

SOUTH AUSTRALIAN GOVERNMENT



**SUBMISSION
to the
Commonwealth Review of
Business Taxation**

April 1999

EXECUTIVE SUMMARY

The South Australian Government welcomes the opportunity to contribute to this Review of Business Taxation and is supportive of the objectives that were outlined in the Review's first paper *A Strong Foundation*: optimising economic growth, ensuring equity and facilitating simplicity.

In this context, the South Australian Government recognises that the efficiency of the Australian taxation system is likely to be enhanced by a company tax system with a broad base, low statutory corporate tax rate, and that generally equalises effective rates of tax across investments. Of course, as noted in *A Platform for Consultation*, in some instances a non-neutral treatment will be desirable, perhaps to remedy some market failure or to ensure that Australia's taxation of investment is internationally competitive.

The South Australian Government has considered the many options presented in A Platform for Consultation. In summary, this Submission supports:

- Efforts to reduce compliance costs and discourage avoidance (which offers particular benefits for small businesses);
- Measures that allow the cashing in of excess franking credits by individuals and approved organisations on low or zero marginal tax rates;
- The proposed Non-Resident Investor Taxation Credit;
- The proposed alternative treatment of collective investment vehicles (CIVs);
- Abolition of FBT on entertainment expenses and car parking at the workplace;
- The extension of the principle of 'consistent treatment for entities' to the availability of R&D tax concessions;
- Detailed modelling of costs and benefits of trade-off between accelerated depreciation allowances and a lower company tax rate;
- A stepped rate CGT, with the rate providing benefits to long term investments;
- A CGT system that provides similar benefits to low income earners in the treatment of their capital gains as those proposed for high income earners;
- Enhancements to the CGT regime which make it more attractive to venture capital providers investing in high technology start-ups; and
- Retention of the existing R&D tax concessions.

The Submission also expresses concern at the proposal to reduce the concessionality applied to FBT on cars. It is also argued that adjustment costs associated with taxation reform may have an unequal impact around Australia and need to be fully accounted for in considering the arguments for change.

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**SUBMISSION TO THE COMMONWEALTH
REVIEW OF BUSINESS TAXATION**

1. INTRODUCTION

This South Australian Government Submission provides comment on some of the wide ranging options analysed by the Review in *A Platform for Consultation*. The Submission does not intend to address all the options identified in that Paper but rather to focus on a few key issues that the Government believes will have a disproportionately large impact on South Australia or which we believe will impact on achievement of your stated objectives at a national level.

2. A NEED FOR REFORM

The South Australian Government is supportive of the objectives that were outlined in the Review's first paper *A Strong Foundation*: optimising economic growth, ensuring equity and facilitating simplicity. Indeed, we recognise that these objectives are inter-linked and that their achievement fundamentally involves the creation of an efficient and internationally competitive taxation system.

In this context, the South Australian Government recognises that the efficiency of the Australian taxation system is likely to be most enhanced by a company tax system with a broad base and low statutory corporate tax rate. Alternatives may be detrimental in terms of efficient allocation of capital and in terms of inflated compliance costs. The South Australian Government also recognises that the capacity of the capital markets to bring about efficient allocation of resources is reliant on a tax system that generally equalises effective rates of tax across investments. For this to be achieved, it is necessary that tax and commercial values generally coincide.

Of course, as noted in *A Platform for Consultation*, in some instances a non-neutral treatment will be desirable, perhaps to remedy some market failure or to ensure that Australia's taxation of investment is internationally competitive. In the case of research and development tax concessions and concessions to attract venture capital, the South Australian Government would argue there are strong arguments for non-neutrality. This Submission will highlight these and other instances for consideration by the Review.

The South Australian Government has also discussed the Review with a number of business groups and notes that some will be seeking to encourage exceptions to the neutrality principle. These representations, including those in relation to accelerated depreciation, should receive very serious consideration because failure to recognise a valid argument for concessionary treatment will clearly diminish the nation's ability to achieve the Review's stated objectives. It will also be very important to ensure that any reforms to the business tax system do not disadvantage and deter foreign investment.

