter 6 of the Discussion Paper be introduced which will allow non-compliant taxpayers to become fully compliant with Division 7A, and allow tax agents who take on new clients to identify any Division 7A breaches and take the appropriate remedial action.

This initiative would ensure that there would be some relief for privately held groups which inadvertently breached Division 7A and provide more certainty for small businesses. In our view such a mechanism must be based on the premise that taxpayers and their advisers must take appropriate corrective action so that the parties are in the same position that they would have been had Division 7A been fully complied with when the original Division 7A trigger event occurred. As a corollary it would not be available by taxpayers who deliberately ignored Division 7A or attempted to circumvent its provisions.

Taken collectively we believe that the implementation of the above three proposed remedial strategies will greatly reduce the complexity associated with the operation of Division 7A and realise considerable compliance savings for small business and the ATO.

Recommendation:
We encourage the government to expedite the implementation of the key recommendations of the Board of Taxation's post-implementation review of Division 7A as set out in Chapter 6 of its second Discussion Paper.

2. Trusts

In recent years, our members and the broader community have faced substantial change and uncertainty concerning the taxation of trusts. The source of this change and uncertainty has come about from (among other things):

- judicial re-interpretation of the basic concepts of Division 6 of the Income Tax Assessment Act 1936 (e.g. the Bamford, Colonial First State and Greenhatch cases);
- hurriedly introduced legislative amendments (e.g. the 2011 trust streaming provisions); and

- the reversal of long-standing administrative practices (e.g. the revocation of Income Tax Rulings IT 328 and 329).

Given these landmark changes, CPA Australia proposed in its response to Treasury's option paper titled 'Modernising the taxation treatment of trust income' in February 2012 that a simplified taxation of trust regime could actually 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.

We proposed that the key features of such a regime be:

- the income of fixed trusts would be taxed on an attribution consistent with the proposed rules applicable to managed investment trusts
- the default position would be that the taxable income of non-fixed trusts would be taxed to the beneficiaries of the trust provided it is distributed to them (including by being applied for their benefit or at their direction) before the date of lodgment of the trust's return for the relevant year. This model would apply a 'follow the money' principle which would tax the beneficiary to whom trust income is distributed. Where income is not distributed to beneficiaries by the required date it would be taxed to the trustee at the highest marginal rate. Under the flow through model, income would retain its character in the hands of the beneficiaries, including but not limited to capital gains and franked dividends. The benefit of the 50 per cent CGT discount and small business concessions would flow through to beneficiaries. This model would be most suitable and attractive for trusts that hold passive investments rather than carry on a business, and
- non-fixed trusts carrying on a business would be given the option of being treated as a company for all tax purposes. Accordingly, the trustee of such a trust would only be assessed on taxable income at a rate of 30 per cent but income would not retain its character as is the case with non-fixed trusts which do not make such an election. Consequently, the trust would also lose its ability to claim the 50 per cent CGT discount. This accumulations model will allow such business trusts to re-invest their after-tax profits into working capital and as such, it would be broadly consistent with the above proposed 'tick the box' election in respect of Division 7A other than it would treat such a non-fixed trust as a company for all income tax purposes.

Whilst it appears counter-intuitive we believe that the development of the above three discrete sets of rules will be more commercially aligned with how the bulk of trusts actually operate and has the capacity to provide greater certainty and ensure that business trusts can effectively reinvest their own after-tax profits into their business.

The need for a new business entity?

In addition, there may be merit in exploring the concept of introducing a US 'S corp' style entity as a vehicle through which a small to medium sized enterprise (SME) can carry on a business in Australia. This potential reform has been raised on a number of occasions. Certainly this is something CPA Australia raised as part of the Review of Business Taxes over a decade ago. We acknowledge that like all major reform options it is not without its issues including its application in tax laws, corporations law, insolvency law and other business law.

Notwithstanding these comments, we believe that the concept of an additional entity being made available for Australian businesses with features of income streaming and limited liability should be considered as part of the proposed forthcoming Tax White Paper tax reform process.

