Response to
A Platform for Consultation

Discussion Paper 2 - Review of Business Taxation

Small Business Development Corporation

Western Australia

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1. OVERVIEW

The stated objective of the Ralph Review is to make recommendations on the design of a business tax system that will improve the competitiveness and efficiency of Australian business.

The Small Business Development Corporation (SBDC) does not consider that the options outlined in the Committee's second discussion paper have the scope to see this aim realised, or to deliver an overall benefit to the small business sector.

The SBDC considers the following issues are essential elements in reforming the current business tax system:

- transparency - removal of hidden taxes to make the system more visible and improve government accountability;
- simplicity - the system as a whole needs to be simplified in order to reduce compliance costs, which are particularly onerous for small business;
- equity - the reformed system should attempt to achieve equity between taxpayers as far as possible;
- efficiency - administrative efficiency suggests that administrative and compliance costs should be reduced. Economic efficiency dictates that the taxation system not interfere with commercial decision making; and
- stability - some degree of certainty as to the future tax environment is particularly important for small business.

While the discussion paper does address some of these factors, the options proposed are generally big business oriented and involve 'tweaking' the current system rather than initiating significant reform. This is largely a consequence of the restrictions placed on the Ralph Committee by the Review's Terms of Reference. These require the Committee to protect the existing revenue base and propose modifications to the current regime, rather than to develop a comprehensive blueprint for a new tax system.

As a result of these limitations, the opportunity to reduce the administrative and compliance burden that the current tax system disproportionately imposes on the small business sector has been lost. This is an area of fundamental concern to small business. However, under this current review there will be no significant outcomes for small business, in fact, a number of the options contained in the discussion paper will actually create new tax and compliance liabilities.

Of major concern is that *A Platform for Growth* has failed to recognise the unique operating characteristics of small businesses (which comprise 97 per cent of all businesses in Australia). For example, on face value the reduction of the company tax rate to 30 per cent appears commendable. However, less than half (45 per cent) of Australia's small businesses operate under a company structure and will be in a position to benefit from this rate cut. The remainder operate as sole traders or partnerships (38 per cent) or other forms, mainly trusts (17 per cent), and would actually be worse off if the accelerated depreciation provisions are removed to compensate for lower company tax revenues.

Among the range of issues and options outlined in the discussion paper, the SBDC has identified specific proposals that will have a significant impact on the small business sector. The SBDC supports proposals to:

- reduce Fringe Benefits Tax (FBT) compliance and administration (Chapter 38);
- apply an entity treatment to the disposal of partnership assets and losses (Chapter 14);
- allow refunds for excess franking credits distributed to shareholders (Chapter 15); and
- carry back capital losses to offset earlier capital gains (Chapter 12).

The SBDC does not support proposals to:

- replace accelerated depreciation with an effective life regime (Chapter 2);
- include work in progress in the valuation of trading stock (Chapter 3);
- tax trusts as companies (Chapter 22);
- remove indexation and averaging in capital gains tax calculations (Chapter 12); and
- remove the ability to roll over balancing adjustments on disposal of depreciable assets against the cost of other depreciable assets acquired (Chapter 3).

In addition, the Corporation proposes the Review Committee consider the introduction of the following reform measures:

- increase the Capital Gains Tax (CGT) exemption threshold from the proposed $1000 in capital gains to $5000, to provide a realistic benefit to small business; and
- introduce a Fringe Benefits Tax threshold of $5,000, under which an employer would be exempt from lodging an FBT return, to ensure FBT compliance costs for very small businesses do not exceed the value of the tax raised.

2. COMMENT ON KEY OPTIONS

2.1 Reduction of Fringe Benefits Tax (FBT) Compliance and Administration

The options proposed in the paper to reform the Fringe Benefits Tax (FBT) include:

- improving equity and transferring tax liability from employer to employee;
- simplifying compliance and addressing key administrative issues; and
- improving efficiency and removing distortions in the valuation of fringe benefits.

The major suggested change is to transfer the allocation of FBT as a tax on employers to a tax on employees. This would see fringe benefits taxed at the employee's marginal rate, rather than at the highest marginal rate as is currently the case.

This change could create significant savings for employers, in terms of compliance and record keeping and for businesses with employees on low marginal tax rates. For example, where an employee on the 31.5 per cent marginal tax rate is provided with a fringe benefit, the benefit is currently liable for an effective tax rate of 48.5 per cent. Under the proposal, the effective tax rate would be 31.5 per cent.