3. A PLATFORM FOR CONSULTATION – THE OPTIONS CONSIDERED

3.1 Support for Key Reform Options

Beyond the objectives and the fundamental commitment to neutrality, there are a number of other aspects of *A Platform for Consultation* that appear particularly attractive to the South Australian Government:

- The focus on reducing compliance costs and discouraging avoidance is strongly supported (although the cost of complying with any future reforms is not stated);
- The proposed tax relief for various types of 'blackhole expenditure' is very welcome;
- The proposals for reduced rates of Capital Gains Tax (CGT) (including a CGT taper for long term venture capital investments) in order to stimulate investment in capital gains producing assets;
- The option of allowing low marginal rate taxpayers to "cash in" excess franking credits is a highly desirable reform, removing the disadvantage faced by lower income earners in investing in corporate entities;
- The proposal to provide non-resident investor tax credits in a revenue neutral fashion is an excellent initiative that is sure to boost Australia's attractiveness as an investment location;
- The Review's proposed alternative treatment for collective investment vehicles (CIVs) is most welcome. The advantages of taxing such CIVs on a "flow through" basis rather than under imputation-like arrangements certainly appear to outweigh the disadvantages; and
- The proposal to remove entertainment and car parking at the workplace from the Fringe Benefits Tax (FBT) base addresses a long time concern of the small business community. The Small Business Deregulation Task Force also recommended abolishing FBT on car parking and meal entertainment in its 1996 report. The initiative will be an important positive for the small business sector that may help offset some of the less attractive reform options from their perspective.

3.2 Key Concerns

However, the South Australian Government also has some concerns and issues that it would like to draw to the Review's attention.

(a) Taxation of Entities

Consistent Taxation of Entities

The Review's blueprint for a more consistent treatment of entity taxation represents an improvement on the current situation. However, it needs to be recognised that this shift will potentially have a large impact on businesses currently using alternative structures. Small businesses and farmers will be particularly affected by any changes. It will be important for appropriate transition mechanisms to be put in place to minimise the costs to individuals of making the transition to new entity structures. The Review's claims regarding the economic value of reduced compliance costs resulting from reform also need to reflect the cost of transition.

In some respects, the proposals for more consistent treatment of entities could go further. For instance, the broad principle outlined is of two types of entity – those that flow through income to persons who are then taxed, and those which are taxed at the entity level as a company. However, the final detail suggests that differential treatment will still be applied to some entities which would be treated as companies (eg. R&D deductions only available to companies in a legal sense). Realisation of compliance cost savings for small business relies on taking some of these complexities out of the law.

In addition, there is no apparent efficiency case for the continuation of some of these anomalies. In fact, the motivating factor seems to be revenue concerns. While revenue concerns are legitimate, it needs to be recognised that tax reform may deliver tax advantages to some entities or activities which do not currently receive them. In these instances, it seems most appropriate to allow this to happen, and then to review the case for those tax advantages existence, rather than simply limiting their availability in the most expedient fashion.

(b) Taxation of Investment

Accelerated Depreciation Allowances

Of all the reform options outlined in *A Platform for Consultation*, none has caused greater debate than the trade off between accelerated depreciation allowances and a lower statutory rate of company tax. Comparison of effective rates of taxation contained in the discussion paper demonstrates the inequality in tax treatment among different investment activities. Much of this

inequity is created by accelerated depreciation allowances that benefit very capital intensive businesses.

The South Australian Government would support some detailed modelling of different options and sub options in relation to this issue. Some limited research commissioned by the South Australian Government is inconclusive. Discussions with business and industry in South Australia demonstrate that there is considerable uncertainty regarding whole of State impacts, which may be the same outcome at the national level. This is one of the key reasons for the division and debate, because no one has done the detailed research and analysis required to assist people in making an informed economy-wide decision. This appears to be a very useful task for the Review.