See **Attachment A** for a more detailed discussion of an 'S corp' style entity.

Recommendations:
Consideration be given to replacing the current taxation of trust regime with a regime which:

- ***recognises taxable income derived by fixed trusts be taxed on an attribution basis***
- ***non-fixed trusts carrying on investment activities be treated as a flow through vehicle with beneficiaries assessed on a 'follow the money' principle***
- ***non-fixed trusts carrying on a business activity be given the option to be taxed as a company at the corporate tax rate thereby allowing the trustee to accumulate after-tax profits***

The Tax White Paper reform process should explore the concept of introducing a US 'S corp' style entity as a vehicle through which a SME can carry on a business in Australia.

3. Small business CGT concessions

In our view the most disputed and litigated aspect of the small business CGT concessions is the ability of a taxpayer to satisfy the $6 million maximum net asset value test where the requirements of the $2 million aggregated turnover test are not otherwise met in satisfying the basic eligibility conditions in claiming the concessions.

This is partly due to the complex eligibility criteria to meet the maximum net asset value test as set out under sections 152-15 and 152-20 of the Income Tax Assessment Act 1997 (the ITAA 1997).
In practice, many small business taxpayers whose eligibility is contingent on meeting the $6 million maximum net asset value test fail to include the net value of CGT assets of connected entities or affiliates, or incorrectly exclude pre CGT acquired assets or post CGT acquired assets such as depreciating assets or trading stock which do not generate capital gains but must nonetheless be included in that calculation.

However, the most problematic aspect of the maximum net asset value test is the inherently subjective nature of determining the market value of the taxpayer's CGT assets which can lead to disputation between the ATO and taxpayers where they have different competing market valuations of assets. Accordingly, we believe that it may be prudent to replace the current subjective maximum net asset value test with some alternate objective test for small business taxpayers which is easier to comprehend and apply with certainty. This may take the form of fully exempting a gain where the aggregated turnover is less than $2 million and tapering entitlement to the concession for those whose aggregated turnover is between $2 million to $6 million.

Recommendation:

We recommend that the subjective $6 million maximum net asset value test be replaced with some alternate objective eligibility test. This could take the form of a revised aggregated turnover test, which could include the concession being gradually reduced above a certain threshold.

4. Trust losses

Schedule 2F of the ITAA (1936) provides legislative clarity on the separate trust loss rules that respectively apply to fixed and non-fixed trusts as it defines when a trust will be regarded as fixed or non-fixed under those provisions.

However, this demarcation between fixed and non-fixed trusts has been undermined by the Decision Impact Statement (DIS) issued by the ATO in response to Colonial First State Investments Ltd v Commissioner of Taxation [2011] FCA 16.

In that DIS the ATO expresses the view that very few trusts satisfy the definition of 'fixed trust' in section 272-65 of Schedule 2F in the absence of the exercise of the Commissioner's discretion to the contrary. Thus, it is uncertain that trusts which would typically be objectively regarded as a fixed trust applying section 272-65 may nonetheless be regarded as a non-fixed trust as the presumption appears to be that a trust is non-fixed unless the Commissioner exercises a discretion to the contrary in accordance with the DIS.

Such an approach creates considerable uncertainty and anomalous outcomes especially where the pattern of distributions test may be applied to a trust which is fixed in nature but may be regarded as non-fixed by the ATO.

Recommendation:

The definitions of fixed and non-fixed trusts under the trust loss provisions be clarified to overcome the uncertainty arising from the ATOs Decision Impact Statement issued following the decision in Colonial First State Investments Ltd v Commissioner of Taxation (2011) FCA 16.

5. Personal services income

We believe that it is very prudent to review the scope of the Personal Services Income (PSI) provisions set out in Divisions 84 to 87 of the ITAA 1997 as work patterns and the differentiation between employees and contractors has evolved considerably since the PSI provisions commenced on 1 January 2000.