However, in switching the FBT liability from the employer to the employee, the Ralph Committee does not address how certain exempt and concessionally treated fringe benefits will be considered. For example, under the current FBT legislation, remote area housing and remote area holiday travel is subject to a reduction of 50 per cent in FBT liability, while superannuation contributions and reimbursement of relocation costs are exempt from FBT. If there are no adequate income tax concessions provided in relation to currently exempt and concessionally treated fringe benefits, certain employees and employers, especially those operating in regional or remote areas of Australia, will be disadvantaged.

The discussion paper also suggests that in view of the complexity of the current rules, entertainment should be excluded from FBT and be treated, as it was before 1995, as a non-deductible expense.

Furthermore, the paper takes the view that the on-premises car parking benefit is unlikely to be abused. In the interest of administrative simplicity, it is proposed that this benefit should be excluded from FBT while remaining deductible for income tax purposes.

These measures will certainly reduce some of the administrative complexity associated with FBT for small business and the SBDC supports their introduction.

Although the simplification measures outlined in the paper are positive steps, they do not represent significant savings on the overall compliance cost of FBT. The FBT impost on small business is considerable, well out of proportion to the revenue generated. The small business sector will continue to seek a real commitment from the Federal Government to reduce the impost of this very onerous tax.

One option that could act to relieve this burden is the introduction of an FBT threshold, where an employer is exempt from paying tax on benefits up to a certain limit and is not required to lodge an FBT return. A reasonable threshold level would be fringe benefits with a taxable value of $5,000 in any year, below which the cost to the business of collecting the tax would exceed the value of the revenue generated.

Recommendations:

The option to transfer FBT from a tax on employers to a tax on employees is supported, however further details of the implementation process are required.

Where the tax liability for fringe benefits is transferred from the employer to the employee, the current concessions and exemptions in the FBT Act (eg. Remote Area Housing and superannuation contributions) should be maintained in the Income Tax Assessment Act.

An FBT threshold of $5,000 should be introduced, where businesses with FBT liabilities of $5,000 or less would be exempt from FBT and not required to lodge a return.

2.2 Application of an Entity Treatment to the Disposal of Partnership Assets and Losses.

For most tax purposes and calculations, a partnership is treated as if it is a single taxable entity.

However, for Capital Gains Tax calculations, partnerships are treated with a ‘fractional interest approach’. That is, each partner is required to keep a separate record of their respective interests in the partnership assets - a considerable compliance burden. This also negates the advantage of partnerships being allowed to prepare a single depreciation schedule as each partner still has to maintain a separate asset register in case of asset disposal.

The discussion paper does acknowledge that many taxpayers have difficulty in complying with CGT record keeping requirements or are unaware of their responsibilities in this area. Two options are proposed to address this:

1. Extend the fractional interest approach to depreciation provisions; and
2. Apply an entity treatment of partnership.

The SBDC considers the entity treatment of partnerships to be the preferred option. Under this approach, the partnership would be regarded as the owner of all the assets of the business and a partner's ownership interest would be in the partnership as a whole. In this way, the fractional interest method currently used for CGT purposes would move away from calculating an individual’s assets to that of calculating the assets of the whole partnership.

This approach would eliminate the need for balancing adjustment roll-over relief and reduce the level of record keeping required.

While the discussion paper suggests that under the entity treatment a capital gain would flow through to the individual partners, the paper is silent in relation to capital losses. It is important for the Review Committee to clarify this matter, that is whether capital losses will be held in the entity or flow through to the partners. Whichever of the two options is finally employed, the SBDC recommends consistency in the treatment of both capital gains and losses within partnerships.

The paper also fails to discuss the treatment of the "goodwill exemption" available under the CGT provisions. The provisions dealing with goodwill exemption broadly state that half of any capital gain arising from the disposal of goodwill is exempt from CGT, provided that the net value of the business disposed of and the related business is less than the net asset threshold (1999 - $2,248,000).

Currently, each partner (under the fractional approach) can individually qualify for the 50 per cent goodwill exemption on the basis that each partner's net assets do not exceed the threshold. The SBDC recommends that this concession be maintained if an entity approach to CGT is adopted. That is, the net asset threshold should increase depending on the number of partners in the partnership.

Recommendations:

To simplify record keeping, the SBDC recommends that the entity treatment of partnerships be adopted in calculating capital gains and losses.

With the adoption of an entity approach, the SBDC recommends that the current 50 per cent goodwill exemption threshold be maintained for each partner.