Correcting the Capital Gains Bias Against Low Income Earners

The South Australian Government is concerned regarding Capital Gains Tax (CGT) reform options that simply cap the rate at 30 per cent. Such a system appears inequitable and will provide benefits to higher income earners that are not available to lower income earners. The Review has already proposed that low-income earners be able to cash-in excess franking credits thereby addressing the inequity they face in the taxation of current capital income. The South Australian Government sees value in a CGT system that provides similar equity to low income earners in the treatment of their capital gains.

Of the options outlined in *A Platform for Consultation*, the one that reduces all marginal rates by 20 per cent appears most equitable, making 80 per cent of gains taxable at the taxpayer's marginal rate, with 80 per cent of losses also being deductible.

Correcting the Capital Gains Bias Against Long-held Investments

The existing averaging arrangements for Capital Gains Tax (CGT) appear biased in favour of short term speculative gains and against long term gains. While the Review's proposal to shorten or eliminate altogether the averaging period goes some way to addressing the bias in favour of speculative gains, it makes the situation for longer term gains even worse. A move away from indexing also has the potential to harm longer-term investments.

In many industries, notably vineyards and other horticultural activities, there is a considerable lag before an investment (in vines and trees) will reach full production. Accelerated depreciation provisions currently offset some of the disadvantage by allowing some individuals and entity types in these industries to depreciate these assets over a period less than their effective life. However, if the new averaging arrangements are introduced and the accelerated depreciation allowances not retained, this will damage the future growth prospects for affected industries.

The South Australian Government sees merit in the introduction of a stepped rate CGT, with the rate depending on the time over which the asset is held.

Targeted Concessions for Research and Development

In principle, there is a case to differentiate effective taxation rates for certain types of investments. This would be so where the investments are believed to have “spillovers” which deliver benefits (or impose costs) to parties separate from the investor. These spillovers drive a wedge between private returns (before and after tax) and social returns from the spillover activity. The investor with a focus on commercial after tax rates of return will not take into account these spillovers. However, if the effective tax rate is varied for relevant investments then it is possible to load the spillover into the investment decision.

The above argument continues to provide an in principle basis for support of the tax concessions for research and development expenditure. The continuing value to industry and the economy of the R&D tax concession has been subject to analysis on a number of occasions by the Productivity/Industry Commission. In particular, the 1995 Industry Commission Report on R&D found that “the 150 per cent tax concession has brought benefits to the Australian economy”.

It is sometimes argued that this R&D support should be provided in the form of a grant. But as noted by Commonwealth Treasury’s Submission to that Review:

“(tax incentives) are most suitable where it is considered appropriate to support all businesses undertaking R&D (eg. because externalities are widespread). Given the large number of firms receiving assistance, it would be difficult to replicate these incentives with grants or loans”.

The Industry Commission also noted that tax incentives are:

“also the most appropriate form of support where there is little information available to administrators to distinguish among firms in terms of their need for assistance and capacity to undertake socially beneficial R&D”.

The South Australian Government notes that there was very little discussion in *A Platform for Consultation* on the R&D tax concessions. The South Australian Government sees value in retention of the existing R&D tax concessions. In fact, given that a reduction in the rate of company tax will diminish the value of the R&D tax concession, it is argued that there should be consideration given to increasing the rate of assistance again to 150 per cent. As mentioned previously, in the interests of consistency, the tax concessions available to companies should not be restricted to use by incorporated entities.

Targeted Concessions for Venture Capital Investment in High Technology Activities

A Platform for Consultation notes arguments that venture capital for high technology start-ups tends to be high risk, provides returns predominantly in the form of capital gains and is extremely sensitive to CGT regimes internationally. The United Kingdom and United States have CGT rates substantially lower than “current income” rates in order to encourage suppliers of venture capital to invest in high technology seed and start-up investments. Consultations with information industries in South Australia suggest that the existing rates of CGT in Australia act as a disincentive for investment in Australia by venture capitalists. In fact, Australia’s regime is arguably the most onerous of the OECD countries.

