The Secretary
Review of Business Taxation
The Treasury
Parkes Place
PARKES ACT 2600

Dear Dr Preston

Attached is a submission from the Australian Society of Certified Practising Accountants relating to Tax Reform and Small Business.

This submission presents a discussion of the proposed tax reforms as they relate to the small business sector. We do, however, intend to address the issue of trusts in a later submission. The submission makes recommendations about how the tax reform proposals could be improved to ensure the resulting tax system better meets the needs of small business.

We are conscious of the fact that the submission covers some taxation matters that are outside the scope of the terms of reference for the Review of Business Taxation. For this reason, we are also making the submission available to the Small Business Consultative Committee. Our aim in constructively contributing to these consultative forums is to help to ensure that reform assists rather than hinders small business growth - benefiting our economic prosperity and employment growth.

We have no objection to the submission being released publicly in its entirety from 5 April 1999.

I will email this letter and the submission to you. If you wish to contact me about the submission, my telephone number is (03) 9606 9830.

Yours sincerely

Angela Ryan
Director – Taxation
1 April 1999

TAX REFORM ISSUES FOR SMALL BUSINESS

The Australian Society of Certified Practising Accountants

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Introduction

As Australia's leading accounting body, the Australian Society of Certified Practising Accountants (ASCPA) is working to ensure that we create a robust and fair tax system that will meet the needs of the country in the new millennium.

This paper represents the first comprehensive and objective discussion of the proposed tax reforms as they relate to the small business sector. It also makes recommendations about how those proposals could be improved to ensure the resulting tax system better meets the needs of small business.

This discussion paper will be provided to the Review of Business Taxation and the Small Business Consultative Committee to ensure that reform assists rather than hinders small business growth - benefiting our economic prosperity and employment growth.

In the interests of furthering the tax reform debate, this paper will also be provided to all major political parties and will be available to the general public via the ASCPA Internet site, CPA Online, at www.cpaonline.com.au.

Copies of this report are also obtainable from the ASCPA by contacting Angela Ryan, ASCPA Director – Taxation on 03 9606 9830.

Acknowledgement

The ASCPA would like to acknowledge the valuable work of Ian Wallschutzky and Brian Gibson in preparing a first draft of this paper. In addition, we would like to thank our many Committee members who provided helpful input to this final document, including the members of our Taxation Centre of Excellence, National Tax Practice Committee, Small Business Centre of Excellence, Indirect Tax Cell, and other members. Specifically, we appreciate the assistance from Brian Andrew, Lisa Armstrong, Colin Beavis, Alan Bliss, Denise Brotherton, Wayne Burgan, Sandra Buth, Ken Claughton, Kerrie Clayton, David Collins, Peter Colliver, Peter Dowling, Paul Drum, Robyn Farrell, Michael Hay, Greg Hayes, John Higgins, Nick Hill, Paul Hockridge, Nicole Hornsby, Vessna Iskra, Keith James, Graeme Kennedy, Richard McMahon, Tony Martin, Mark Morris, Joycelyn Morton, Robert Oser, John Pernice, James Pollifrone, Nathan Rose, Jonathon Sear, Peter Senserrick, Ian Thomas, Peter Thomson, Gordon Thring, Richard Vann, Max Warlow and Stephen Wearne.

Executive summary

The Government's proposals in *Tax Reform – not a new tax, a new tax system* (*ANTS*), and the policy options explored by the Ralph Committee's *Review of Business Taxation* (*RBT*), will potentially have a major impact on the taxation of small businesses in Australia for many years to come. This paper explores some of the significant taxation implications of this tax reform process for the small business sector, and makes a number of recommendations based on that analysis. It particularly focuses on the compliance and compliance cost effects of the proposals and policy options, but also considers the likely cash flow and other considerations that will arise.

The Australian Society of Certified Practising Accountants welcomes the general approach to tax reform that is currently occurring. Many of the proposals and policy options contained in *ANTS* and *RBT* specifically address the needs and concerns of small business taxpayers. There is no doubt that the sector, so important for future economic growth and employment opportunities, will benefit considerably from long overdue reform. For example, changes to the nature and timing of tax payments made in respect of their own liabilities and liabilities of others (including PAYE and FBT) will assist businesses considerably.

But there are other areas where the changes need to be very carefully considered in the light of their potential to reduce the sector's capacity to comply with its tax obligations or to increase the costs of complying with the Australian tax system (which already suffers relatively high compliance costs compared to many similar countries). Those compliance costs are also highly regressive, with the result that the small business sector carries far more than its proportionate share of those costs. This will be exacerbated with the introduction of the GST.

In the light of this, the paper makes a number of recommendations which it believes will enhance the process of tax reform that is under way. These proposals are grouped by reference to specific taxes (income tax, CGT, FBT, GST, Payroll tax), and by reference to tax administration issues (the payment of tax and the relationship of the ATO with the small business sector). Essentially the recommendations seek to improve the efficiency and reduce the complexity of the existing tax system without impugning the integrity and equity features. So far as possible, they seek to do this within the constraint of revenue neutrality. More specifically, the recommendations seek to build upon the process of reform already started by:

- ensuring that the GST remains a simple, broad-based consumption tax;
- seeking to considerably simplify the operation of the regimes for taxing income, capital gains and fringe benefits; and
- improving the process of tax administration in Australia.

The specific recommendations that relate to these areas are summarised in Part 5 of the paper. The Australian Society of Certified Practising Accountants believes these recommendations will lead to a more certain, stable, equitable and efficient tax environment, and one in which small businesses can prosper. It also looks forward to its continued involvement with the consultative process of tax reform.

1 Scope and purpose of the paper

In August 1998 the Howard Government released its plan for a new Australian tax system – *Tax Reform – not a new tax, a new tax system* (*ANTS*). Subsequently – and as a separate issue - the Review of Business Taxation (*RBT*) has been established and asked to conduct wide ranging consultations with a view to making recommendations about the fundamental redesign of business tax arrangements. The *RBT* has so far published two discussion papers and one information paper[1]. The proposals and policy options contained in both *ANTS* and the *RBT* will have major implications for the small business community.

The purpose of this discussion paper is to assess the impact of these tax reforms on small business taxpayers. The paper provides a basis for discussion of the implications of the proposed and possible tax reforms on the small business sector, and makes a number of recommendations which it believes will assist small business taxpayers in this process of reform. The paper focuses on both the taxes themselves as well as the administrative procedures adopted by the ATO to implement those taxes. In doing so, it recognises that the *RBT* has not made any firm proposals or recommendations as yet. Its output thus far has been confined to identifying business tax reform options for consideration. This paper does not address issues that relate to the taxation of trusts. This is a very important issue for small business that will be addressed in a separate submission.

The approach is to identify, in Part 2, problems small businesses have with taxation. These include, predominantly, issues relating to compliance, and in particular to the burden imposed on small business taxpayers in complying with their taxation obligations ("compliance costs"). Part 3 then deals with a number of issues relating to the compliance burdens imposed on small business by the tax system itself and considers each of the major federal taxes – existing and proposed – in turn. In each case the paper reviews the *ANTS* and *RBT* proposals and considers the likely implications of proposals and policy options contained in those documents before moving on to make specific recommendations. Part 4 deals with the compliance and related burdens imposed on small business by aspects of tax administration, and particularly concerns itself with the payment of taxes by small business taxpayers and with the relationship of the small business sector with the ATO. Again, specific *ANTS* and *RBT* proposals are identified and reviewed, the likely implications are considered and recommendations made. Finally, a conclusion and summary of recommendations is presented in Part 5.

This discussion paper identifies a number of taxation issues relevant to the small business community. Some of these are at the policy level, and others are more technical in nature. It is primarily concerned with a consideration of the impact of likely and possible changes to the taxes faced by the small business sector, and to the administration of those taxes. The potentially far-reaching implications of some of the *ANTS* and *RBT* proposals as they relate to the manner in which specific entities (and especially trusts) may be taxed in the future are not generally considered in this paper.

It should also be noted that this paper does not consider superannuation or superannuation fund issues. Neither *ANTS* nor *RBT* devote much attention to this area, and it is therefore

[1] *A Strong Foundation* (November 1998), *An International Perspective* (December 1998) and *A Platform for Consultation* (February 1999). The Review of Business Taxation is chaired by John Ralph AO.

inappropriate to dilute the focus of this paper, despite the significance of superannuation to the small business sector.

2 Small business taxation issues

2.1 Defining small business

Small business is often acknowledged as a vital sector of the Australian economy, particularly in terms of its ability to generate employment opportunities and economic growth. A key concern in the tax reform debate is thus small business and the impact of the tax system on such taxpayers.

For practical purposes, small businesses are typically defined in terms of employment or turnover. The ABS definition of small business (excluding agriculture) is based on the number of employees. For non-manufacturing businesses a small business is defined as one employing less than 20 employees; for manufacturing firms, those with less than 100 employees are categorised as small. The ATO adopts, for its purposes, a definition based on turnover. A business is classified as being small if its annual turnover is less than $10 million. Whilst the ABS and ATO definitions are not strictly comparable, in the aggregate they do not differ very much. Under both definitions small businesses account for upwards of 97% of all private sector business in Australia. According to the latest *Taxation Statistics* for 1996-97[2] there are more than two million individuals and over half a million companies involved in the small business sector (as defined by the ATO).

2.2 Identifying small business tax issues

In recent years, considerable research has been undertaken into tax issues that affect the small business sector. That research, much of which is summarised in Appendix A, identifies a number of key concerns that have been expressed by small business. Overwhelmingly, the sector is concerned at the complexity and ever-changing nature of the tax system and the excessive burden of red tape that it imposes upon small businesses. Closely allied to this is a concern with compliance issues – with "getting things right and not falling foul" of the ATO, with not incurring penalties or being audited. This concern also feeds in to the problem of excessive compliance costs, as taxpayers are obliged to spend more of their limited time on complying with their taxation obligations, and/or pay more to their tax advisers.

In addition, research indicates that small businesses have an on-going problem with cash flow issues. Their liquidity is constantly impacted by the tax system – and in particular by the arrangements under which they are required to pay their own tax liabilities and hand over taxes collected on behalf of others (PAYE, PPS etc). A final major area of concern for many small business taxpayers lies in the perception that other taxpayers may be "getting away with it". This accusation, and its related concern about the underlying integrity and fairness of the tax system, is levelled not only at those operating in the cash economy who are able to undercut the prices of legitimate small business taxpayers. There is also a concern that the businesses in the "big end of town", with sophisticated advisers and aggressive tax planning, are able to get away with far more than the small business taxpayer.

[2] Table1: Small Business (Individuals) and Table 2: Small Business (Companies), *Taxation Statistics 1996-97*, Commonwealth of Australia, March 1999.

The broad thrust of most of the research into tax issues affecting the small business sector is clear. The complexity of the tax system and the demands it imposes upon small businesses lead to disproportionately high, harshly regressive and increasingly intolerable compliance burdens on that sector. There is a clear need for reform, and a perception that the reform needs to be fundamental rather than "more of the same".

The remainder of the paper considers whether the proposed reforms and policy options contained in the *ANTS* and *RBT* documents adequately address these issues, and makes specific recommendations aimed at reducing the compliance costs faced by small businesses and enabling the sector to more easily comply with its tax obligations. The discussion and recommendations also include policy and technical changes – not always canvassed by *ANTS* and *RBT* – which may assist small business. Where they are available, the revenue costs and gains of the proposals are indicated, and the intention, overall is to produce a revenue neutral package.

3 Issues relating to specific taxes

Some of the particular compliance burdens faced by small business arise out of design features of the tax system itself. By changing these features the compliance burden of small business might be reduced. However, in doing so there might be other implications such as increased administration costs for the ATO, loss of tax revenue, delay in collection of revenue, unequal treatment of small businesses relative to other taxpayers and the like. Where possible this discussion paper identifies such implications, but does not explore them in depth. Its primary function is to highlight the issues which cause the compliance burdens which are of greatest concern to small business. In this part we identify problems, classified by the tax to which they mostly relate, and comment on the likelihood that the problem will be overcome by proposed tax reforms. The taxes explored are respectively income tax, capital gains tax, fringe benefits tax and the goods and services tax (including an analysis of some currently existing WST issues that impact on small business). It is obviously recognised that both capital gains tax and fringe benefits tax are not, strictly, separate taxes, but statutory extensions of the income tax. They are dealt with separately for convenience and because there are very specific compliance and compliance costs issues that relate to each.

3.1 Income tax

The impact of income tax on small businesses

Income tax is the tax that impacts most directly and most frequently on small business taxpayers. Approximately 75% of small business taxpayers recorded that they dealt with income tax occasionally (one to three times) or frequently (four or more times) in the 1994-5 tax year[3], compared to less than 30% for any other tax. Small business personnel (mainly at the proprietary level) spent an average of 2.4 hours per month on income tax matters, out of a total of 3.6 hours per month on all taxes[4].

As a result of this, income tax causes by far the highest compliance costs for small business taxpayers. In 1994-95 it accounted for $4.2 billion out of total compliance costs of $7.9 billion faced by the small business sector (53% of all compliance costs)[5]. The second most significant area (after income tax) was PAYE, at $1.1 billion, or 14% of the total.

Given these figures, it is clear that dealing with income tax matters is a very important aspect of the tax affairs of the small business community. The *ANTS* and *RBT* proposals have the potential to have a considerable impact, both on the burden of the tax itself and on the costs of complying with the tax (though, as will be seen, that potential does not appear to be fulfilled).

[3] Evans, C. Ritchie, K. Tran-Nam, B. and Walpole, M. *A Report Into the Incremental Costs of Taxpayer Compliance*, Commonwealth Government Publishing Service, Canberra, 1996; Table 7.46, page 117.
[4] Evans *et al*, 1996, *op cit*, Table 7.62, page 129.
[5] Evans, C. Ritchie, K. Tran-Nam, B. and Walpole, M. *A Report Into Taxpayer Cost of Compliance*, Australian Government Publishing Service, Canberra, 1997, Table 5.14, page 82.

ANTS and *RBT* proposals for income tax

The *ANTS* document contains proposals to cut income tax rates (the 20% rate is to be cut to 17%, and the 34% and 43% rates combined and reduced to 30%) and increase income tax thresholds from 1 July 2000. This will clearly have an impact upon the fortunes of many unincorporated small business taxpayers. It will also be of benefit to those who derive their income from distributions (salary or dividends) from companies in the small business sector. The income tax changes are designed primarily to assist those on low and middle range incomes, which is where the majority of small business taxpayers find themselves.

Similarly the proposal to move towards a company tax rate of 30% (contingent upon progress towards a consistent approach to the taxation of all business entities) is likely to have beneficial impacts upon the burden of income taxation, at least for those small business taxpayers operating through companies.