In addition, further practical guidance is required to be provided in respect of the various exceptions to the application of the PSI rules especially the requirement in the unrelated clients test that services be provided as a direct result of the individual or personal services entity making offers or invitations to the public at large or to a section of the public. It is unclear how various taxpayers can meet this condition when they do not advertise to the public but rely on word of mouth referrals.

Recommendation:
The Board of Taxation review the on-going efficacy of the Personal Services Income rules, and whether sufficient clarity on the various exemptions has been provided particularly in respect of the unrelated clients test.

6. Greater use of safe harbours in the tax law

Tax laws often make little or no distinction between large and small businesses and their differing ability and capacity to comply with the law. To ease compliance we strongly advocate that the ATO develop administrative safe harbour practices which will cut compliance costs whilst simultaneously ensuring that an appropriate reasonable amount of revenue is collected.

A key area where such safe harbours may be effectively deployed is in respect of the revised transfer pricing provisions which will apply a 25 per cent penalty on any tax shortfall for failing to maintain contemporaneous transfer pricing documentation as a taxpayer will not be able to evidence a reasonably arguable position in the absence of such documentation.

In our view it is anomalous that an SME with international related party transactions of $5 million has the same compliance burden as large businesses whose cross border transactions with associated taxpayers exceed $5 billion.

Such safe harbour initiatives may take the form of, amongst others, a range of agreed interest rates on related party international loans, agreed range of mark-ups in applying the resale price margin method for wholesalers and an extension of the current mark ups applicable to the cross-border provision of services between related parties under Taxation Ruling TR1999/1.

Consideration could be given to legislating some of the above transfer pricing safe harbours especially in respect of a small business taxpayer where the potential revenue raised is disproportionate to the compliance costs incurred.

Recommendation:
The Commissioner makes greater use of safe harbours in his administration of the tax law especially in respect of transfer pricing, and that consideration be given to legislating safe harbours to provide additional certainty for small business.

7. Consolidations regime

We suggest that the Board consider the merits of introducing a revised and simplified tax consolidations regime for SMEs as privately held groups often carry on business through multiple structures and the complexity of the existing tax consolidations regime (especially on entry in the system) is prohibitive.

Recommendation:

The Board consider the value of a revised and simplified tax consolidations regime for SMEs being introduced.

8. Use of specific anti-avoidance rules rather than relying on general anti-avoidance provisions

Our tax laws ought to be designed to make it simpler for the vast majority of taxpayers who are compliant rather than develop overly complex law for the small minority of those who may be avoidant and whose activities can be attacked under the general anti-avoidance provisions such as Part IVA.

Recommendations:
Instead of tackling avoidant behaviour through new laws, the Commissioner of Taxation should make greater use of his powers under general anti-avoidance provisions, such as Part IVA.

If the Commissioner is to make greater use of his powers under Part IVA, the Commissioner should publish further guidance on the type of arrangements the Commissioner may seek to apply Part IVA, particularly arrangements where the application of Part IVA is opaque.

9. The proposed reduction in the small business instant asset write off relief from $6,500 to $1,000

CPA Australia supported the introduction of the $6,500 instant asset write-off threshold for small business and suggests that, when fiscal circumstances permit, the threshold be increased back to at least $6,500. Such a relief is an important cash flow benefit to small business investing in capital assets to grow their business.

The delay in the passage of the Bill that would reduce the threshold from $6,500 back to $1,000 from 1 January 2014 has the potential to cause confusion. We suggest that consistent with the Government's commitment to reducing regulatory burden that there be a common application date of 1 July 2014 for both the repeal of the Mining Rent Resource Tax and the reduction in the instant asset write off threshold.

Recommendations:

The government consider increasing the instant asset write-off threshold back to $6,500 once fiscal circumstances permit.

There be a common start date of 1 July 2014 for the MRRT and the reduction in the instant asset write-off threshold to $1,000.

10. The proposed repeal of the loss-carry back provisions

CPA Australia supported the introduction of the loss-carry back provisions. We propose that when fiscal circumstances permit, that the provisions be re-introduced. Such loss-carry back provisions can be an important source of cash flow for businesses going through difficult periods.