The South Australian Government has welcomed Commonwealth initiatives such as the Innovation Investment Fund (IIF) that are intended to partially meet the needs for venture capital in Australia. Such initiatives are complemented at a State level by the availability of ‘Investment Ready’ workshops and matching services. However, the South Australian Government sees merit in proposals to make Australia’s CGT regime much more competitive with regimes internationally in order to attract venture capital.

These views are supported by specialists in the area of venture finance. For example, Mr Jim Morrison, Tax partner – IT, Deloitte Touche Tohmatsu, suggests that if a foreign investor is considering investing in Australian technology, “it makes no sense for them to leave it inside the Australian capital gains tax net”. There is considerable anecdotal evidence suggesting that US pension funds would very much like to invest in high technology Australian companies but are reluctant to do so because of the impact of the Australian CGT regime. There is also a view that a much lower CGT rate for these types of investments will stimulate venture capital investment by Australian superannuation funds.

A recent report for the Queensland Government’s Venture Capital Reference Group has emphasised how reductions in tax on capital gains help create a “virtuous circle” whereby venture capital is stimulated, increasing the pay-offs to overall private and public R&D investment, and thereby stimulating further R&D investment, and higher economic growth and employment. Overseas studies also emphasise the positive impact on economic growth, employment and saving of a lower CGT rate. Lowering the CGT rate also has the potential to improve the efficiency of resource allocation in the economy by minimising the ‘lock-in’ effects.

There is a strong argument in favour of specifically targeted concessions for venture capital aimed at high technology start-ups. The ambit of venture capitalists is very wide. The arguments for venture capital assistance seem to be strongest when applied to investment in spillover-generating high technology activities. The CGT concessions should be specifically designed

to make Australia's CGT regime internationally competitive to encourage investment in these activities.

(c) Taxation of Fringe Benefits

Motor Vehicles

The South Australian Government is concerned regarding the proposal to change the formula for determining FBT payable for motor vehicle expenses.

The proposal to change the treatment of motor vehicles will lead to an increase in the cost of vehicles to employees in high tax brackets, and presumably to some economising in vehicle costs. It is easy to imagine that over time this would involve greater use of lower cost passenger vehicles. This will be particularly threatening to domestic producers, which occupy the upper medium car sector (with over 90 per cent of production being vehicles of this type). Such a scenario is likely to lead to a greater presence of smaller imported models in the market and market share losses for domestically produced models.

A shift to smaller cheaper vehicles is already pronounced in the household market for new motor vehicles, which does not enjoy concessional tax treatment. The consequences for the Australian automotive industry of a similar shift in the business and government markets will be disastrous. This will have a particularly severe impact on regions such as Adelaide's northern and southern suburbs which are highly dependent on the automotive industry. The industry employs around 15,000 people in South Australia, and generates employment for perhaps 30,000 more elsewhere in the State's economy.

The automotive industry has endured intense competitive pressures during the past ten years as Commonwealth tariffs have been progressively phased out. While the four remaining local car makers have successfully met the challenges to date by improving their performance to match that of many of their overseas counterparts and competitors, the transition is not yet complete. The industry is now at a critical stage in the process of global integration, requiring sustained high levels of investment and further penetration of overseas markets.

The Australian industry does not have access to the very high levels of government support, by way of tariff and non-tariff barriers and other local production incentives, which are offered to their competitors overseas. Australia must do everything possible to strengthen the cases made by local car makers when they are bidding for a share of their parent company's global investment and production. Car makers are already extremely anxious with regard to the transitional arrangements for the Goods and Services Tax (GST). Discussions regarding changes to the FBT formula in relation to

motor vehicles will only serve to further damage the position of the motor vehicle industry in this country.