Some mention is made in *ANTS* of the inconsistent treatment of physical assets and of financial assets and liabilities, and there are suggestions of the need for a more consistent and commercial approach to the manner in which these assets/liabilities are dealt with for tax purposes. Otherwise, the bulk of the *ANTS* proposals relate to the appropriate measures necessary to reform the taxation of business entities, which is not the focus of this discussion paper. It may be noted in passing, however, that a more consistent approach to the taxing of business entities is likely to help to reduce the compliance costs of the owners of those entities. Research has shown that the compliance costs of using particular vehicles for conducting business activities (for example, trusts) can be significantly higher than using other business entities[6]. Many of the options canvassed in the *RBT* proposals suggest that trusts will involve still higher compliance costs if those proposals are implemented.

There is extensive discussion in *RBT* about reform of the income tax system, and it would be beyond the scope of this paper to attempt to summarise all of the proposals and policy options that are mentioned. Moreover, many of the potential changes that are discussed would be of marginal concern to the small business sector (for example the appropriate tax treatment of many financial assets and liabilities, including debt/equity hybrids and synthetic arrangements).

A major theme of the *RBT* is the possible trade-off of accelerated depreciation for a reduction in the rates of income tax applicable to companies. The labour intensive (as opposed to capital intensive) nature of many small businesses might suggest that the sector would generally benefit from this potential shift. However, the relatively limited number of small business taxpayers operating under the corporate veil would mean that the shift is unlikely to deliver much in the way of benefit to the small business sector[7]. It remains the case that most of the income tax proposals (as well as many of the other proposals and options canvassed in *RBT*) concern issues and problems that arise outside the small business sector.

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[6] Evans *et al*, 1997, *op cit*, Table 4.12, page 52.

[7] Table 4.1 of *Taxation Statistics 1996-97* shows that only 13.3% of the client population dealt with by Small Business Income (SBI) (the ATO business line which deals with business taxpayers with turnover of up to $10 million per annum) are companies. In contrast, 64.2% are individuals, 12.4% are partnerships, 6.5% are trusts and 3.6% are superannuation funds. In absolute terms, there are 2,549,700 individuals and 530,500 companies.

There are also suggestions for the rationalisation of the methods of valuing trading stock for tax purposes. Again, these may be of peripheral interest, but are unlikely to have a significant small business impact.

One issue that the *RBT* raises for consultation (at page 19) is "whether a distinction should be made between incentives facing closely-held, as opposed to widely held, entities - on the grounds that closely held entities have considerably greater control over their distribution policies and, in particular, are not subject to the same pressures to make distributions that apply to widely held entities. That distinction would pose the case for subjecting closely held entities to special tax arrangements where they do not distribute all, or some substantial proportion, of their income annually." This could have major implications for the small business sector, and its implications are explored below.

Implications of the income tax proposals for small business

It should be clear from the preceding sections that neither *ANTS* nor *RBT* are likely to deliver much to the small business sector so far as income tax is concerned - either in terms of the burden of the income tax itself, or the compliance costs that relate to that income tax burden. Clearly, the proposals to reduce income tax rates and to increase income tax thresholds will be welcome. Likewise (and to a lesser extent) any cut in the rate of tax for companies will be of benefit. But the small business sector needs more than these general cuts in income tax if it is to prosper.

The recent announcement, in the UK Budget of 9 March 1999, of concessional rates of tax for small business (both incorporated and unincorporated) may point the way to reforms that should be considered in Australia. More particularly, the UK will introduce a 10% corporation tax rate from 1 April 2000 for companies with profits up to £10,000, 20% for companies with profits between £50,000 and £300,000 and 30% for those companies with profits in excess of £1.5 million. For those companies with profits between £10,000 and £50,000, and between £300,000 and £1.5 million, a form of tapering relief (marginal small companies relief) will operate to ensure that the average rate of tax falls between 10% and 20%, and between 20% and 30% respectively[8]. On the unincorporated side, the income tax rates for earned income for 1999-00 will consist of a lower rate of 10% on income up to £1,500, a basic rate of 23% on taxable income between £1,501 and £28,000 and the higher rate of 40% thereafter. Individual taxpayers also receive the benefit of an annual tax free threshold of £4,335 per individual, with the possibility of a further £1,970 married couples allowance.

These income and corporation tax rates are clearly significantly lower than the Australian rates. It is accepted that the revenue cost of introducing major cuts in tax rates would rule out any such change in Australia (though some degree of equivalence should perhaps be a longer term goal). The important point is that the tax system needs to encourage its small business sector, which will permit it to thrive and grow. Some such encouragement can be delivered through the rates of tax charged to small businesses, without necessarily reducing the revenue yield significantly. In the UK, only about 10% of companies pay tax at the full (30%) rate,

[8] It should also be noted that there are very simple anti-avoidance measures in place to prevent profit splitting within and between entities.

but they account for 85% of the revenue yield[9], suggesting that concessional rates may be possible without significant loss of revenue.

Recommendation 3.1.1

Consideration should be given to the introduction of concessional rates of tax for small businesses.

So far as the compliance costs of income tax are concerned, there are a number of issues that need to be more fully addressed. These include:

- The alignment of income tax and accounting principles, and in particular the opportunity for small business taxpayers (defined by reference to some level of turnover) to make greater use of their financial statements as the basis for their tax calculations. This is partially addressed in both *ANTS* and *RBT*, but no firm conclusions of benefit to the small business sector are derived in either document (other than a call for submissions on the issue).

  Recommendation 3.1.2

  Small business taxpayers with a turnover of less than, say, $100,000 per annum, should be permitted to use the financial accounting profit shown in their financial statements as the basis of calculating the assessable income derived from their business activities.

- Flowing from this, there is a need to consider the possibility of enabling a larger part of the small business sector to base its tax calculations on a straightforward cash receipts and outgoings basis, rather than on the basis of taxable income less allowable deductions. Again, a sensible level of turnover could be used to determine those businesses entitled to access this concession.

  Recommendation 3.1.3

  Small business taxpayers with a turnover of less than, say, $100,000 per annum, should be permitted to use the financial accounting profit drawn up by reference to cash receipts and outgoings as the basis for calculating the assessable income derived from their business activities.

- There is also a need for much simpler depreciation provisions than currently exist under the income tax code. The existing provisions are extremely complex. At present there are a number of different options available to calculate the tax depreciation, and an almost infinite number of rates. The process could be simplified, and compliance costs proportionately reduced, with the introduction of one single method of depreciation and a significantly reduced number of applicable rates. For example, the UK permits tax depreciation of the vast majority of business wasting assets on the simple reducing balance basis with a single 25% rate after an initial (first year allowance) of 40% of the capital expenditure. The only significant variations from this are for some items of

[9] [http://www.hm-treasury.gov.uk/budget99/nr/ir19.txt accessed on 17 March 1999] *Inland Revenue Budget Press Release No. IR19*, issued 9 March 1999.

capital expenditure that can be written off entirely in the first year (usually because they are below a *de minimus* threshold), and some items where the expected life exceeds 25 years (which enjoy a reduced, straight line tax depreciation of 4% per annum).

Recommendation 3.1.4

The tax depreciation provisions should be considerably simplified, with the introduction of a single rate (25%) for all items of capital expenditure, applied on a reducing balance basis. The only variations from this should be to grant a 100% tax write off for single items of capital expenditure costing less than $1,000, and to impose straight line tax depreciation of 4% per annum for all items of capital expenditure eligible for tax allowances which have an effective life of 25 years or greater.

- Finally, the potentially adverse impacts of the possible re-introduction of an undistributed profits tax need to be addressed. As noted above, the RBT raises the possibility of subjecting closely held entities to special tax arrangements where they do not distribute all, or some substantial proportion, of their income annually. The majority of closely held entities are small businesses. A tax of this type was in place up until 1987 (Division 7 of *ITAA* 1936 - the undistributed profits tax). Not only was it universally unpopular it also may have acted as an impediment to business growth.

  Such "special tax arrangements" would create a further layer of complexity for small businesses and exacerbate horizontal inequity, by denying the benefit of a lower tax rate for profits retained to smaller businesses compared to other larger businesses. They would also act as a disincentive to the reinvestment of profits to fund working capital and investment and introduce an unnecessary and unwelcome boundary between types of entities when one of the general premises of tax reform is equity.

  Retained earnings are the best form of small business finance, and appropriate checks and measures already exist to counter any perceived abuse. The operation of a robust Division 7A (of *ITAA* 1936), coupled with Fringe Benefits Tax (or a regime for taxing employee benefits), ensures that there is no significant risk to the revenue.

  Recommendation 3.1.5

  In order to ensure equity between widely held and closely held entities regarding distributions of income, there should be no special tax provisions for closely held entities that do not distribute all, or some substantial proportion, of their income annually.

3.2 Capital gains tax

The impact of CGT on small businesses

The taxation of capital gains is a complex matter for all taxpayers affected. Small businesses, because they usually do not have specialist tax/accounting help in-house, probably find it more complex than most. They are likely to encounter the CGT regime on a number of

"bread and butter" issues revolving around the acquisition and disposal of business assets (or of businesses themselves), and access to the small business roll-over on replacement of business assets (Division 17A of *ITAA* 1936), to the small business retirement exemption (Division 17B of *ITAA* 1936) and to the goodwill exemption (Subdivision 118-C of *ITAA* 1997). Their concerns are often with compliance issues (keeping appropriate records of assets, maintaining pre-CGT status, determining whether CGT applies to something they have already done, establishing whether an exemption or relief may be available) rather than on more esoteric planning and structuring issues. However, they may also need to deal with more complex aspects of CGT, such as value shifting and other anti-avoidance provisions. And as individuals, many business proprietors will come across other aspects of CGT when they receive capital distributions or dispose of land, shares and other assets.

But the impact of CGT on the small business sector needs to be kept in perspective. Only about 7% of individuals and 5% of companies included capital gains in their returns of income for 1996-97[10]. Most small business taxpayers do not make capital gains or capital losses, and many may not even have to consider the CGT regime as they conduct their business affairs. For example, in 1994-95, 73.9% of small business taxpayers indicated that they did not deal with any CGT issues at all in the year[11], and CGT accounted for only 3.5% of the compliance costs faced by the small business sector[12]. Nonetheless, CGT implications will need to be taken into account (even if they do not lead to any CGT liability) by many small business taxpayers in a wide variety of situations. As such, CGT cannot generally be ignored and often imposes a high compliance burden on the small business sector.

ANTS and *RBT* proposals for CGT

The *ANTS* document is relatively limited in the number of CGT proposals it makes that are likely to be significant for small businesses, but it does foreshadow some of the discussion points raised in the *RBT*. So far as CGT is concerned, *ANTS*:

- announces the extension of the CGT small business roll-over relief and retirement exemption (Divisions 17A and 17B of *ITAA* 1936) to include land and buildings integral to a business where these assets are owned separately (pages 18, 24 and 126);

- indicates that further CGT relief for business investments may be in prospect (page 112);

- raises the possibility of capping the rate applying to capital gains for individuals at 30% (page 125); and

- raises the possibility of introducing a $1,000 per annum CGT tax-free threshold for individual taxpayers (page 125).

The *RBT* is considerably more forthcoming in raising CGT issues that may have significant implications for the small business sector. The information paper *An International Perspective* notes (at page 80) that CGT tends to be an area where other countries provide more generous treatment than does Australia, although this depends on the rate of inflation

[10] Table 2: Capital gains subject to tax by entity, *Taxation Statistics, 1996-97*, Commonwealth of Australia, March 1999.
[11] Evans *et al*, 1996, *op cit*, Table 7.46, page 117.
[12] Evans *et al*, 1997, *op cit*, Table 5.14, page 82.

and how long assets are kept. The paper also notes that Australia has moved to a more preferential treatment of small business in its CGT regime.

The *RBT* second discussion paper (*A Platform for Consultation*) devotes, *inter alia*, four complete chapters to CGT issues (Chapters 11-14). The first of these considers the case for taxing capital gains more lightly than other investment income (on the basis of arguments that it may increase economic efficiency). If the case for preferential taxation of capital gains is sustained, it queries whether a general approach (such as reducing CGT effective tax rates) is more appropriate than more targeted approaches (such as specific provisions aimed at, say, the start up venture capital sector). Chapter 12 examines the case for removing indexation and reforming the averaging arrangements, and Chapter 13 is concerned with rationalisation of the taxation of involuntary receipts. Finally, so far as CGT is concerned, Chapter 14 considers the CGT treatment of the disposal of partnership assets and interests.

A considerable number of the CGT issues raised in these four chapters are significant for the small business sector. These particularly include the following identified options:

- the introduction of a 30% capped rate of CGT for individuals;

- the adoption of a stepped-rate CGT depending on the time over which the asset is held (often known as taper relief);

- the introduction of a $1,000 CGT tax-free threshold for individual taxpayers;

- the merging and simplification of the business reliefs and exemptions currently available to small business taxpayers, possibly by replacing the goodwill exemption with a generalised exemption of, say, 20% of all capital gains arising on disposal of active assets of a small business;

- the removal of indexation of the cost base of CGT assets;

- modification of the averaging arrangements, possibly by removing the effect of multiplying the tax-free threshold and taxing capital gains above this threshold on the basis of two year (rather than five year) averaging to determine the marginal rate of tax at which to tax capital gains. This is suggested in order to prevent the abuse whereby taxpayers with variable income from non-capital gains take advantage of this to realise assets selectively, to reduce their tax burden by effectively taking five-fold advantage of the income tax-free threshold (currently $5,400, and due to be increased to $6,000 under *ANTS*) or low marginal rates of tax;

- permitting some relaxation of the rules which quarantine capital losses against current and future capital gains. More particularly, four possibilities are canvassed. The first would allow carry forward of capital losses at an appropriate interest rate. The second would enable taxpayers to carry back losses to offset earlier capital gains. In the third option, capital losses would not be quarantined where the taxpayer accepted that gains were assessed on an annual (arising) basis, but could be offset against gains from those assets. Finally, in the fourth option, capital losses from all assets other than shares and units in trusts could be offset against ordinary income, and quarantining would only be maintained for capital losses deriving from shares and units in trusts;

- the possible introduction of a "scrip for scrip" roll-over relief for listed public companies; and

- rationalisation of the CGT treatment of disposals by partnerships and partners and the income tax depreciation provisions, which are currently treated differently under the CGT and depreciation provisions.

There are a number of other CGT issues raised in the *RBT*, but they are either relatively inconsequential or are not of significance to the small business sector.

Implications of the CGT proposals for small business

Simplistic solutions to complex problems need to be resisted in order to maintain such underlying integrity as still does exist in the Australian tax system. And, ironically, much of that integrity exists because of the introduction - in 1985 - of the CGT. In this section the major *ANTS* and *RBT* options for reform of CGT are considered in the light of small business concerns, and some further areas which are in need of reform are explored.