2.3 A More Competitive Regime For Taxing Capital Gains

The current system taxes real capital gains at marginal rates, which acts as a disincentive to savings and investment by businesses and individuals. To encourage investment and capital attraction, the discussion paper proposes some preliminary options and alternate treatments for capital gains, including:

1. Capping the CGT rate for individuals at 30%; and
2. The introduction of a $1,000 per annum CGT tax free threshold.

The introduction of a capped 30 per cent tax rate on capital gains would provide a definite incentive for individuals to invest in income bearing assets. The discussion paper makes the comment that the concession would be confined to individuals to limit its revenue cost, as well as certain investment vehicles such as trusts and superannuation funds.

However it is unclear whether the 30 per cent rate will apply to incorporated entities, and if not, a significant inequity will exist between incorporated and non-incorporated businesses. This issue must be addressed before any of the above options are implemented.

The paper also comments that a lower rate on capital gains than on other forms of income would require tight controls, as investors sought to convert ordinary income into capital gains income. This may lead to increased administrative and compliance requirements on both individuals and eligible companies holding investment assets.

However, despite the potential limitations, the reduction in the capital gains tax rate to 30 per cent, whether capped or stepped, should be supported and the SBDC recommends the Review Committee consider an equitable basis for its implementation.

A further option supported by the SBDC is the proposed $1000 CGT threshold for individuals. Again the issue of equity arises between incorporated and non-incorporated businesses and the fairest treatment would be access to the threshold by all tax paying entities - both individual and corporate.

Due to the increase in administration and compliance that would accompany such a move, the SBDC recommends that the threshold be increased to $5000, that is, the first $5000 capital gain is tax free for both individuals and corporate entities. This would compensate business for compliance costs and provide an additional incentive to invest.

Recommendation:

The option to cap the effective Capital Gains Tax rate at 30 per cent is supported, subject to equitable access by both individual and incorporated investors.

The tax free capital gains threshold be increased to $5000 and provided to both individual and incorporated investors.

2.4 Carrying Back Capital Losses to Offset Earlier Gains

Currently capital losses are quarantined and can only be offset against realised capital gains. The discussion paper proposes the following options in respect of the treatment of capital losses: -

1. Allow carry forward at an appropriate interest rate;
2. Allow carry back of losses to offset earlier gains;
3. Remove quarantining of capital losses where gains on assets are assessed on an annual basis; and
4. Limit quarantining of past and future losses to shares and units in trusts.

Given that capital gains tax is calculated over an artificial time frame that does not necessarily align with business cycles, Option 2, allowing the carry back of capital losses to offset earlier capital gains is preferred.

In addition, the ability to offset capital losses against ordinary income should also be considered by the Review Committee. Under the current system, a capital gain is included in assessable income while capital losses are quarantined and can only be offset against a capital gain. This restriction on capital losses is at best inequitable.

Although the discussion paper suggests that only certain capital losses should be offset against ordinary income, the SBDC is of the opinion that this should be extended to include any capital loss. This would promote investment and risk taking by small business and provide a more equitable and less complex treatment of capital gains than proposed in the discussion paper.

Recommendation:

The carry back of capital losses would be considered equitable and is recommended.

Extend the provisions to offset capital losses against all forms of ordinary income.

2.5 Replacing Accelerated Depreciation With An Effective Life Regime

The Review Committee has considered the current accelerated depreciation provisions and reaches the view that accelerated depreciation can be seen as a "loan" by Treasury. The paper suggests that the accelerated depreciation provisions should be abolished as part of the trade-off for a reduction in the corporate tax rate to 30 per cent.

Accelerated depreciation provides an incentive for small business to invest and update its plant and technology. The benefits available to individual businesses depends significantly on industry type and activity. The discussion paper acknowledges that accelerated depreciation provides significant benefits to capital intensive industries such as mining and manufacturing, while being of little benefit to service industries such as finance, education and retailing.

The argument put forward in the discussion paper for the removal of accelerated depreciation, is that compensating business with a reduced company tax rate across all industries would provide a more equitable solution, even though some sectors would still suffer and others benefit. The Committee considers that the long term outcome would be a more competitive business sector in the international arena. Furthermore, introducing an effective life depreciation regime would still enable businesses to effectively write off their capital investments, but in a more uniform manner.

The paper does recognise that removal of accelerated depreciation would make investments in depreciable assets less attractive to businesses. The reduction of company tax rates would be expected to offset (to varying degrees) the impact of the removal of accelerated depreciation in affected businesses and benefit those industries with little demand for asset depreciation.

However, the removal of accelerated depreciation rates should be resisted by small business unless there is adequate compensation for non-incorporated businesses. Many small businesses in Australia (approximately 350,000) do <u>not</u> operate in a company or trust structure and will not receive a reduction in their tax rates to offset the loss in depreciation allowances.