Recommendation:

The government consider re-introducing the loss-carry back provisions once fiscal circumstances permit.

11. Innovation and R&D tax incentives in Australia

Innovation is fundamental to improving the future competitiveness and productivity of Australia and is critical in helping Australia make the transition to a knowledge economy. Without innovation Australia will be competing with developing nations which have significantly lower labour and other business costs. Not only does innovation allow Australian business to better compete, it creates new business opportunities, supports new growth and creates new jobs.

Australia needs to improve its ability to innovate and should aim to be one of the top 10 innovative countries globally, seize the potential opportunities available to business in the Asian century, and develop a dynamic and creative problem solving culture in Australian business. Retaining an effective suite of R&D tax incentives targeted at growing small to medium sized enterprises (SMEs) is a critical element in fostering a culture of innovation.

We need to acknowledge what the rest of the world is doing and ensure that we are doing all we can to promote innovation in Australia. One current example is the newly introduced Patent Box rules that enable UK companies that have undertaken the development of a patent in the UK to apply a 10 per cent corporate tax rate to the profits earned from any patented inventions. If Australia is to compete globally we also need to ensure that we are competing on the policy front if we are to successfully compete in attracting business, talent, innovation and development to Australia.

Recommendation:

CPA Australia supports the continuation of the existing R&D tax incentives currently being offered to Australian SMEs and the development of additional innovation-incentivising policy settings.

12. Indexation of certain tax thresholds and caps

There is a litany of thresholds and caps in tax laws. Most are historical and are not indexed. For example – work related expenses without receipts - $300, FBT minor and incidental amounts $300 – these limits were set in the 1980’s.

More recently – in the 1990’s – we have caps set for CGT concession eligibility for SMEs. Further in 1999 taxpayers were given the option of applying CGT indexation at September 1999 values or a 50 per cent GCT discount on capital gains.

Recommendation:

There be a review of the various thresholds and caps in the tax laws as many are now trivial, non-commercial and out of date with a view to making them more relevant.

13. State taxes including payroll tax and transaction taxes on real property

While state taxes may be outside the scope of the Board of Tax's current review, many such taxes are inefficient and are an impediment to small business.

Briefly, we make the following two points:

- Payroll tax is a very efficient tax in economic terms. However time and again member feedback is that payroll tax is a significant handbrake on small businesses employing more than a certain number of people to ensure they do not trigger a payroll tax liability.
- Transaction taxes such as stamp duty on the transfer of real property is a disincentive to buying and selling property which impacts turnover, labour mobility and general economic activity, including best use of scarce resources.

Both of these measures, in their own ways operate as an impediment to small business. These need to be reviewed as part of the holistic Tax White Paper Review.

Recommendation:

State taxes and their impact of the economy be reviewed as part of the holistic Tax White Paper Review.

Attachment A

Positive aspects of an 'S corp' style entity being introduced

- Cuts accounting, audit and tax regulation
- Division 7A would prima facie not apply if all the tax liability vests with the members and there are no timing disadvantages (which would be further enhanced if the directors of such a company were limited to natural persons)
- Depending on how it is designed, it could eliminate the mismatch between trust income and net taxable income and thereby both reduce complexity and tax avoidance involving the re-characterisation of trust income as capital
- Depending on how it is designed, it could reduce unpaid present entitlement (UPE) amounts owed by trusts to default corporate beneficiaries (which would be further enhanced if the directors of such a company were limited to natural persons)
- Provides an alternate structure for SMEs compared to trusts where there is great uncertainty especially from a taxation perspective and 'traditional' corporations which are subject to significant corporations law, accounting and tax regulation
- Constructive design feature would be to limit such companies to resident trading businesses and not those merely holding passive investments
- Appears to provide a more definitive form of limited liability than that available in respect of trustees where such protection is only available where a corporate trustee is used and/ or the trust deed expressly limits the liability of the trustee to the net assets of the trust
- Appears to simplify potential access to the small business concessions where the members in the company are natural persons as it is the member and not the entity making the capital gain
- Allows funds to be retained in the trading entity.