At the policy level, the essential features of the reform of the taxation of capital gains must lie in tackling any inefficiencies that do exist and reducing the complexities of the current regime without impugning its equity. The essence of an equitable CGT regime is that it should treat all gains - all accretions to net wealth, whether income gains or capital gains - on the same basis. To quote from the words of the Canadian Carter Report of 1966 "a buck is a buck is a buck". It doesn't matter whether the dollar arises from working as an employee, is gained through operating a business, is received from renting or selling property, or indeed is a windfall - it is a dollar of income and should be taxed as such. Flowing from this, preferences and concessions need to be kept to a minimum, and only introduced where there are very strong reasons – based on overwhelming equity, efficiency or simplicity considerations.

A 30% capped rate of CGT for individuals

Interfering with capital gains tax rates will inevitably undermine the equity basis on which the regime is established, and should be resisted. Of course, it would be better for all concerned, including small business, if Australia's tax rates - on income and capital - were not as high. But to reduce one and not the other would be to deal a body blow to the major reason that capital gains tax regimes exist: to ensure horizontal equity in the tax system.

Capital gains should therefore be charged to tax at prevailing income tax rates, and, in recognition of this, arguably capital losses should be available for set off against all income (subject to certain anti-avoidance provisions designed to prevent taxpayers taking advantage of obvious timing differences), not quarantined against capital gains. To this extent, the *RBT's* brief consideration of the offset of capital losses is welcome.

Recommendation 3.2.1

Capital gains should continue to be charged at income tax rates, with greater potential for the offset of capital losses against other income.

A stepped-rate CGT (taper relief)

There should not be any distinction between short term and long term capital gains (for example, with the introduction of forms of taper relief). Overseas experience shows that countries have introduced such tapers, only to shelve them at a later stage, and with no clear economic benefit or advantage having been derived. Moreover, different treatment of such gains causes difficulties at the margin, encourages the "lock-in" effect, significantly adds to the complexity of the regime and undermines the fundamental principle that all gains are income and should be treated as such.

Recommendation 3.2.2

Taper relief should not be introduced.

A CGT tax-free threshold

The introduction - for individuals - of a separate annual exempt amount or tax-free threshold, on the lines of the UK[13] provisions is a welcome development that could be of great assistance to those small business taxpayers who encounter the CGT regime. However, the suggestion in both *ANTS* and the *RBT* of a threshold of $1,000 is woefully inadequate, and would not be worth introducing.

Whilst the cost to the revenue is clearly a factor that needs to be taken into account[14], this is an area where one single measure could significantly reduce the compliance cost burden for a considerable number of small business taxpayers who encounter the CGT regime. At a very minimum the threshold needs to be introduced at a level of, say, $5,000. Concerns about the possibility for abuse of the threshold (for example, through so-called bed and breakfast arrangements) can be allayed relatively simply with the same sort of anti-avoidance provision introduced in the UK in 1998.

The annual threshold amount should also be indexed annually on an automatic basis in order to avoid the problems of erosion (akin to bracket creep) that will otherwise occur.

Recommendation 3.2.3

A CGT tax-free threshold of at least $5,000 should be introduced for individuals, and this threshold should be annually indexed in line with inflation.

The removal of indexation of the cost base of CGT assets

Again this is a reasonable proposal, although it will clearly work to the detriment of many taxpayers who return capital gains. But indexation does not exist for capital or other income, and does not need to be granted for capital gains, especially in a low inflation environment. Clearly, its abolition would remove some element of the complexity that currently exists in taxing capital gains. Moreover, the revenue saving from the abolition could help to fund a more generous tax-free threshold than is currently suggested.

[13] Currently (1998-99) £6,800, and due to rise to £7,100 for 1999-2000.

[14] The *RBT* indicates that the introduction of a $1,000 threshold would cost $0.2 billion in 2003-2004 (*A Platform for Consultation, op cit*, page 71).

Recommendation 3.2.4

The existing indexation provisions could be removed from the CGT regime, and the revenue saving used to fund a larger CGT tax-free threshold than is currently mooted.

Modification of the averaging arrangements

The *RBT* concern about averaging appears to be wholly driven by perceived abuse of the provisions. There is no doubt that some abuse does occur, though the point may be overstated. In the interests of simplicity it might be sensible to remove the averaging provisions altogether (rather than to attempt to solve the problems with ever more complicated provisions designed to replicate some form of averaging whilst preventing abuse). Once again, the revenue savings[15] from the abolition of the averaging provisions could be used to fund a more appropriate tax-free threshold.

It can also be argued that the tax-free threshold can act as a form of proxy for averaging. Averaging supposedly exists to provide a measure of relief (to those on all but the highest marginal rate of tax) for the fact that a gain that may have accrued over a number of years is taxed only in one year (on realisation). But there is nothing magical or intrinsically correct about pretending the gain is attributable to five years (which is more or less what the current averaging provisions are based upon). A tax-free threshold does not pretend to estimate or anticipate the period over which a gain derives, but can form a rough and ready relief to assist taxpayers to carry the burden of the capital gains regime when it does apply.

Recommendation 3.2.5

The existing averaging provisions could be removed from the CGT regime, and the revenue saving used to fund a larger CGT tax-free threshold than is currently mooted.

Rationalisation of the small business reliefs and exemptions

There are currently three exemptions or reliefs that are specific to small businesses – the replacement of business assets roll-over relief (Div 17A of *ITAA* 1936), the retirement exemption (Div 17B of *ITAA* 1936), and the 50% goodwill exemption (Subdiv 118-C of *ITAA* 1997). These three concessions use two different thresholds – a net asset test ($5 million) for the first two and a business exemption threshold (of $2,248,000 for 1997-98) for the third. It is encouraging that the *RBT* (at paragraph 11.78) notes that the provisions are complicated and that there would appear to be scope to merge and simplify them to make them operate more efficiently.

The *RBT* suggests (at paragraph 11.79) the replacement of the goodwill exemption with a generalised exemption of 20% on the disposal of small business active assets. It is considered that the exemption figure of 20% is far too low. It is arguable that it would be possible to introduce a generalised exemption on the sale of active assets at 50% with little if any further cost to the revenue. For example, prior to the High Court of Australia's decision

[15] The *RBT* indicates that the removal of CGT averaging would produce a gain of $0.2 billion in 2003-2004 (*A Platform for Consultation, op cit*, page 71). This would presumably fund a further $1,000 increase in the tax-free threshold.

in *FC of T* v *Murry* 98 ATC 4585; (1998) 39 ATR 129 (*Murry's* case) most business sales included a significant proportion of the sale value as goodwill with little capital gains, if any payable on other active business assets. As *Murry* has, to a certain extent, clarified the goodwill valuation issue, it is likely that in the future the value attributed to goodwill will be lower, while the value of other business assets will be higher on disposal than in the past. This means that post *Murry* it is likely that the cost of introducing a 50% general CGT exemption on the sale of all active business assets would roughly equate to the cost of the 50% goodwill exemption pre- *Murry*. Therefore, extending a 50% general CGT exemption to all business assets is unlikely to cost the revenue more than the existing goodwill exemption has to date.

A generalised exemption would also operate to overcome the compliance difficulties associated with determining the value of goodwill on the sale of a business.

As noted above, the current qualifying conditions that business taxpayers have to meet in order to access the small business replacement roll-over and retirement exemption are unduly complicated and restricted. The extension of the relief to certain land and buildings announced in August 1998 (as proposed by the JCPAA in Report Number 364) is welcome. However this extension fails to acknowledge the fact that a small business may, for genuine commercial reasons (for example, asset protection) hold assets other than land and buildings that are integral to the operation of a business outside the business operating entity. One recent example related to a commercial fisherman and a fishing trawler. The proposed extension of the 17A or 17B provisions announced on 13 August 1998 should be extended to accommodate these circumstances, and not be limited only to land and buildings outside the operating entity.

Recommendation 3.2.6

The existing goodwill exemption be replaced with a 50% general exemption on sale of small business active assets, and consideration be given to aligning the general exemption threshold to $5 million in line with the current Div 17A and 17B net asset test. Also, in the interests of equity, extend the definition of active assets for the small business roll-over relief (Div 17A of ITAA 1936) and the retirement exemption (Div 17B of ITAA 1936) provisions to include all assets integral to the operation of a business but held outside the operating entity.

Extension of scrip for scrip roll-overs to non-listed businesses

If a scrip for scrip roll-over is to be introduced in Australia (and there are sound policy arguments to support its introduction), there is no intrinsic reason why it should not also be available to mergers and consolidations in the non-listed business sector. Clearly this will involve some revenue cost, but to introduce the relief for only one part of the business community will exacerbate horizontal inequity and create even more boundary disputes than currently exist.

It also raises the question as to why the proposal should be limited only to scrip for scrip and not to equity for equity mergers and consolidations. Many small businesses do not operate through incorporated structures, and would benefit from roll-over relief on other non-scrip transactions where they are looking to merge or consolidate. The absence of this type of roll-over relief is a significant impediment to small business growth.

Recommendation 3.2.7

Scrip for scrip roll-over relief should be extended to all incorporated businesses, and not just listed companies. Further, the roll-over relief should be extended to other non-scrip merger and consolidation transactions.

Removal of grandfathering

One area which is not addressed in either *ANTS* or *RBT* is the issue of "grandfathering", whereby assets acquired before 20 September 1985 remain outside the CGT net. This is, perhaps, not surprising given the hostile political reaction the notion of removing the concession attracted during the 1998 election campaign. And yet the removal of this uniquely Australian anachronism is worthy of more serious consideration. It has been estimated that the decision to shelter such assets from CGT has increased the volume of legislation dedicated to CGT by at least 20%[16]. It is a primary cause of complexity in the provisions, leads to elements of "lock-in", and inevitably impacts upon the compliance costs of small business taxpayers. However, its removal would only begin to become acceptable if a suitable lead time were involved and if it were accompanied by the simultaneous introduction of a more generous CGT tax-free threshold.

Recommendation 3.2.8

The tax-sheltered status of pre-CGT assets should be phased out, conditional upon the introduction of a more generous CGT tax-free threshold for individual taxpayers.

Record keeping

A major CGT problem is that of record keeping. Often small businesses mistakenly believe their external accountant keeps whatever records are necessary. Even where this is the case, small businesses may have changed accountants between the time of purchase and time of sale of an asset. In these circumstances relevant "file notes" about cost base information and dates amounts were incurred are not transferred from the first accountant to the second. Efforts need to be made to better inform small business owners of their obligations. Division 121 of *ITAA* 1997 requires taxpayers to maintain CGT records for five years after it is certain that no CGT event can happen. Amendments[17] to the 1936 Act (not yet incorporated in the 1997 Act) allow taxpayers to transfer some or all of the information contained in CGT records into an asset register. It would be of great assistance to small business taxpayers if they were provided – perhaps at the business start-up stage – with a standard CGT asset register.

Recommendation 3.2.9

A standard capital gains asset register should be distributed to all small business taxpayers.

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[16] *The Australian Capital Gains Tax: Rationale, Review and Reform*, Evans, C., (1998) Australian Tax Forum 14 at page 137.

[17] Emanating from the Bell Report, Bell, C. (Chair), *Time for Business: Key Findings and Recommendations, Report of the Small Business Deregulation Task Force,* COA, 1996.

Partnerships

The *RBT* notes (at page 328 of *A Platform for Consultation*) that acquisitions and disposals of assets by partnerships, and acquisitions and disposals of interests in partnerships are currently treated differently under the CGT and depreciation provisions. They go on to state that this inconsistent treatment, especially the 'fractional interest' approach under CGT, gives rise to complexity and can be difficult to comply with. This raises the possibility of aligning the CGT treatment of partnerships with the treatment currently given to partnership depreciation.

However, it is considered that the compliance costs and complexity referred to by the *RBT* are overstated. In any event they would be unlikely to be reduced by either of the options provided. It is considered that 14 years after the introduction of CGT, taxpayers have learned to live with the any compliance problems associated with the fractional approach for CGT either by:

- using spreadsheets or other products available that calculate fractional interests for CGT purposes (some products can calculate fractional interests to 5 decimal places); or

- planning around it (for example through the use of service trusts in professional partnerships).

Incidentally, a more pressing issue in respect of partnerships which the *RBT* has not addressed is the lack of symmetry in relation to payments and receipts in respect of work in progress upon the admission or retirement of a partner (refer *Crommelin* v *DFC of T* 98 ATC 4790). Although not part of the RBT's tax reform terms of reference, this is a long outstanding issue in need of urgent legislative attention.

Recommendation 3.2.10

The current treatment of partnerships for CGT purposes should be maintained. However, the RBT should consider the issue of payment and receipts in respect of work in progress upon the admission or retirement of a partner.

3.3 Fringe benefits tax

The impact of FBT on small businesses

There are some indications that FBT is not a significant tax issue for the small business sector. In 1996 it was estimated that only 3% of small businesses pay FBT, and that there are only about 73,000 FBT payers in total[18]. In 1996-97, the majority of FBT was paid by large businesses (with a turnover in excess of $10 million), although they represented only 14% of FBT payers[19]. Moreover, because tax agents complete small business FBT returns, the FBT system sometimes does not seem to present small business with a great number of problems.

[18] Rimmer and Wilson, *Compliance Costs of Taxpayers in Australia*, 1996, Office of Regulation Review, at page 14.
[19] *Taxation Statistics* 1995-96, at page 72.

But this does not do justice to the impact that FBT does have on those small businesses that have to deal with it. The overall costs of compliance with the FBT system were estimated at $468 million in 1994-95, representing over 5% of all social compliance costs and more than 10% of FBT revenue[20]. Of the 73,000 FBT payers, some 55,000 are small businesses[21], and if 16% of FBT payers are "large" business, then by extrapolation up to 84% of FBT payers are small business. They may not pay much in terms of FBT revenues, but they are nonetheless burdened with compliance with the FBT regime. And the fact that many tax agents deal with their small business clients' FBT affairs does not prevent FBT from being a small business compliance issue – it merely transfers the compliance cost from being an internal expense to an external one. For all these reasons, therefore, the implications for the small business sector of the *ANTS* and *RBT* proposals and options need to be carefully examined.

ANTS and *RBT* proposals for FBT

The Government announced a number of significant FBT changes in its tax reform package, *ANTS*, largely driven by a need to improve income tests for surcharges and government benefits. In particular, the grossed up values of fringe benefits (where the total of the underlying benefits exceeds $1,000 for the employee) are to be reported on group certificates from 1 April 1999. Certain car parking and entertainment benefits do not have to be reported. In addition, from 1 April 2000 there will be a limit of $17,000 per employee of grossed up value of concessionally treated fringe benefits supplied by Public Benevolent Institutions and certain not-for-profit organisations. Finally, certain benefits provided by trusts and companies to beneficiaries, shareholders and their associates will be brought within the FBT net, to the extent that they are not otherwise assessable.