Further economic modelling and assessment would be invaluable in assessing the potential net costs of the proposals to the Australian automotive industry and to regional economies that are highly dependent on the automotive sector. Decisions over issues such as the FBT formula should also involve extensive consultation with the Australian motor vehicle industry and those States that are most directly affected.

4. SMALL BUSINESS PERSPECTIVES

Small business is a key generator of economic growth and employment in Australia. Between 1993-94 and 1996-97, the number of non-agricultural, private sector small businesses operating in Australia grew by more than 10 per cent to almost 900,000, and the number of people employed in such businesses grew by 11 per cent to over 3.2 million. In 1996-97, small businesses accounted for 97 per cent of all private sector, non-agricultural businesses and 50 per cent of all private sector, non-agricultural employment in Australia.

With such a significant presence in the economy, a vibrant and dynamic small business sector is vital to Australia's future growth and prosperity. Small businesses have many important advantages. In particular, their small size makes them very flexible to changing market circumstances and to new market opportunities, and they can focus on specific market niches that may not be cost-effective for larger competitors. However, small businesses also face many disadvantages, for example, having more limited access to finance, specialist skills and market research, and a greater sensitivity to regressive government systems of taxation and regulation.

The 1996 Report of the Small Business Deregulation Task Force told the Commonwealth Government that small business found the taxation system to be "complex and expensive". More than half the submissions to the Task Force raised the issue of taxation.

The most significant taxation issue from a small business perspective is the high cost of taxation compliance. Numerous studies, in Australia and overseas, have highlighted the highly regressive nature of business tax compliance. For example, a 1997 study for the Commonwealth Government found that typical compliance costs in 1994-95 were \$24.71 per \$1,000 of turnover, \$0.98 for a medium sized business, and -\$0.68 for large businesses. These estimates take into account cash flow benefits (which are of particular value to larger businesses) and the tax deductibility of certain costs.

The other major problem area for small businesses in relation to the taxation system is the impact on cash flow. Arrangements for the payment of business tax liabilities as well as other tax liabilities such as PAYE need to be sensitive to their impact on small business liquidity. Proposals to move away from the

taxation of capital gains on realisation toward a system that taxes the gain as it is accrued will also have serious implications for small business cash flow.

A number of the options outlined in A Platform for Consultation will deliver direct benefits to small business taxpayers in Australia (for example, the proposal to scrap FBT on car parking and entertainment). Small business will also benefit from the overall enhancements to Australia's economic efficiency and international competitiveness. However, in recognition of the significant contribution made by small businesses to the economy and the special difficulties that the taxation system presents for the sector, the South Australian Government believes that the Review of Business Taxation needs to give serious consideration to a number of issues:

- Small businesses do not have access to legal and financial advice on the same level as larger businesses and this suggests that small businesses should benefit, on the whole, from options that deliver substantially on the Review's objective of 'simplicity';
- The current FBT legislation requires a significant overhaul. The provisions are overly complex and onerous for small business to comply with, often with little revenue gain to the Commonwealth;
- Proposals involving the taxation of unrealised gains are likely to result in unacceptable additional compliance costs and cash flow constraints for small businesses;
- While trust structures offer particular advantages to small business beyond any taxation benefits, trusts already face relatively high compliance costs in comparison with other entity structures. The proposal to tax trusts as companies will need to be carefully considered to avoid even higher compliance costs;
- Only a small proportion of small businesses are incorporated entities. This suggests that small businesses will receive little benefit from a lower company tax rate despite potentially losing some significant concessions in order that the Commonwealth Government can achieve that goal;
- Compliance costs for small business can be significantly reduced by simplifying both the methods of calculating depreciation rates and reducing the number of applicable rates;
- The taxation of capital gains is a particularly complex matter at present for small businesses. There appears to be scope to significantly simplify overall compliance costs in this area through a range of measures such as rationalisation of exemption thresholds and the provision of asset registers to all small business taxpayers; and
- The need for education and training programs for small business in relation to transitional and implementation issues.