Recommendation:

The SBDC does not support the removal of accelerated depreciation provisions as a trade off for a reduction in the company tax rate.

2.6 Including the Valuation of Work in Progress as Trading Stock

The discussion paper proposes to extend the definition of trading stock to include work in progress (WIP) for professional services. The rationale being that operating expenses are deductible at year end, although the WIP is not treated at that stage as assessable income.

The SBDC is strongly opposed to the valuation of WIP for professional services as trading stock. If introduced, it would:

- add to compliance costs by requiring the valuation of work in progress by one of the allowable accounting methods; and
- create cash flow implications for businesses in meeting tax liabilities before payment for work is received.

In addition, there is no guarantee that small business will actually receive payment for the work in progress or make a profit on the transaction. In which case any prepaid tax would not be recoverable before year end.

For small business there is no benefit to change or restrict the current valuation methods for trading stock. The inclusion of consumables in trading stock will add greatly to compliance and record keeping with minimal revenue benefits to Government.

Recommendation:

The inclusion of WIP for professional services is not supported as there is no guarantee the work will mature to a recoverable amount. Furthermore, this will bring forward the taxing point of income which will have significant impact on the cash flow of many small businesses.

2.7 Taxing Trusts as Companies

A key focus of the discussion paper is the desire to introduce a more consistent tax treatment of income regardless of the type of entity. Under the current system the treatment of business income and imputation credits can vary widely between different entity structures, particularly companies and trusts. The result of this is increased complexity and compliance, loopholes for tax avoidance and the inconsistent treatment of entity income and shareholder distributions.

The discussion paper proposes that trusts be taxed as companies and that all distributions be fully franked. It also makes the point that the existing imputation system is overly complex and that taxpayers who are unable to use the imputation credits made available with franked dividends lose those credits.

The SBDC is of the view that the taxation of trusts as companies would be disadvantageous to small business. Many small businesses, particularly family trusts, distribute to individuals whose average rate of tax is lower than the proposed 30 per cent company tax rate. The incidence of tax will therefore increase as well as the complexity and cost of administering trusts.

In addition, what is evident but not discussed in the paper, is that under the entity method trust distributions would no longer retain their special characteristics in terms of primary production, dividends and capital gains. Options are proposed to treat primary production income separately, however no special provisions have been made for the treatment of capital gains under a trust structure.

This is likely to impact on many small business owners. Currently capital gains distributed by a trust to an individual forms part of their overall capital gain or loss position. On this basis, the capital gain from the trust can be offset against an individual's capital losses and is subject to averaging concessions. Under the proposed entity taxation system these concessions will not be available.

The discussion paper also proposes that entities take into account a beneficiaries effective tax rate when making distributions. This will enable a beneficiary to recover any excess imputation credits immediately and would be of significant benefit to the affected individuals. However, this also adds to the compliance burden on businesses, particularly those with multiple shareholdings and beneficiaries, and places additional cash flow demands on businesses required to cover the reimbursement.

Recommendations:

The SBDC recommends the Review Committee consider an alternative to taxing all trusts as companies by allowing "family trusts" (as defined under the trust loss provisions) to operate under the current system.

The recommended approach to refunding imputation credits would be through the individuals tax return from the ATO, which would alleviate the need for onerous record keeping by the distributing entity. For entity chains, the taxing of unfranked dividends is preferred as the simplest option.

In addition to recognising the primary production income element of a distribution, the characteristic treatment of capital gains by trusts should also be retained.

2.8 Removing Indexation and Averaging in CGT Calculations

The current capital gains tax system includes indexation and averaging features. The paper argues that removal of the indexation feature would remove complexity in the system by unifying the treatment of both appreciating and depreciating assets. Currently, depreciating assets are depreciated without adjustment for inflation. The paper also proposes that averaging of capital gains is removed or modified to prevent ‘abuse’ of the system by individual taxpayers.

The proposal to remove indexation and averaging on capital gains to prevent ‘abuse’ of the system is not supported. Once again this measure impacts inequitably on small business and small investors as incorporated entities will not be affected. The removal of indexation may not be significant in the current low inflation environment but a rationalist approach dictates that this will not always be the case and high inflation rates will reduce real capital gains while increasing tax liabilities.

Removal of these features will act as a definite disincentive to business investment and economic growth as small businesses evaluate the timing and cost benefit of asset purchases and disposals.

Recommendation:

The current system of indexation and averaging on capital gains should be retained.