The *RBT* recognises that whilst the *ANTS* proposals may make the FBT system more comprehensive, a number of problems remain relating to inequity, administrative complexity and inefficiency. Accordingly, the *RBT* has chosen to include a significant number of FBT issues within its review, and a number of strategies for possible reform are identified. These are grouped around the three central concerns of equity, simplicity and efficiency.

Equity issues: transferring liability to the employee

One policy option identified by the *RBT* is to transfer the tax liability from the employer to the employee in order to improve equity. The discussion paper notes that this would bring Australia into line with most other developed countries, though at a revenue cost of approximately $435 million, as some benefits currently taxed at 48.5% would attract lower rates if taxed in the hands of employees. Clearly there would be additional compliance and administrative costs for employers, although the *RBT* suggests that this may not be significant if employers already plan to comprehensively allocate benefits on a per employee basis in order to determine who exceeds the proposed $1,000 limit. The paper also notes that some of the FBT problems currently encountered by expatriates working in Australia would be overcome with this shift of liability from employer to employee.

[20] Evans *et al*, 1997, *op cit*, at pages 56 and 57.

[21] *More Time for Business*, Statement by the Prime Minister, the Hon John Howard MP, 24 March 1997, in response to the Bell Report, Commonwealth of Australia, 1997, at page iv.

Simplicity issues

The *RBT* identifies three areas where compliance could be simplified and some of the key administrative issues could be addressed. These are:

- adopting a system of specific inclusion of benefits (as most other countries do) rather than one of including all fringe benefits unless they are specifically excluded. Such a change, it is argued, would lead to less complex rules and greater certainty;

- dealing separately with entertainment and on-premises parking. It is suggested that both these difficult items could be removed from the FBT net to considerably improve the administrative simplicity of the FBT regime, and that entertainment expenses would then be non-deductible for tax purposes, whilst the costs of providing car parking would remain tax deductible; and

- aligning the FBT and income tax years. The *RBT* points out that the current misalignment adds to the complexity of tax compliance and may make group certificate reporting additionally complex. However the paper also notes that having the FBT year end 3 months ahead of the income tax year may aid the timely issue of group certificates. It therefore calls for submissions on the point.

Efficiency issues

The *RBT* notes that the current highly concessional statutory formulas for valuing car benefits considerably distort decision making. More particularly, the statutory formula typically provides an effective tax rate of around 34% on the income sacrificed to obtain a private use vehicle as part of a salary package (assuming the vehicle travels just over 15,000 kms in the FBT year and is used solely for private purposes). The effective rate becomes even lower as the kilometres travelled rise. Clearly, the statutory formulas, introduced in an attempt to reduce compliance and administration burdens whilst not significantly detracting from revenue, efficiency or equity, are not working effectively.

Accordingly, the RBT proposes two options for modifying the current valuation of car benefits. Under the first – the schedular approach – employers would use a schedule of running costs, based upon motoring organisation surveys or upon ATO commissioned data. They would then identify the percentage of business use, and the value of the fringe benefit would flow from this. The second option involves modifying the existing statutory formulas by reducing the concessional element for private use, thereby eliminating the inefficiencies promoted by the formula.

Implications of the FBT proposals for small business

Reporting of fringe benefits on group certificates

It is to be noted that the *A New Tax System (Fringe Benefits Reporting) Bill* 1998 proposes to amend existing law to require the reporting on group certificates of the grossed up taxable value of fringe benefits (other than car parking and entertainment) provided to employees. Even though this only applies to benefits over $1,000 it will be a significant burden for small business, many of whom prepare group certificates manually. In a joint letter to the Prime

Minister five professional bodies[22] have criticised the proposed tax change to require the value of fringe benefits to be reported on group certificates.

While some amendments to the proposed *Bill* will reduce compliance costs relative to the original proposals, the fact remains that the compliance costs from this measure will be very high. Of particular concern is the fact that further changes to FBT reporting will almost certainly be required following the outcome of the *RBT* review, and to accommodate the interaction of the GST and FBT. It would have been far preferable to address all of these changes as a consistent whole so that the expensive and costly systems adjustments needed to accommodate all of these changes could have been undertaken in one hit, rather than on a one-off piecemeal basis.

Recommendation 3.3.1

Wherever possible, when changes are made to a particular tax such as the FBT, and further change is on the horizon, all expected change should be finalised and dealt with in one package of amendments. This would allow changes to systems and processes to be made in one hit, rather than requiring revisiting of compliance issues on multiple occasions.

Alignment of FBT and income tax years

Employers and their advisers have mixed feelings as to whether the FBT year end should be aligned with their income tax year end. For some employers, the misalignment may lead to the need for more calculations and record keeping requirements, and there would seem to be a real logic in aligning the two financial periods. Others, however, prefer to maintain different year ends in order to be able to manage work flows more successfully. In this connection, they would argue that the requirement to incorporate the value of certain benefits on group certificates may be more readily met with an FBT year that ends prior to the income tax year.

The different views do not appear to be related to size or industry. In the light of these different concerns, it would seem advantageous to align the years as the general default position, but to permit employers who wish to remain on the current FBT year end (31 March) to elect to continue to do so. This may require transitional rules to be adopted to ensure that the timing of collections was not adversely affected.

Recommendation 3.3.2

The FBT and income tax years should be aligned, with the proviso that those employers who wish to continue with an FBT year ending on the 31 March should be permitted to elect to do so.

In recognition of the fact that the alignment of the years may make it more difficult for group certificates to be prepared timeously, some small concession on the date for issue of group certificates may be appropriate (see Part 4.2 below).

[22] Taxation Institute of Australia, Australian Society of Certified Practising Accountants, ATA, Institute of Chartered Accountants, and the Law Council of Australia.

Switch from taxing employers to taxing employees

Consistent with almost every other developed country in the world, Australia should tax employees on employment related benefits. Once the value of benefits are reported on group certificates (from 1 April 1999), the non-disclosure problem of the past must disappear. The ATO would still have a relatively small number of revenue collectors because employers would remit the additional PAYE (in broad terms, which they currently remit as FBT).

There are considerable advantages in attaching the tax liability for FBT on to employees. The fringe benefits derived are income, and properly "belong" to the employee and not the employer. Such a change would lead to greater equity and may improve the efficiency of the tax system. But it would be naïve to expect that the compliance burden for employers would be reduced. Employers would still act as the unpaid collectors of the tax on benefits enjoyed by employees. Presumably benefits would be included in the taxable income of the employee on an on-going basis through the year, and PAYE would be appropriately deducted and remitted by the employer. Moreover, the annual group certificate would act as a reporting mechanism for employee and the ATO alike.

Since the release of the second discussion paper, the Treasurer has cast some doubt on the likelihood of the transfer of FBT liability from employers to employees (transcripts of interviews with Peter Costello on 22 and 24 February 1999). He suggested that taking FBT off employers and putting it on employees would move the tax from about 70,000 employers to about 1,000,000 employees, and that there "would be a lot of reticence about such a change"[23]. However, Mr Costello may be missing the point somewhat. The taxation of benefits at the employee level would not mean a shift of the taxing point from employer to employee, merely a shift of the ultimate liability. In fact, shifting the liability to the employee provides an opportunity to abolish FBT and permit employers to collect and remit the income tax on fringe benefits enjoyed by employees under the new PAYG provisions. Existing PAYE forms and tables could be adapted to incorporate information on the provision of the mainstream benefits that would be taxable, along with wages and salaries, on the employee.

Recommendation 3.3.3

FBT should be abolished and the ultimate liability for benefits provided to employees in connection with their employment should belong to the employees. Employers should be responsible for collecting and remitting tax on employees' wages, salaries and benefits in line with the PAYG provisions (and subject to fine-tuning at the end of the year by reference to the employee's tax return and the employer's end of year reconciliation).

There would be problems in taxing employees who currently benefit from the FBT exempt or rebateable status of their employer. However, such problems would be outweighed by the benefits of a more logical and equitable regime for the taxing of benefits. As a transitional measure, consideration might be given to providing such employees with a rebate, reducing over say 3 years, to assist in the restructuring of remuneration packages and the financial affairs of such employers generally.

[23] Surprisingly, this does not seem to be an impediment to the introduction of a GST, which will move indirect tax from about 70,000 WST taxpayers to about 1.6 million GST registered businesses.

Recommendation 3.3.4

Consideration should be given to transitional measures designed to assist those employees of FBT exempt employers who would lose out as a result of the shift from an FBT regime to a regime which taxed employee benefits as income of the employee. Such measures might take the form of a three year reducing rebate for such employees.

A comprehensive system of benefits taxation

Fringe benefits are currently captured by way of an exhaustive approach, whereby all benefits are included, unless an exemption or reduction is provided for. In favour of this approach it is argued that it is difficult to conceive of a limited list of benefits which would be sufficiently comprehensive to minimise anti-avoidance and still remain relatively simple. On the other hand, many countries adopt an inclusive approach. Under this approach it is argued that the system for the taxing of benefits should not attempt to cover absolutely everything, but in the interests of equity all of the mainstream benefits (such as the provision of a motor vehicle for private use, subsidised loans and housing, the provisions of goods and services etc) should be included.

In reality there may be little difference between an exhaustive and an inclusive approach. The important point is that the system for taxing benefits needs to be as comprehensive as possible (in order to maintain equity), but needs to recognise (on simplicity grounds) that it cannot embrace every last benefit. A *de minimus* exemption can often act as a sensible feature of a benefits taxing regime.

A modest *de minimus* exemption often provides little record keeping relief, as employers would still have to keep sufficient records to determine whether, by year end, the threshold was breached. Having said that, an exemption in the range of $500 to $1,000 to cover incidental items, often provided by way of courtesy, would assist. It is unlikely that such an exemption would be exploited by way of use in remuneration packages, as many fringe benefits are provided for sound commercial reasons and are not part of remuneration. The *de minimus* is likely to be absorbed, to a large degree, by benefits outside of remuneration arrangements and this should prevent abuse of the exemption.

Recommendation 3.3.5

Benefits should be taxed on a comprehensive basis. A modest de minimus threshold of between $500 and $1,000 should be built into the system.

Entertainment benefits

In recognition of the difficulties associated with identifying and valuing entertainment expenses, and regardless of whether benefits are taxed at the level of the employer or the employee, such expenses should normally be removed from the benefits taxing regime. In consequence, employers would not normally be entitled to a deduction in respect of costs incurred in providing entertainment. However, an exception to making entertainment non-taxable and non-deductible should arise where entertainment constitutes remuneration (for example, a holiday, religious or family function for an employee), particularly when provided on a salary sacrifice basis. While it is accepted that grey areas would arise, in our

view it is quite conceivable that, in the great majority of situations, legislative tests could make it quite clear whether remuneration was provided by way of entertainment. Tests might include:

- the time and nature of the event;
- the cost;
- the location;
- who attended (eg the number of employees and associates, clients etc);
- who decided the location, form etc;
- whether a salary sacrifice arose; and
- whether it is customary for employers in that industry to provide such functions.

Recommendation 3.3.6

Entertaining should be removed from the regime for taxing fringe benefits, and employers should normally be denied a deduction for expenses incurred in connection with entertainment expenses (subject to exceptions based on clearly determined legislative rules).

Car parking benefits

The existing car parking rules are extraordinarily and unnecessarily complex. The existing and proposed small business concessions are relevant to very few employers. This is an area where there needs to be careful consideration of the trade off between simplicity and the potential for revenue leakage. There are strong arguments that the car parking rules should be scrapped entirely or at least fundamentally simplified. The ASCPA takes the former view, and suggests the benefits should not be taxable (though employers would continue to be entitled to revenue and capital income tax deductions for any expenses of providing car parking facilities to employees under existing provisions).

Recommendation 3.3.6

Car parking benefits should be removed from the regime for taxing fringe benefits.

Valuation of car benefits

The equity and efficiency distortions caused by the existing car benefit valuation rules need to be addressed. Shifting to an employee based regime for taxing benefits will assist in this process. The schedular basis for taxing car benefits, based on objective evidence and estimation of the level of business and private use (without onerous substantiation requirements), would then prove an appropriate measure of the value of the benefit. Even without a shift to an employee based regime for taxing benefits, there would be some improvement in neutrality if such a system of valuing car benefits were adopted. Given the

small number of employers who use the operating cost method, consideration should also be given to whether the schedular system should become the only method of valuing car benefits.

Recommendation 3.3.7

The valuation of car benefits should be based on the schedular method suggested in the RBT, subject to sensible rules for determining the level of business and private use. Consideration should be given to abolishing the operating cost method.

Rationalisation of FBT

If there is not to be a shift of benefits taxation from the employer (by way of FBT) to the employee, consideration needs to be given to the rationalisation of the existing FBT legislation. The provisions are complex and onerous, and involve massive amounts of replication and unnecessary congestion. They would have benefited from the approach taken by the Tax Law Improvement Project (TLIP) rewrite team. Therefore it might be appropriate for resources to be devoted to the rewriting of the FBT legislation in a more user-friendly fashion and in a plain English style.

Recommendation 3.3.8

The FBT legislation, if it is to be retained, should be rewritten in accordance with the TLIP guidelines.

3.4 Goods and services tax

The impact of indirect taxes on small businesses

Considerable research has been undertaken, in Australia and overseas, into the impact of indirect taxes on the small business sector. So far as Australia's existing WST is concerned, research into the 1990-91 year of income[24] suggested that the overall costs of compliance of WST were $179 million, or 1.9% of tax revenue (2.1% after the cash flow costs of the WST were taken into account). Later research in respect of the 1994-95 year of income[25] indicated that compliance costs may have risen to $519 million (after cash flow benefits/costs and after taking into account the tax deductibility of certain of the compliance costs), or 4.7% of WST revenues. This increase may confirm a conclusion of the Wallschutzky and Gibson study of small business taxpayers[26], which noted that WST, out of all the taxes faced by small business taxpayers, caused the most compliance problems. That research also showed that small businesses with WST tax obligations suffered real cash flow problems as a result of the WST.

[24] Pope J, Fayle R, and Chen D, *The Compliance Cost of Wholesale Sales Tax in Australia*, Australian Tax Research Foundation, Sydney 1992.
[25] Evans *et al*, 1997, *op cit*, page 75.
[26] Wallschutzky, I.G. and Gibson, B. Small Business Cost of Compliance, *Australian Tax Forum*, Vol. 10 No. 4, 1993, p.527.