5. A REGIONAL PERSPECTIVE

The terms of reference for the Review require it to consider business tax reforms in a revenue neutral manner. This implies that effective tax rates for some investments would go up (in spite of a lower statutory tax rate) while effective rates for others would go down. The burden of taxation would not be significantly lowered but just distributed differently. This shift in the burden of taxation also implies a shift in investment, production and employment patterns in the Australian economy. While a more efficient and competitive tax system will have a growth dividend associated with it, much of the structural shift will reflect improved returns in some industries and worsening returns in others.

Differing industry structures in the States and Territories also implies that some jurisdictions will benefit from a particular reform package while others will be disadvantaged relative to their current position. As such, it will be important for the Commonwealth Government to be aware, in making decisions on the appropriate mix of reform options, of the potential negative impacts on particular industries and on the regions in which these industries are concentrated.

The strains of adjustment may be felt most strongly in regional areas. In South Australia, industries like wine, food processing, forestry, agriculture and mining are important contributors to regional economies. A shift in the tax mix in favour of industries that are concentrated in urban areas has the potential to negatively impact on production, investment and employment in regional areas. The transition costs involved in this type of shifting of resources may be immense and need to be carefully measured, weighed and communicated to the Commonwealth Government.

This issue stresses the need for extensive consultation between the Commonwealth and State and Territory Governments on the reform proposals and on how the transitional costs of reform will be managed. However, these consultations should not be restricted to government but also involve key affected industry sectors.

6. CONCLUDING COMMENTS

Reform of business taxation, like the broader taxation reform agenda currently under way, is critical to the ongoing growth and prosperity of the Australian economy. Reform is fundamentally about making the tax system more efficient to improve the allocation of resources in Australia. The tax system currently disadvantages many of the high growth, service based industries of the future through a bias in favour of capital-intensive industry.

However, it is not simply enough to focus on efficiency. The international competitiveness of the business tax regime is also critical. The tax regime must not hamper the ability of Australian businesses to compete and to attract

investment globally. The Review clearly needs to look more closely at issues of competitiveness in making decisions about some very key aspects of the business tax system, especially in relation to accelerated depreciation and capital gains tax.

The Review also needs to place a special focus on the issue of compliance costs. Small businesses make up 97 per cent of all Australian non-agricultural, private sector businesses and are extremely sensitive to the compliance burdens imposed by the taxation system. Consideration of compliance costs needs to extend to those costs associated with making the transition to a new business taxation environment.

The South Australian Government has considered the many options presented in A Platform for Consultation. In summary, this Submission supports:

- Efforts to reduce compliance costs and discourage avoidance;
- Measures that allow the cashing in of excess franking credits by individuals and approved organisations on low or zero marginal tax rates;
- The proposed Non-Resident Investor Taxation Credit;
- The proposed alternative treatment of collective investment vehicles (CIVs);
- Abolition of FBT on entertainment expenses and car parking at the workplace;
- The extension of the principle of 'consistent treatment for entities' to the availability of R&D tax concessions;
- Detailed modelling of costs and benefits of trade-off between accelerated depreciation allowances and a lower company tax rate;
- A stepped rate CGT, with the rate providing benefits to long term investments;
- A CGT system that provides similar benefits to low income earners in the treatment of their capital gains as those proposed for high income earners;
- Enhancements to the CGT regime which make it more attractive to venture capital providers investing in high technology start-ups; and
- Retention of the existing R&D tax concessions.

The Submission also expresses concern that the proposal to reduce the concessionality applied to FBT on cars may have serious negative economic consequences for those regions with a high concentration of automotive industry.

Finally, the Review of Business Taxation should seriously consider the adjustment costs associated with their final reform proposals. Industry structural adjustment in response to reform of business taxation has the

potential to impact severely on particular regions. The Commonwealth Government should consult extensively with State and Territory Governments in making its final decisions.

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