In broad terms, therefore, the WST does not impact on a large volume of businesses in the small business sector (simply because it does not impact on many firms in total), but when it does impact on small firms, that impact - both in terms of compliance costs and in terms of cash flow - is significant.

By contrast, a GST will impact on the vast majority of small businesses. Preliminary estimates contained in the Regulation Impact Statement of the Explanatory Memoranda accompanying the GST *Bills* suggest that 1.4 million businesses will register for GST at the implementation stage (to 1 July 2000), and a further 200,000 will register by 2001-02. All will need to make monthly or quarterly GST returns and otherwise participate in the GST regime.

Overseas research into the compliance costs of the GST tends to indicate that the compliance costs are high, and that they fall with particular severity on small business taxpayers. Sandford and Hasseldine[27] conducted research into the compliance costs of New Zealand's GST and identified the following major outcomes:

- the total compliance costs of GST were about 7.3% of revenue collected (in contrast to the 2% - 5% identified for the Australian WST);

- overall there was a very considerable cash flow benefit from GST, but it benefited primarily the larger firms dealing in taxable supplies;

- the size of business was the most significant factor in determining compliance costs;

- nearly 60% of the compliance costs fell on businesses with turnover below NZ$250,000;
- fees paid to external advisers accounted for only 15% of the total compliance costs (proprietors own time being the major cost component);

- it was also found that "a mix of charging categories does have the effect of increasing compliance costs, although this effect may be less apparent for larger firms with more sophisticated accounting systems than for the smallest businesses";[28]

- Registration and deregistration issues are important, particularly for small business taxpayers; and

- compliance costs increase if transactional arrangements are long and complex and if they vary from existing accounting procedure.

ANTS and *RBT* proposals for GST

A key element of the Government's indirect tax reform strategy is to introduce, from 1 July 2000, a broad based indirect tax - the GST – to replace the WST and nine separate taxes currently levied by the States. In announcing this strategy, it was noted in *ANTS* that whilst most health, education and childcare services would be excluded from the tax, most other goods and services (including food and clothing) would be subject to the tax. Indeed, the

[27] Sandford, C. and Hasseldine, J, *The Compliance Costs of Business Taxes in New Zealand*, Institute of Policy Studies Wellington, 1992.
[28] *Ibid.*, p.70.

major advantages of the proposed GST were seen as its broad base and the single rate that was applicable (10%).

ANTS recognised the compliance burden that a GST would impose on small and medium sized businesses and indicated that financial incentives of up to $500 million would be provided to such businesses to assist them to upgrade their record-keeping capacity through software and hardware, so that the start up costs of the GST would be minimised. It also indicated that business would be consulted through a Small Business Consultative Committee to ensure that these financial incentives were targeted and delivered in the most effective way.

The *ANTS* document (and subsequent *Bills* that have been tabled) give further details on a number of the key features of the GST, such as the registration thresholds, determination of the tax base, transitional provisions and the like. These are more fully discussed in the section below on the implications of the GST proposals for the small business sector.

Implications of the GST proposals for small business

There may be many justifiable reasons for introducing a GST, but the possibility of reducing small business compliance costs is not one of them. The GST will be **more** onerous for **more** small businesses compared to the WST. The critical issue is therefore to ensure that all that is possible is done to minimise this impact. In order to achieve this, a number of broad principles[29] need to be followed in the process of implementing and operating the GST. These, in turn, lead to a number of specific recommendations which will assist the small business sector.

Broad principles

- where there is a choice between administrative costs and compliance costs the balance should always be directed towards higher administrative costs because of the regressiveness of compliance costs;

- compliance costs are likely to be minimised where the base is broad, single rates are used and if the GST regime can be built as much as possible on existing accounting systems;

- exemptions and rating categories need to be kept to a minimum. Definitions should be standardised and free of ambiguity;

- the combined compliance costs and administrative costs incurred in respect of very small businesses probably exceed the revenue generated by the GST from those businesses. Therefore, the rules on GST registration and deregistration need to be sufficiently flexible to encourage businesses below the threshold to deregister if appropriate;

[29] These broad principles rely on the work of Sandford (see, for example, his chapter entitled Minimising the Compliance Costs of GST in Evans, C. and Greenbaum, A., (Eds.), *Tax Administration: Facing the Challenge of the Future*, Prospect Media Pty Ltd., 1998) and Cnossen ("Administrative and Compliance Costs of VAT: A Review of the Evidence", *Tax Notes International*, 8, pp.1649-1668).

- thresholds need to be as high as possible for registration in order to minimise compliance costs and reduce economic distortions[30] for small businesses;

- it is vital that small business (indeed all business) enjoys a period of stability and certainty once the GST is introduced. Getting it wrong is costly for business. It is absolutely imperative to get it right first time; and

- a comprehensive education and training program is necessary both for the GST administrators within the ATO (so that accurate and timely advice is available to enquirors) and to traders (and their tax advisers) operating the GST system.

Specific recommendations

Thus if compliance costs are to be kept down for small business there are a number of specific recommendations that can be made. It should be noted first, however, that a number of features in the legislation currently before the Parliament are beneficial for small business, and we would like to recommend that these features remain unaltered in securing passage of the legislation. These include:

- the tax base is relatively broad, and GST is applied at a single rate. Any attempts to narrow the base further, or to introduce multiple rates should be resisted at all costs. Application of the GST to a broad tax base at a single (positive) rate is essential to keep compliance costs down for small business;

- the legislation allows for businesses with turnover under $20 million to report on a quarterly rather than a monthly basis. Because most businesses will be collecting more GST on their outputs than they pay on their inputs, this means that the cash flow advantage to small business from the GST will be greater than if they also had to report on a monthly basis. We strongly support the quarterly reporting for small business as one way of providing some advantage to offset the higher compliance costs they will face;

- the legislation also allows for small businesses to report on a cash rather than an accruals basis, and this will greatly ease compliance costs by allowing those businesses to make minimal adjustments to existing record keeping procedures (though we suggest the threshold for cash reporting should be increased - see below); and

- the application of a 10% rate of GST is also strongly supported as it is the simplest tax fraction, and makes compliance easier for those small businesses still making manual calculations.

Recommendation 3.4.1

In securing the passage of the GST legislation, structural elements such as the relatively broad base, the single rate of 10%, the option for quarterly reporting by

[30] Research conducted in the UK for the NatWest Small Business Research Trust established that nearly 18% of firms which were not registered for VAT intentionally kept their turnover below the threshold in order to avoid having to register (*VAT and Compliance Burdens*, in NatWest SBRT Quarterly Survey of Small Business in Britain, Vol 14, No.1, April 1998, at page 19).

small business and the cash reporting option for small business should all be unaltered.

We also note that the Government proposes a timetable of passage of the legislation by 30 June 1999, with the proposed start date for the tax of 1 July 2000. We strongly urge adherence to this timetable. Many small businesses are making plans now based on the expected start date - in the circumstances they cannot do anything else. Reviewing contracts, estimating impacts on prices, and supply and demand for outputs and inputs, forward orders and the like are all being estimated on the basis of this timetable. This makes passage of the legislation by 30 June 1999 imperative.

That said, should Parliamentary delays mean that passage is delayed, then it is essential that there be at least a 12 month lag between the passage of the legislation and the start date for the tax if small business is to have sufficient time to prepare for the tax.

Recommendation 3.4.2

That every effort be made to secure passage of the GST legislation by 30 June 1999. Should there be any difficulties in achieving passage by that date, then a minimum of twelve months between passage and implementation is necessary to ensure that small businesses have time to make the necessary administrative and systems changes to collect and remit the tax.

A compensation package for small business

Given that small firms will suffer a disproportionate burden of compliance costs upon the implementation and operation of the GST in Australia, one possibility is for the Government to offer an on-going compensation package to small businesses. This could be done by allowing small businesses to retain a portion of the GST collected. This practice is followed in some European countries that operate VAT systems. For example, in Germany the relief is based on turnover. As noted by Sandford[31], a maximum of 80% relief of VAT is allowed for a turnover of DMX,000. The relief is reduced by 1% for every DMY increase in turnover. So that, if X was 50,000 and Y was 1,000, the relief would cease at DM130,000. But for turnover up to that figure a measure of relief would be available.

Whilst such measures do not reduce compliance costs, they do offer compensation to small businesses, and also have the advantage of taking the sharpness off the tax threshold.

Recommendation 3.4.3

Consideration should be given to providing a compensation package for GST registered small businesses, by permitting them to retain some portion of the GST collected.

In addition to the recurrent compliance costs of the GST once it is up and running, small business taxpayers will also face considerable temporary or one-off costs as the GST is introduced. The Government has indicated that a sum of $500 million will be available as a financial incentive to small and medium sized businesses. It is recommended that a major

[31] In *Minimising the Compliance Costs of GST, op cit*, at page 136.

proportion of this go to small firms as they bear the costs disproportionately, relative to other firms. In policy terms the Government should view this as an investment in small and medium business helping them get it right rather than as compensation for the compliance burdens imposed by the tax.

Recommendation 3.4.4

The bulk of the $500 million financial incentive available to assist small and medium sized businesses to upgrade their record keeping capacity through software and hardware should be made available to the small (rather than the medium sized) business sector.

Further to this, there is inconclusive evidence about the extent to which computerisation significantly reduces the compliance costs of small business. From the research so far, the superiority of computerisation for the smallest of firms remains to be demonstrated. Canadian research[32] suggests that those small businesses that were computerised showed a marked compliance cost advantage over those that were not. But this contrasts with research in both New Zealand[33] and the UK[34], where the results were inconclusive. Given this uncertainty, and also given the fact that in 1994-95 less than one in four of the smallest category of businesses (those with a turnover of $100,000 or less) in Australia used any form of computer for tax purposes, it is recommended that the $500 million should not be restricted only to computerised record keeping upgrades. Rather, it should be made available to small businesses to enable them to consult with external advisers about the most appropriate form of record keeping for their business, whether paper based or computerised.

Recommendation 3.4.5

The $500 million financial incentive available to assist small and medium sized businesses to upgrade their record keeping capacity should not be restricted to computerised record keeping, but should also enable the smallest businesses to consult with external advisers about the most appropriate form of record keeping for their business.

Threshold issues

Individuals, partnerships, companies, trusts and other bodies that engage in taxable activity will be required to register if their total sales exceed $50,000 per annum ($100,000 for not for profit organisations). Entities with smaller annual turnovers may opt to register, but are not obliged to do so. The level of $50,000 looks to be sufficiently high to avoid the distortion and disaffection that can occur where too many low turnover taxpayers are brought into the GST regime and its consequent high compliance costs. But this situation may need constant monitoring. For example, the New Zealand Inland Revenue Department has just released a discussion paper[35] which proposes an increase in the compulsory registration threshold from NZ$30,000 to NZ$40,000, largely because of the sorts of threshold issues identified above.

[32] Plamondon, R. *GST Compliance Costs for Small Business in Canada*, Finance Canada, 1993.
[33] Sandford, C. and Hasseldine, J., *op cit*.
[34] National Audit Office, *Report by the Comptroller and Auditor General, HM Customs and Excise: Costs to Business of Complying with VAT Requirements*, HMSO, London, 1994.
[35] *GST: A Review*, Policy Advice Division of the Inland Revenue Department, Wellington, March 1999.

Recommendation 3.4.6

After the introduction of GST, compliance costs of small firms should be monitored to determine whether revenue collections for those at or predominantly above the threshold exceeds the compliance and administration costs of those firms. The GST registration threshold may need to be adjusted in the light of this monitoring.

The experience in New Zealand has shown that many registered businesses only deal with other registered businesses. This is mainly because of the risk of error in processing invoices that do not include GST. Dealing only with registered businesses (that always charge GST on their outputs) avoids inadvertent non-compliance where an invoice from a non-registered business is entered into a system as a GST inclusive invoice. In addition, businesses with turnover below the threshold may wish to claim input tax credits, and may also see some competitive advantage in not having their competitors know that their turnover is under $50,000. All of these factors mean voluntary registration below the compulsory registration threshold should be allowed. However, some businesses may find it is in their interest not to register where they are not required to do so.

Recommendation 3.4.7

Businesses below the compulsory registration threshold should have the option of registering. Whether a business chooses to register should be assessed carefully on a case by case basis.

Some restrictions are necessary on deregistration in order to avoid the situation where businesses come into existence, register to obtain the advantage of refunds on their inputs (which are likely to exceed outputs in the early stages of a new business) and subsequently deregister. However, where enterprises are registered, the deregistration process should not be too difficult.

Recommendation 3.4.8

Deregistration should not be too onerous.

Under the proposed GST, very small business (i.e. those with an annual turnover less than $50,000) may have GST compliance costs even though they are not registered. Registration is required if turnover for the current month and either turnover for the last 11 months, or turnover for the next 11 months exceeds or is expected to exceed (respectively) $50,000. This will mean that very small businesses will need records which track monthly sales on a 12 month moving basis as well as records which will predict future sales. Given that the likely loss of revenue might be small, this seems to be an overly cautious approach. A simpler method would be to require registration from 1 July where turnover to the preceding 30 June was greater than $50,000. Registration in other circumstances (e.g. where it was expected to be greater than $50,000) would be optional.

Recommendation 3.4.9

Compulsory registration for small businesses should be based on the annual turnover of the preceding year to 30 June rather than on the recent experience of turnover or on expected future sales.

Basis of accounting

Many overseas countries permit businesses with turnover below a specified amount to account for GST on a cash (or, more strictly, payments) rather than an accruals basis. Such businesses do not have to account for the GST until after they have received the tax. They do not therefore have to worry about the cash flow problems that derive from slow payers (which is often a problem with the current WST regime), and they do not have the problem of paying tax on debts which subsequently turn out to be bad. In its initial *ANTS* proposals, registered persons with sales of less than $250,000 per annum had the option of accounting for GST on a payments basis. Subsequently, that threshold has been increased to $500,000. However, the New Zealand experience may suggest that even that threshold is not sufficiently high, and proposals there have been made to increase the limit from NZ$1 million to NZ$1.3 million[36]. This increase is suggested despite the fact that the existing threshold allows 94% of registrants to report on a cash basis. It is interesting to note that all non-profit bodies are also allowed to report on a cash basis in New Zealand. A similar limit may be appropriate for Australia.

Recommendation 3.4.10

Increase the threshold below which firms may opt for the payments basis from $500,000 to $1 million and permit all non-profit bodies to report on a payments basis.

Where possible, GST rates should not require small business to use much more than existing cash books, bank statements and other records to complete their GST returns. Some existing businesses are able to use the cash basis for income tax accounting purposes, and it would be unfortunate if any such businesses were precluded from using the same basis to account for GST. Most such businesses are likely to fall within the $500,000 limit (or preferably $1 million limit referred to in recommendation 3.4.10). But some businesses on a cash basis may not. Therefore any business operating (with the concurrence of the Commissioner) on the cash basis for income tax, should be entitled to adopt the payments basis for GST purposes.

Recommendation 3.4.11

Businesses able to operate on the cash basis for income tax purposes should be entitled to operate on the payments basis for GST without having to apply to the Commissioner to do so.

[36] *GST: A Review, op cit*, at pages 8 and 23-24.

Education

Clearly a great deal of attention will focus on the extensive education and training of ATO officers, of tax advisers and of the business community as the GST comes to be introduced. That process is already in train. But education needs to be ongoing as new enterprises commence business on a regular basis. These enterprises not in existence when the initial campaign is undertaken may be disadvantaged if education is not continuous. In addition, GST literature should be free and enquiry lines should be set up via both toll free numbers and through e-mail. Given the reluctance of many small businesses to approach the ATO for information it may be best if the body supplying information to small business had a degree of independence from the ATO and government. The recent (9 March 1999) Budget announcement in the UK of the setting up of a Small Business Agency may provide an appropriate model.

There will inevitably be some problems in transition to the new tax, but to minimise these problems it is essential that a good information and education program is established that addresses the needs of small business on a sector by sector basis. The establishment of the GST Co-ordination Office in New Zealand, which concentrated its resources on supplying information to small businesses, is an excellent model which should be replicated in Australia. The Office was chaired by a senior accountant, had a degree of independence from Government, and was separate from the tax authority (although it received substantial back up from them). We may wish to have a similar structure that included the participation of all of the professional bodies. The Office undertook a sizeable information campaign using the full range of communication media, and provided face to face contact where possible. Breakfast and weekend seminars were particularly successful in reaching small business people. The Office also helped in minimising the consumer backlash facing small businesses by, for example, supplying all supermarkets and grocery stores with flyers (free of charge) that went into shopping bags explaining that price changes at the time of transition were due to tax changes, not profiteering by retailers.

The ATO, the various accounting bodies, the banks and representatives of the small business sector also need to collaborate to design software, record keeping requirements, bank statements etc that work together rather than conflict. The information/education office could facilitate collaboration on this issue. Moreover financial institutions and others that deal with small business need to be educated about the cash flow and other implications that will face small business as a result of the introduction of GST.

Recommendation 3.4.12

An information/education agency, independent of the ATO, including representatives from the professional bodies, should be established to provide specific GST information free of charge to small business taxpayers including by phone, post and email. Such an agency could also advise on appropriate record keeping methods for small businesses. This could include facilitating the collaboration of accounting bodies, banks and small business representatives to ensure effective and consistent record keeping.

The transitional stage

Transitional rules need to be kept as short and as simple as possible. Experience elsewhere suggests that the transition may be the hardest and most expensive period for small business. These short-term problems or costs can be alleviated through a number of specific actions, including education and financial assistance given to small business. We have already addressed these issues above, but other transitional issues also deserve consideration.

A major issue that will hit small business harder than anyone else relates to the grand-fathering provisions in the *Transition Bill* for non-reviewable contracts involving long term supplies. Under the transitional rules, supplies made after 1 July 2005 would be subject to GST, even though that GST cannot be recouped from the recipient. This will apply even if the recipient would be entitled to an input tax credit, so the supplier faces losing 1/11th of the income.

To avoid this situation arising, there are two possible options:

- Only impose GST when the consideration under a contract can be reviewed to recoup the tax; or

- Implement a global amendment of all existing contracts to enable the supplier to vary the consideration to recoup the GST. This option may be less attractive because of the difficulties of jurisdictional constraints where, say, contracts involve international participants.

Recommendation 3.4.13

The transition rules for long term supplies at a fixed consideration need to be amended to allow either: that the GST is imposed only when a contract can be reviewed to recoup the tax; or that all existing contracts can be amended to enable the supplier to vary the consideration to recoup the GST.

Another issue in transition relates to the proposed refund that will be available for WST paid on trading stock still on hand at 30 June 1999. Firm guidelines on the nature and detail of records that would be accepted by the ATO as proof for sales tax refunds in respect of stock held at the changeover date need to be developed and published. Methods of calculation that will be acceptable also need to be determined.

Recommendation 3.4.14

The ATO should develop and publish firm guidelines concerning the records and calculation methods that will be acceptable as proof for sales tax refunds in respect of stock held at the change over date.

There are another set of issues relating to the rules that govern the refund available for WST. It is presently intended that that it should apply in respect of "stock held for resale by retail". Precisely what this is intended to cover needs to be clarified. For example, it should cover goods held by panelbeaters and builders that are currently classified as being for own use and not for sale.

In addition, one of the big refund items in New Zealand was for WST on stationery. Virtually every business will have to print new stationery with their registration number (ABN) and to revise invoices to include provision for the GST just before the start up date. Provision for WST refunds on stationery is not currently provided for in the *Bills* before Parliament. Small businesses should not be out of pocket in relation to WST on purchases of stationery required to meet their GST obligations. In fact, the WST credit could be extended to include all WST incurred in respect of items purchased to make the transition to a GST possible.

Going further, the WST credit could be extended further to cover anything on hand at 30 June 1999 on which WST has been paid, but which has not yet been used. Only if the WST credit is extended this far will it truly meet the intention of removing double taxation on goods in the transition.

Recommendation 3.4.15

The definition of the WST credit needs to be clarified. It should also be extended to cover WST on purchases made to comply with the GST, including in particular stationery on hand at the change over date to a GST. Ideally, the credit should be extended still further to cover WST paid on anything on hand at 30 June 1999, but which has not yet been used.

Changes

Change to the GST system that is implemented should be kept to a minimum. This will ensure certainty and stability for small business.

Recommendation 3.4.16

After the settling in period, legislative amendments should be brought together in one amending bill during 2001-02, and only after full consultation with all affected parties.

Pending Regulations

There are a number of issues that will be determined by regulation under the legislation. The following recommendations relating to forthcoming regulations should help to minimise compliance costs.

It is intended under the legislation that a formal tax invoice will not be required to substantiate input tax credits for supplies for consideration under $50. The nature of invoices where consideration is over this amount is yet to be determined by regulation. The New Zealand example should be followed here in two respects. Firstly, small businesses in New Zealand were adamant that it was most beneficial for them to be given some flexibility in how they showed GST on invoices. While all invoices should have to show a GST inclusive amount, there should be flexibility to allow that the invoice can then include GST inclusive or GST exclusive prices. Small businesses dealing mainly with final consumers will most likely want to show GST inclusive prices, but those dealing mainly with tradespeople or other businesses will want to show GST exclusive prices (as this is the "real" cost to the business, and that to which their margin applies).

Recommendation 3.4.17

The Regulations providing for the detail required on invoices should require that, as a minimum, all invoices show a GST inclusive price. However, there should be flexibility to allow for GST inclusive prices or GST exclusive prices to be shown on the invoice as well.

In addition, there should be provision for an abbreviated invoice for smaller amounts (so that details such as the recipient's name and address and the quantity and volume of goods supplied would not be required), with a full invoice required only for larger amounts. The recent New Zealand review has suggested increasing their threshold for abbreviated invoices from NZ$200 to NZ$1,000[37].

Recommendation 3.4.18

The Regulations should permit abbreviated invoices in respect of supplies for consideration totalling up to $1,000.

Cash flow will be an important consideration for small business importers, as they will face big up-front payments on incoming shiploads that may not be sold for some time. The current Bills propose that the time for payment of GST on imports will be when the GST return is lodged claiming the input tax credit, where a credit is available.

Recommendation 3.4.19

We support the treatment of imports proposed in the Bills that allows for GST on imports to be paid at the time the GST return is filed claiming an input tax credit, where such a credit is available.

Another issue yet to be determined is the design of forms for the GST. It will presumably form part of the new BAS statement. Again, drawing on New Zealand experience, small business operators advised that terms like "input tax" and "output tax" caused confusion in the start up phase of the tax in New Zealand. Careful consideration needs to be given to using terminology that makes sense to small business operators when designing the GST return.

Recommendation 3.4.20

The ATO should seek advice from the professional bodies and small business representatives when designing the return form for the GST.

3.5 Payroll tax

As part of the ANTS reforms, a GST is to be introduced. The economic impact of the payroll tax is intended to be very similar to the GST. The payroll tax should therefore be removed to prevent effective double taxation.

[37] *GST: A Review*, *op cit*, at pages 24-26.

While many small businesses do not pay payroll tax, it is still of major concern to the small business sector. In has been called the tax that keeps small business small. The payroll tax is a real impediment to small business growth. This is because taking on additional employees can mean exceeding the payroll tax threshold, so that small businesses may well choose to invest in capital rather than labour. The payroll tax is therefore a significant factor in stifling employment growth in the sector of the economy that generates the most employment. While the payroll tax is levied by the States, it will require Commonwealth co-operation if it is to be removed because of the significant revenues that the States generate from the tax.

Recommendation 3.5.1

Payroll tax should be abolished.

4 Issues relating to tax administration

This part of the paper considers two major areas of tax administration that are of fundamental importance to the small business sector. The first relates to the payment of taxes. Liquidity/cash flow issues are a vital concern to small business taxpayers, and the incidence and timing of the payment of tax liabilities (both their own and those arising from obligations to collect and remit taxes from others) can have a significant impact on their well-being. Poorly designed tax payment systems can also have a significant effect on taxpayer compliance costs and on the ability of taxpayers to comply properly with tax obligations.

The second area of tax administration dealt with in this part of the paper concerns the relationship of small business taxpayers with the ATO. Again, this is a vital concern for the small business sector, and one where the impact of tax reform proposals and policy options can have a considerable impact on the ability and propensity to comply and on compliance costs.

4.1 Payment of taxes

The existing situation

There is little doubt that this is an area of the tax system which is in need of fundamental review and reform. Small business taxpayers, and in particular those who are also employers, currently face what *ANTS* (at page 129) refers to as "a maze of obligations, [where] many tax instalment systems…do the job of one". The same document notes (page 131) that the current design of the tax system can require a small or medium manufacturing employer to make, in the space of 12 months, at least 12 payments of tax instalments on behalf of employees, 4 income tax payments, 12 sales tax payments and, perhaps, 4 FBT payments. That's 32 separate interactions with the Tax Office, as well as other obligations (for example, lodging Group Certificates).

And it is not just the volume of the payments that is of concern. The timing of the payments can also be problematic. At present there are a variety of due dates for payment of tax. For example:

Group Tax (PAYE)	7th day of following month
Provisional Tax- Quarterly	1st day of last month of quarter
WST	21st day of following month
FBT	28th day of month following end of quarter
PPS (small remitters)	7th day of month following end of quarter

In addition, to concerns about the volume and timing of payments of taxation, small business taxpayers are faced with enormously complex tax payment provisions. One example will suffice. The PAYE rate scales are, at present, quite complex compared with rate scales in existence a decade or so ago. This is because the scales have been required to take into account a range of other measures (including Family Tax Assistance, Medicare Levy, Higher Education Contributions Scheme, Failure to quote a Tax File Number).

All of this – problems of scale, of timing and of complexity in the payment of tax - imposes an enormous compliance cost burden on small business taxpayers. Research in the 1994-95 year of income[38] has indicated that a typical "small" business (turnover up to $100,000 in that year) would spend an average of 2.2 hours per month on PAYE, and 1.8 hours on FBT. In "medium" sized businesses (turnover from $100,000 to $10 million), the comparable figures were 3.7 hours on PAYE and 2.1 hours on FBT. Inevitably most of this work in these sized firms would tend to be undertaken by the owner/managers, which exacerbates the problem, as such personnel carry the highest opportunity cost and can be least spared from mainstream activities of the business.

ANTS and *RBT* proposals

The bulk of reforms relating to the payment of tax are contained in *ANTS*. In that document the Government announced proposals to replace five existing payment and reporting systems (PAYE, PPS, RPS, provisional tax and company instalments) with a comprehensive Pay As You Go (PAYG) system. The principal features of the new system, which is to be introduced from 1 July 2000, are:

- a consistent and vastly simplified timetable of payments covering all five previous systems will be introduced;

- as a result, the one year lag that currently applies to company tax payments compared to individuals will cease to apply (and provisional tax and the uplift factor will be abolished);

- businesses will have the opportunity to make one net quarterly payment for all of the liabilities previously covered by the five payment and reporting systems (on the 21st day of the month following the end of each quarter);

- for businesses that are registered for GST, the quarterly payment date for income tax will be aligned with the payment date for GST. Such businesses will be able to offset credits of GST against income tax payable on the quarterly due date;

- the quarterly payment dates will also be aligned with the payment by employers of FBT liabilities. Thus the payment date for FBT will be advanced by 7 days to the 21st of the month following the end of the quarter;

- in certain circumstances businesses will be able to pay the income tax liability on an annual (rather than quarterly) basis. More particularly, businesses (incorporated and unincorporated) not registered for GST and with annual income tax of less than $8,000 will be able to choose whether to remit their taxes annually or quarterly. Where they pay annually, the payment date will move out from its present April/May due date to 21st October from 2003, in order to align it with the payment date of other businesses. This will represent a six month timing advantage for unincorporated businesses, but will advance the payment date by 54 days for companies.

Given the very comprehensive set of proposals developed in *ANTS* for reform of the business tax payment system, the *RBT* is relatively silent on the issue.

[38] Evans *et al*, 1996, *op cit*, Table 7.37, page 112.

Implications of the proposals for reform of the payment of taxes

Overall, there is much in the proposals for the reform of the tax payment system that can be welcomed by the small business community. There is no doubt that the proposals, once implemented and once the awkward transitional phase is over, will considerably simplify the collection and remission of tax. This should lead to significantly lower compliance costs in the longer term – so long as the system is permitted to keep its essential simplicity. It should also permit small businesses to plan their cash flows with a greater degree of certainty and precision, and thereby remove some of the problems small businesses face when they are required to remit taxes they have collected on behalf of others, but which have been used to meet cash flow needs of the business. And finally, through the cross matching of data arising from the filing of GST and income and other tax information at one point of time and in one location, there is the possibility that greater compliance with the tax system will be secured and the cash economy correspondingly diminished.

Nonetheless, there are still areas of concern for small business taxpayers. These are addressed in the section below, with specific recommendations.

Adverse cash flow implications

Some small business taxpayers will be adversely affected by cash flow aspects of the new system. In particular, small businesses that are currently able to remit income tax on an annual basis (because their annual income tax liability is less than $8,000 per annum), but who wish to register for GST, will be forced to move from an annual payment date to quarterly payments. And the payment date for small companies (where the annual income tax liability is less than $8,000 per annum) who are not in the GST system will be advanced by 54 days if they choose to remain on an annual payment basis, or by a considerably longer period if they elect for quarterly settlement. Finally, medium companies (annual income tax liabilities of $8,000 to $300,000) and large companies (annual income tax liabilities over $300,000) will pay their income tax liabilities 8 months earlier and 5 months earlier respectively (though subject to transitional relief whereby part of the 1999-00 liability is deferred and paid on an interest free basis over subsequent years).

To some extent there are offsetting benefits. PAYE and other remittances will be paid later (quarterly rather than monthly) by many taxpayers as a result of the new arrangements. But many small business taxpayers do not have employees and so obtain no cash flow benefit from the later payment dates. The deferral of payment dates for PAYE is more likely to provide significant cash flow benefits to larger businesses with larger numbers of employees than to the small business sector.

Recommendation 4.1.1

Estimates should be made of the number of small business taxpayers who will suffer adverse cash flow outcomes from the proposed changes to the tax payments system, and an appropriate compensation package should be offered to assist such taxpayers in the initial year of change.

4.2 Dealing with the Australian Taxation Office

The existing situation

It is probably not an exaggeration to state that relations between the small business sector and the ATO are not as good as they should be, and that sometimes they are positively hostile. Small businesses, like other taxpayers, need tax information but are often reluctant to seek it by approaching the ATO. If they have external accountants/tax agents they are likely to be charged for any advice sought so, for what seem to be small matters, they do not approach anyone. Long term this can cause problems. Also, small businesses often mistrust the ATO. They see the ATO mainly via its compliance arm and not via its service role. Often the ATO has the answers, but there seems to be no point in having them if small business taxpayers will not ask the questions.

Problems of complexity and time sometimes compound this adversarial relationship. Proprietors of small businesses rarely have sufficient hours in the day to deal with all the issues that have to be addressed. The Bell Report highlighted the problems small businesses face in dealing with numerous regulatory bodies, each with different identifiers. Even within the tax system there are a number of different identification numbers for different tax types.

There are therefore a number of issues that derive from the relationship of small business taxpayers with the ATO. Some of these have been addressed in *ANTS* and (to a considerably lesser extent) in *RBT*.

ANTS and *RBT* proposals

The introduction of the GST, foreshadowed in *ANTS*, has given the Government the opportunity to rationalise the existing business registration system. More particularly the Government proposes (as part of *ANTS*) to change the system of business registration to make it possible for business to deal with the whole of government (all three tiers) at one place and with one business identifier. The Australian Business Number (ABN) will be set up before the introduction of the GST and will be administered by the ATO. It will be a unique identifier (separate from the Tax File Number to maintain privacy) which will enable business taxpayers to deal with, and obtain information and assistance from, all government agencies through one, or as few as possible, entry points.

ANTS also identifies a number of measures designed to improve taxpayer certainty and the reliability of advice. More particularly, it proposes:

- to make tax administration simpler for taxpayers with simple affairs by reducing the period of review and adjustment. For taxpayers with simple tax affairs, it is proposed to limit the period for amendment of an assessment from 4 years to 2, in order to enable taxpayers to proceed with more certainty and reduce compliance costs;

- to make the ATO more accountable for its oral advice by providing that such advice for taxpayers with simple affairs will be binding on the Commissioner in much the same way as private written rulings; and

- to make taxpayer services more accessible. *ANTS* notes (page 148) that better access and modern delivery will be provided by the ATO entering into arrangements with other

government agencies to make services available through networked access points. Additionally, it will continue the promotion of electronic connections and seek to provide better taxpayer enquiry services.

Implications of the proposals on relations with the ATO

The proposals contained in *ANTS* which relate to improvements in dealings with the ATO are entirely laudable. However, with the possible exception of the introduction of an ABN, they might also be construed as little more than pious statements of intent unless they are backed up with more specific proposals and significant resources and facilities. In the meantime, there are a number of areas where improvements to the small business/ATO relationship can continue to be made.

The service function

The ATO already recognises that it needs more face to face contact with small business either through visits to small business premises or by providing information on neutral ground. Different systems of information dissemination are being considered - and this is especially welcome given the advent of GST. In particular the ATO appears to be recognising that it may be useful to divorce the enforcement arm of the ATO from the information/service arm. This is evident in a number of developments:

- increased emphasis on service booths in shopping centres;
- the provision of some small business toll free phone information; and
- ATO information officers visiting small businesses to see how the ATO can assist with existing small business tax problems.

Recommendation 4.2.1

It is recommended that the ATO continues to give consideration to means by which it can physically separate its enforcement arm from its service arm. It should show a commitment to the service arm by continuing to actively promote such programs as information booths in shopping centres, toll-free information lines and field visits by ATO information officers.

Dealings with Australian Taxation Offices

Small businesses sometimes complain about their dealings with the ATO. The complaints include:

- not being able to find the right person to deal with;
- not getting a timely response;
- getting different answers to the same question; and
- not getting written responses.

The ATO could help by using more experienced staff to deal with such enquiries.

Recommendation 4.2.2

ATO enquiries staff should be experienced officers trained in dealing with people who might not know what they are looking for. Further, on request, fax answers should be provided to those who seek evidence of the ATO position on particular matters.

It is also the case that small businesses do a lot of their tax compliance work in the evenings or weekends. It is therefore out of normal office hours that they have questions. If the ATO is to service this need they would need to staff enquiry services in the evenings or at weekends.

Recommendation 4.2.3

At least during the peak period of the tax season, the ATO should consider undertaking further trials of enquiry/advisory services outside normal office hours. If this was centralised it should not be at a great cost and a single "1800" number could be used. This could be designated either by size of business or even by type of industry.

Group Certificates

There is an impression that generally among employers there are a large number of errors made on group certificates. This is not surprising given the number of items that are required to be disclosed and the complexity in working out the amount of tax deducted. Leaving aside long service leave, just the issue of allowances is complex and warrants either a ruling or explanation in the group employers' booklet. From 1 April 1999 the taxable value of fringe benefits is required to be shown. This will provide further potential for error. Thus the ATO needs to increase the efforts in educating employers in relation to correct completion of group certificates.

Recommendation 4.2.4

The ATO needs to increase the efforts in educating employers in relation to completion of group certificates.

Further, there will inevitably be teething problems in the first year that fringe benefits are to be put on group certificates. The ATO should therefore adopt a more lenient approach to the penalties regime so far as the submission of the group certificates and reconciliation statement to the ATO in the year that the fringe benefits are first reported on Group Certificates.

Recommendation 4.2.5

Consideration should be given to the reasonable waiver of penalties for late submission of group certificates and reconciliation statements by employers after the end of the 1999-2000 tax year, in recognition of the additional burden taken on by employers from that year onwards.

Group Tax

Often small businesses do not *deduct* the correct amount of PAYE tax instalments from employees wages. Sometimes this is the fault of the business. At other times it is the complexity of the PAYE system itself. However, on audit the small business employer is liable irrespective of the reason and irrespective of how good a record there has been. Similarly small businesses do not always *remit* the PAYE deductions on time. It is considered that in the first instance small business should be given the benefit of the doubt. Therefore it is recommended that on the first group tax inspection and for the first late remittance small businesses be given a warning and advice how to remedy their non compliance rather than a penalty. This would help small business and improve relations between small business and the ATO.

Recommendation 4.2.6

The "initial" visit by ATO source deduction auditors should have as its primary focus "helping small business get it right" rather than penalising them for errors. This will become more important under GST as small firms struggle to cope with the new tax. Additionally, in the first instance of a small business failing to remit PAYE tax (or GST) in a timely fashion, a warning letter should be sent out rather than a penalty advice. Penalties should be imposed for subsequent offences.

Other administration matters

It is imperative for small business that the tax system is administered in a way that provides as much certainty, simplicity and stability as possible. An important ingredient in providing for such a system is an effective rulings system, an effective system of producing taxation law, and an effective review and advisory mechanism for the policy development and implementation process. The ASCPA has already provided the *RBT* with a comprehensive paper on the rulings system, and proposes to provide papers on the policy and law making process, and an advisory board. All of these issues are important in underpinning a tax system with the features that small business most needs.

Recommendation 4.2.7

The RBT should consider submissions on the rulings system and on the policy and law making process, including the advisory board, with a view to recommending reforms that will produce a more certain, simple and stable tax system.

5 Conclusions and recommendations

Many small business taxpayers set up their own businesses in order to obtain a greater degree of control over their lives than would otherwise be the case. They often find that any freedom or autonomy is considerably undermined by the overwhelming burden of paperwork and regulation that they encounter once they are in business. Much of that burden derives from their interaction with the tax system.

The extensive proposals for tax reform contained in the *ANTS* and *RBT* packages have the capacity to impact significantly upon the small business sector. It is important that the political parties have a clear understanding of that potential impact before instigating yet another round of change and upheaval on the sector. If, as the Government recognises, the small business sector is to provide the engine for economic growth in the new millennium, there must be a clear appreciation of the particular problems this sector faces, and that tax reform must be tailored to meet the needs of this sector.

The proposed tax reform package is like a curate's egg - it is good in parts. Some of the proposed tax reforms will go some way to alleviating compliance problems faced by small business. In particular, the proposed new payment system (PAYG) will be welcome. However, other reforms may create difficulties as they do not mesh well with existing tax arrangements.

The ASCPA believes that the adoption of the following recommendations will considerably enhance the progress of tax reform, and make the process more useful and enduring for the small business sector. Most of the recommendations in this paper can be adopted within the framework of revenue neutrality. The result will be a more certain, stable, equitable and efficient tax system.

Summary of recommendations

Income tax

Recommendation 3.1.1

Consideration should be given to the introduction of a concessional rate of tax for small businesses.

Recommendation 3.1.2

Small business taxpayers with a turnover of less than, say, $100,000 per annum, should be permitted to use the financial accounting profit shown in their financial statements as the basis of calculating the assessable income derived from their business activities.

Recommendation 3.1.3

Small business taxpayers with a turnover of less than, say, $100,000 per annum, should be permitted to use the financial accounting profit drawn up by reference

to cash receipts and outgoings as the basis for calculating the assessable income derived from their business activities.

Recommendation 3.1.4

The tax depreciation provisions should be considerably simplified, with the introduction of a single rate (25%) for all items of capital expenditure, applied on a reducing balance basis. The only variations from this should be to grant a 100% tax write off for single items of capital expenditure costing less than $1,000, and to impose straight line tax depreciation of 4% per annum for all items of capital expenditure eligible for tax allowances which have an effective life of 25 years or greater.

Recommendation 3.1.5

In order to ensure equity between widely held and closely held entities regarding distributions of income, there should be no special tax provisions for closely held entities that do not distribute all, or some substantial proportion, of their income annually.

Capital gains

Recommendation 3.2.1

Capital gains should continue to be charged at income tax rates, with greater potential for the offset of capital losses against other income.

Recommendation 3.2.2

Taper relief should not be introduced.

Recommendation 3.2.3

A CGT tax-free threshold of at least $5,000 should be introduced for individuals, and this threshold should be annually indexed in line with inflation.

Recommendation 3.2.4

The existing indexation provisions could be removed from the CGT regime, and the revenue saving used to fund a larger CGT tax-free threshold than is currently mooted.

Recommendation 3.2.5

The existing averaging provisions could be removed from the CGT regime, and the revenue saving used to fund a larger CGT tax-free threshold than is currently mooted.

Recommendation 3.2.6

The existing goodwill exemption be replaced with a 50% general exemption on sale of small business active assets, and consideration be given to aligning the general exemption threshold to $5 million in line with the current Div 17A and 17B net asset test. Also, in the interests of equity, extend the definition of active assets for the small business roll-over relief (Div 17A of ITAA 1936) and the retirement exemption (Div 17B of ITAA 1936) provisions to include all assets integral to the operation of a business but held outside the operating entity.

Recommendation 3.2.7

Scrip for scrip roll-over relief should be extended to all incorporated businesses, and not just listed companies. Further, the roll-over relief should be extended to other non-scrip merger and consolidation transactions.

Recommendation 3.2.8

The tax-sheltered status of pre-CGT assets should be phased out, conditional upon the introduction of a more generous CGT tax-free threshold for individual taxpayers.

Recommendation 3.2.9

A standard capital gains asset register should be distributed to all small business taxpayers.

Recommendation 3.2.10

The current treatment of partnerships for CGT purposes should be maintained. However, the RBT should consider the issue of payment and receipts in respect of work in progress upon the admission or retirement of a partner.

FBT

Recommendation 3.3.1

Wherever possible, when changes are made to a particular tax such as the FBT, and further change is on the horizon, all expected change should be finalised and dealt with in one package of amendments. This would allow changes to systems and processes to be made in one hit, rather than requiring revisiting of compliance issues on multiple occasions.

Recommendation 3.3.2

The FBT and income tax years should be aligned, with the proviso that those employers who wish to continue with an FBT year ending on the 31 March should be permitted to elect to do so.

Recommendation 3.3.3

FBT should be abolished and the ultimate liability for benefits provided to employees in connection with their employment should belong to the employees. Employers should be responsible for collecting and remitting tax on employees' wages, salaries and benefits in line with the PAYG provisions (and subject to fine-tuning at the end of the year by reference to the employee's tax return and the employer's end of year reconciliation).

Recommendation 3.3.4

Consideration should be given to transitional measures designed to assist those employees of FBT exempt employers who would lose out as a result of the shift from an FBT regime to a regime which taxed employee benefits as income of the employee. Such measures might take the form of a three year reducing rebate for such employees.

Recommendation 3.3.5

Benefits should be taxed on a comprehensive basis. A modest de minimus threshold of between $500 and $1,000 should be built into the system.

Recommendation 3.3.6

Entertaining should be removed from the regime for taxing fringe benefits, and employers should normally be denied a deduction for expenses incurred in connection with entertainment expenses (subject to exceptions based on clearly determined legislative rules).

Recommendation 3.3.7

Car parking benefits should be removed from the regime for taxing fringe benefits.

Recommendation 3.3.8

The valuation of car benefits should be based on the schedular method suggested in the RBT, subject to sensible rules for determining the level of business and private use. Consideration should be given to abolishing the operating cost method for valuing car benefits.

Recommendation 3.3.9

The FBT legislation, if it is to be retained, should be rewritten in accordance with the TLIP guidelines.

GST

Recommendation 3.4.1

In securing the passage of the GST legislation, structural elements such as the relatively broad base, the single rate of 10%, the option for quarterly reporting by small business and the cash reporting option for small business should all be unaltered.

Recommendation 3.4.2

That every effort be made to secure passage of the GST legislation by 30 June 1999. Should there be any difficulties in achieving passage by that date, then a minimum of twelve months between passage and implementation is necessary to ensure that small businesses have time to make the necessary administrative and systems changes to collect and remit the tax.

Recommendation 3.4.3

Consideration should be given to providing a compensation package for GST registered small businesses, by permitting them to retain some portion of the GST collected.

Recommendation 3.4.4

The bulk of the $500 million financial incentive available to assist small and medium sized businesses to upgrade their record keeping capacity through software and hardware should be made available to the small (rather than the medium sized) business sector.

Recommendation 3.4.5

The $500 million financial incentive available to assist small and medium sized businesses to upgrade their record keeping capacity should not be restricted to computerised record keeping, but should also enable the smallest businesses to consult with external advisers about the most appropriate form of record keeping for their business.

Recommendation 3.4.6

After the introduction of GST, compliance costs of small firms should be monitored to determine whether revenue collections for those at or predominantly above the threshold exceeds the compliance and administration costs of those firms. The GST registration threshold may need to be adjusted in the light of this monitoring.

Recommendation 3.4.7

Businesses below the compulsory registration threshold should have the option of registering. Whether a business chooses to register should be assessed carefully on a case by case basis.

Recommendation 3.4.8

Deregistration should not be too onerous.

Recommendation 3.4.9

Compulsory registration for small businesses should be based on the annual turnover of the preceding year to 30 June rather than on the recent experience of turnover or on expected future sales.

Recommendation 3.4.10

Increase the threshold below which firms may opt for the payments basis from $500,000 to $1 million and permit all non-profit bodies to report on a payments basis.

Recommendation 3.4.11

Businesses able to operate on the cash basis for income tax purposes should be entitled to operate on the payments basis for GST without having to apply to the Commissioner to do so.

Recommendation 3.4.12

An information/education agency, independent of the ATO, including representatives from the professional bodies, should be established to provide specific GST information free of charge to small business taxpayers including by phone, post and email. Such an agency could also advise on appropriate record keeping methods for small businesses. This could include facilitating the collaboration of accounting bodies, banks and small business representatives to ensure effective and consistent record keeping.

Recommendation 3.4.13

The transition rules for long term supplies at a fixed consideration need to be amended to allow either: that the GST is imposed only when a contract can be reviewed to recoup the tax; or that all existing contracts can be amended to enable the supplier to vary the consideration to recoup the GST.

Recommendation 3.4.14

The ATO should develop and publish firm guidelines concerning the records and calculation methods that will be acceptable as proof for sales tax refunds in respect of stock held at the change over date.

Recommendation 3.4.15

The definition of the WST credit needs to be clarified. It should also be extended to cover WST on purchases made to comply with the GST, including in particular stationery on hand at the change over date to a GST. Ideally, the credit should be extended still further to cover WST paid on anything on hand at 30 June 1999, but which has not yet been used.

Recommendation 3.4.16

After the settling in period, legislative amendments should be brought together in one amending bill during 2001-02, and only after full consultation with all affected parties.

Recommendation 3.4.17

The Regulations providing for the detail required on invoices should require that, as a minimum, all invoices show a GST inclusive price. However, there should be flexibility to allow for GST inclusive prices or GST exclusive prices to be shown on the invoice as well.

Recommendation 3.4.18

The Regulations should permit abbreviated invoices in respect of supplies for consideration totalling up to $1,000.

Recommendation 3.4.19

We support the treatment of imports proposed in the Bills that allows for GST on imports to be paid at the time the GST return is filed claiming an input tax credit, where such a credit is available.

Recommendation 3.4.20

The ATO should seek advice from the professional bodies and small business representatives when designing the return form for the GST.

Payroll tax

Recommendation 3.5.1

Payroll tax should be abolished.

Payment of tax

Recommendation 4.1.1

Estimates should be made of the number of small business taxpayers who will suffer adverse cash flow outcomes from the proposed changes to the tax payments

system, and an appropriate compensation package should be offered to assist such taxpayers in the initial year of change.

Relations with the ATO

Recommendation 4.2.1

It is recommended that the ATO continues to give consideration to means by which it can physically separate its enforcement arm from its service arm. It should show a commitment to the service arm by continuing to actively promote such programs as information booths in shopping centres, toll-free information lines and field visits by ATO information officers.

Recommendation 4.2.2

ATO enquiries staff should be experienced officers trained in dealing with people who might not know what they are looking for. Further, on request, fax answers should be provided to those who seek evidence of the ATO position on particular matters.

Recommendation 4.2.3

At least during the peak period of the tax season, the ATO should consider undertaking further trials of enquiry/advisory services outside normal office hours. If this was centralised it should not be at a great cost and a single "1800" number could be used. This could be designated either by size of business or even by type of industry.

Recommendation 4.2.4

The ATO needs to increase the efforts in educating employers in relation to completion of group certificates.

Recommendation 4.2.5

Consideration should be given to the reasonable waiver of penalties for late submission of group certificates and reconciliation statements by employers after the end of the 1999-2000 tax year, in recognition of the additional burden taken on by employers from that year onwards.

Recommendation 4.2.6

The "initial" visit by ATO source deduction auditors should have as its primary focus "helping small business get it right" rather than penalising them for errors. This will become more important under GST as small firms struggle to cope with the new tax. Additionally, in the first instance of a small business failing to remit PAYE tax (or GST) in a timely fashion, a warning letter should be sent out rather than a penalty advice. Penalties should be imposed for subsequent offences.

Recommendation 4.2.7

The RBT should consider submissions on the rulings system and on the policy and law making process, including the advisory board, with a view to recommending reforms that will produce a more certain, simple and stable tax system.

Glossary of abbreviations and acronyms

ABN	Australian Business Number
ABS	Australian Bureau of Statistics
ANTS	A New Tax System
ATO	Australian Taxation Office
BAS	Business Activity Statement
FBT	Fringe Benefits Tax
GST	Goods and Services Tax
ITAA	Income Tax Assessment Act
PAYE	Pay As You Earn
PAYG	Pay As You Go
PPS	Prescribed Payment System
RBT	Review of Business Taxation
RPS	Reportable Payment System
TLIP	Tax Law Improvement Project
VAT	Value Added Tax
WST	Wholesale Sales Tax

Appendix A Australian research into small business taxation issues

This Appendix reviews research into Australian small business taxation issues. It is primarily concerned with issues relating to compliance costs, but many of the other issues (compliance generally, cash flow/liquidity etc) that are relevant to the small business sector are also considered.

According to Sandford[39] *compliance costs* are "the costs incurred by taxpayers in meeting the requirements laid on them by the tax laws and revenue authorities". Compliance costs are distinguished from *administrative costs* which are the costs incurred by the revenue authority in collecting the tax. If a tax was abolished compliance costs would disappear. If particular costs were still incurred after a tax was abolished then the cost could not really be regarded as a compliance cost. Measurable compliance[40] costs for an individual include:

- costs of acquiring knowledge to meet one's tax obligations;
- the imputed cost of the taxpayers own labour in completing one's own tax obligations;
- fees paid to any adviser or tax agent; and
- incidental expenses such as travel costs to see an adviser, stationery, telephone, postage, use of computers, electricity etc.

Sandford[41] states that business compliance costs would include:

- costs of collecting, remitting and accounting for tax on products and profits of the business and on the wages and salaries of its employees; and
- costs of acquiring and updating the knowledge to enable this work to be done.

The following Australian studies have considered the issue of compliance and compliance costs in small business.

(a) The Pope Studies (1989-1992)

Pope *et. al.*[42] conducted five separate studies of compliance costs in Australia. Amongst other things these studies showed:

> "The major Commonwealth taxes with the highest aggregate compliance costs were companies' income tax, FBT, personal income tax and employers' PPS.....(t)he WST and employers' PAYE had the lowest costs,..."[43].

[39] Sandford, C. (ed.) *Tax Compliance Costs Measurement and Policy*, Fiscal Publications, Bath, 1995. p.1.
[40] These exclude psychic and psychological costs. See Sandford, C., *ibid.*.
[41] *Ibid.*
[42] For a summary see Pope, J. The Compliance Costs of Major Taxes in Australia, in Sandford, C. (ed.)*Tax Compliance Costs: Measurement and Policy*, pp. 101-123.
[43] *Ibid*. p. 103.

Consistent with overseas studies the Pope studies also showed that:

> "Overall, costs as a percentage [of taxation revenue collected] decreased as tax remittance and business size increases, confirming the regressive nature of the compliance costs of business taxes".[44]

(b) Wallschutzky and Gibson [1993]

The first compliance cost research, conducted in Australia, focussing solely on small business was that by Wallschutzky and Gibson[45]. It found that:

- the average time taken to complete small business tax compliance obligations was approximately 12 hours per month. However, the time taken varied greatly from one business to another and from one month to another;

- the compliance cost also varied widely according to how opportunity cost was estimated. In fact stable estimates of opportunity costs were **not** discovered;

- taxation was not the biggest problem facing small business. Rather cash flows and related problems of low turnover, low profits and high costs were the main problems; and

- the tax which gave rise to the greatest problem was WST.

(c) McKerchar [1995]

McKerchar[46] looked at the influence of taxpayer knowledge and understanding of tax laws. Her conclusions were that small business taxpayers did not have a satisfactory level of knowledge of taxation and may be unintentionally non-compliant as a result.

(d) Bardsley [1997]

Bardsley[47] examined the likely impact on the small business sector of the tax law improvement project (TLIP) undertaken by the ATO. He concluded that simplification should reduce both direct compliance costs and uncertainty about the application of tax law.

(e) Evans *et al* [1996 and 1997]

Evans *et al*[48] published two reports on taxpayer compliance costs. The first study focussed on incremental costs of compliance. It identified values and weighting to be attributed to the various time and monetary components of compliance costs, so that the impact on those compliance costs could be measured and properly taken into account when changes to the tax system were proposed. Amongst its findings were:

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[44] *Ibid.* p.105.
[45] Wallschutzky and Gibson, *op cit*, pp.511-43
[46] McKerchar, M. Understanding Small Business Taxpayers: Their Sources of Information and Level of Knowledge of Taxation, *Australian Tax Forum*, Vol. 12 No. 1, 1995.
[47] Bardsley, P. Simplifying the Tax Law: Some Implications for Small Business, *Australian Tax Forum*, Vol. 13 No. 1, 1997.
[48] Evans *et al* 1996 and 1997, *op cit*.

- taxpayers perceive that it is the complexity of the Australian tax system that causes many of the difficulties and much of the concern about compliance costs;

- the persons primarily responsible for the implementation of policies and systems to cope with the effects of tax changes are the proprietors/directors; and,

- accountants and tax agents play a key role in providing businesses with information about tax changes.

The second report was concerned with the level of taxpayer compliance costs in Australia. Its objectives were to provide estimates of compliance costs faced by business and personal taxpayers, to analyse compliance costs according to taxpayer and tax characteristics (such as business size); and to make appropriate international comparisons. The relevant findings include:

- the aggregate compliance costs in Australia for 1994-95 (before any offsets for cash flow benefits or tax deductibility were taken into account) were $10.4 billion. The small business sector accounted for $7.9 billion of this total;

- compliance costs were confirmed to be highly regressive, with a disproportionately high burden borne by small business. The typical compliance costs (after taking into account cash flow benefits and the tax deductibility of certain of the costs) for small business per $1,000 turnover in 1994-95 was $24.71 compared to $0.98 for a medium sized business and negative $0.68 for large business (which benefit from significant cash flow advantages).

- despite the high use of tax agents, the costs of these agents is not the major component of taxpayers' compliance costs. The major component is in fact taxpayers own time;

- analysis of employment related costs showed that the tax with the highest rate of compliance cost to revenue collected was PPS (followed by FBT and PAYE).

- WST was confirmed as a major source of concern for those businesses which dealt with it; and

- Australian compliance costs were at the higher end of the range of international comparisons.

(f) Bell (Chair), Small Business Deregulation Task Force [1996]

The Bell Committee Report[49] was a consequence of a review of the "compliance and paper burden imposed on small business"[50]. The task force made 62 recommendations, many of which are commented on later in this paper.

Generally the task force found:

[49] Bell, C. *op cit*, 1996.
[50] *Ibid.* p.3.

- on average, small business spent 16 hours a week on administration and compliance activities of which three hours is directly associated with taxation matters. (Both the Wallschutzky and the Evans (1996) research confirm the weekly figure for tax matters);

- on average, total compliance costs were $7000 per year (including $3000 on external advice but not including costs of lost opportunities and disincentive effects); and

- important reforms from a small business perspective were required in the areas of taxation; administration of regulation; coordination between government agencies; and the poor scrutiny of regulation and review processes. [51]

Dealing specifically with the taxation system (which was where the most important issues were raised by small business) the task force reported:

> "the system is too complex in terms of the number of taxes, the uncertainty of the law, the frequency of changes, the difficulty of interpretation, the burden of record keeping and the cost of compliance. Small businesses want simplicity and certainty in taxation matters"[52]

(g) Bickerdyke and Lattimore [1997]

In a paper published by the Industry Commission[53] these authors focussed on both "the nature and extent of the regulatory costs imposed on business and the rationale underlying initiatives to vary regulatory requirements according to firm size"[54]. In chapter 6, they reviewed the results of three recent perception based surveys[55] and concluded:

- none of the regulatory problems could be described as unique impediments for small business. Small, medium and large firms tend to be mainly concerned about the same sort of issues and to a similar degree; and

- regarding the degree of concern about overall regulatory burden it seems the smallest firms may be likely to have the least concerns.[56]

(h) Gabbitas and Eldridge [1998]

This Productivity Commission report[57] is directed at State and local Government taxation rather than Commonwealth. From a compliance perspective they make the observation (p.50) that the costs of complying with State taxes are higher:

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[51] *Ibid.* p.4.
[52] *Ibid.*, p.5.
[53] Bickerdyke, I. and Lattimore, R. Reducing the Regulatory Burden: Does Firm Size Matter? Industry Commission, Staff Research Paper, COA, 1997.
[54] *Ibid.*, p.xiii.
[55] Australian Chamber of Commerce and Industry, What Business Seeks from the Next Government in Australia, ACCI Review, No. 18, 1996; Chamber of Manufactures of NSW, Manufacturing Industry and Regulation Reform, 1995; and Australian Bureau of Statistics, Business Growth and Performance Survey 1994-95 (including unpublished data), 1996.
[56] *Ibid.*, p.89.
[57] Gabbitas, O. and Eldridge, D. "Directions for State Tax Reform" Productivity Commission, Staff Research Paper, 1998.

- where the taxpayers are required to fill out a return rather than pay an assessment[58];
- where payment is more frequent;
- where taxpayers are required to modify the record keeping procedures in order to comply with the tax; and
- where the definitions used for those purposes differ between States or are inconsistent with those used by the Commonwealth.[59]

[58] Note while this might be true of some taxes it is not true for all. Consider, for example, land tax, after the first year's assessment.

[59] *Ibid.* p.50.