SMALL BUSINESS TAX REFORM

The National Institute of Accountants

NATIONAL INSTITUTE
OF ACCOUNTANTS

Submission to the Review of Business Taxation

A Platform for Consultation

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EXECUTIVE SUMMARY

This submission has been produced for the benefit of small business from the small business perspective. The issues and recommendations raised in this paper aims to assist the Review of Business Tax (RBT) adequately recognise and address small business issues.

The National Institute of Accountants (NIA) strongly supports the main recommendation of the introduction of a 30 percent corporate rate in a revenue neutral environment. The NIA is broadly supportive of the other proposed reforms and the approach Government has taken to the Review and to business tax issues. However, the NIA strongly forewarns the Government that it must provide small business with the assistance necessary to implement tax reform, otherwise the burden on small business will be horrendous.

The other principle recommendations of this submission are:

- *As a matter of priority the top marginal personal income tax rate be aligned with the corporate tax rate.*

- *Accounting standards should be used in the calculation of taxable income in all possible situations, therefore allowing businesses the opportunity to use their financial accounting profit as their taxable income.*

- *The Collective Investment Vehicle carve out from the entity tax regime be extended to a special class of funds designed specifically to invest funds in small businesses.*

- *The Government allow entities that have a minority employee shareholding to be allowed to consolidate into a group.*

- *The existing goodwill exemption be replaced with a 50% general CGT exemption on the sale of small business active assets and the threshold for the exemption be extended to $5 million of net assets (indexed annually).*

- *For equity reasons, extend the definition of active assets for the CGT small business rollover relief/exemption to include all assets integral to the operation of a business but held outside the operating entity by a related entity.*

- *Scrip for scrip rollover relief should be extended to all incorporated businesses (including non-listed entities) and be extended to rollover relief for other non-scrip merger and consolidation transactions for unincorporated entities.*

- *FBT should be abolished and taxation of benefits provided to employees and their associates in connection with the rendering of services should be captured within the Income Tax Assessment Act, thus shifting ultimate liability for such taxation to the employee. Remittance and compliance should be the responsibility of employers and remittance should be made through a modified PAYE (PAYG). system.*

- *The FBT and the income tax years should be aligned but an option should remain for FBT payers to remain on the existing FBT year if they elect to do so.*

- *The 125 percent R & D concession be removed in favour of a system of direct grants equivalent to the amount that would have been received under the special concession.*

- *Part IVA be modernised but that the 'dominant effect' test* ***not*** *be included in Part IVA.*

Introduction

For the purpose of the submission, the National Institute of Accountants (NIA) will deal with the taxation of fringe benefits, wasting assets and capital gains separately to company taxation.

The recommendations in this paper specifically deal with small business tax issues. The Government has shown a commitment to business tax reform and the NIA is generally supportive of the direction taken by Government. This submission is designed to highlight issues of importance to small business, with some of the recommendations not discussed in *A Platform for Consultation.*

The NIA supports many of the recommendations by the Review of Business Tax (RBT) and the NIA will extend further support if the recommendations were to be extended to non-business taxation. Even though the terms of reference refer specifically to business taxation, many of the principles for reform flagged by the RBT would successfully apply to all taxation.

Income Tax

Income tax by far is the largest compliance burden on small business. In the 1994-95 income year, compliance with income tax cost small business $4.2 billion. The total compliance costs for small business in that year was $7.9 billion[1] thus any major reform of taxation must concentrate on income tax.

Aligning the personal income tax rates with the corporate tax rate

The NIA submits that the aligning of the top marginal rate and the corporate rate should be a priority so that incentives to enter many of the schemes to minimise tax are reduced and it further eliminates the need for tax consequences to be a major consideration as to how a small business is structured. Thus the aligning of the two rates is seen as a major benefit to small business in reducing compliance costs and reducing the tax burden upon small business.

Recommendation 1

As a matter of priority the top marginal personal income tax rate be aligned with the corporate tax rate.

Special rates of tax for small business

Small business is mostly conducted through closely held entities; closely held entities have greater control over how and when they distribute as opposed too widely held entities. This control exists because of the greater involvement of the owners of the

[1] Evans et al, *A Report Into Taxpayer Cost of Compliance,* Australian Government Printers, Canberra, 1997 p.82

small business in the operation and control of the business and a greater interest in the success of a business than investors in widely-held, larger entities do.

For this reason, because of the different nature of small business, there is an opportunity to apply different taxing arrangements to small business. One option for applying different tax rates is to introduce a progressive corporate tax regime, with progressively higher rates of tax based on higher amounts of taxable income (there will be a need for adequate anti-avoidance provisions to prevent profit splitting.

Recommendation 2

The Government consider introducing a progressive corporate tax rate system.

Accounting standards and taxable income

The NIA fully supports the use of accounting information as the basis for the calculation of taxable income. By applying the accounting standards to the computation of taxable income, compliance costs will be considerably reduced, especially for small business as there will no longer be a need nor incentives for businesses to maintain “two sets of books”, one for accounting and one for taxation.

The removal of unnecessary duplication of record keeping and a consistent approach to the calculation of taxable income will result in reduced compliance burdens for small business and allows more time for business.

The NIA supports the introduction of accounting standards into the tax law in virtually all situations. Departures from the accounting standards will be necessary in some situations, and where this is the case, the reasons for a departure from the applicable accounting standard must be clearly stated. The NIA foresees that a departure from the accounting standards is only necessary where the implementation of that standard would be in conflict with the national tax objectives (proposed in *A Strong Foundation).*

Recommendation 3

Accounting standards should be used in the calculation of taxable income in all possible situations, therefore allowing businesses the opportunity to use their financial accounting profit as their taxable income.

Taxation of Leases

Recommendation 4

The taxation of leases should be based on economic substance although if such a measure were adopted, very clear rules and guidelines will be necessary to avoid imposing additional confusion and complexity on an already complex area of taxation.

Anti-Avoidance Provisions

Any change to the general anti-avoidance provisions in Part IVA should not include the "dominant effect test" because of possible negative consequences of such a test. The unintended consequences would mean that a transaction entered solely for the purpose of economic gain might still be caught under Part IVA if the dominant effect of the transaction created a tax benefit.

Any move to introduce such a measure is unacceptable as it removes the ‘guilty mind’ clause out of the law. This would then cause taxpayers to act in a manner inconsistent with the aims of the Review, that is, taxation should be structured to minimise the distortion on economic decisions. With a clause that can catch a taxpayer for tax avoidance even though there was no intention to do so, taxpayer decisions will increasingly become distorted by taxation consequences because the taxpayer will have to be extremely cautious of the tax consequences of entering any transaction lest it trigger Part IVA.

Recommendation 5

Part IVA be modernised but that the ‘dominant effect’ test not be included in Part IVA.

Specific anti-avoidance rules

The NIA is also very supportive of the approach by the RBT of reviewing the core problem of specific policy rather than looking at specific anti-avoidance rules to cover faults in policy. By amending or removing policy that is seen as deficient rather than protecting bad policy with specific anti-avoidance provisions, the RBT will substantially simplify the law and hopefully lead to a reduction in compliance costs.

The NIA recognises that changes in policy will not remove all specific anti-avoidance provisions but if specific anti-avoidance provisions are to be maintained or introduced, the policy behind the anti-avoidance provisions should be reviewed to see if any problem can not be ‘fixed’ by changes to policy first. Only if changes to or removal of policy is determined to not overcome a problem, should specific anti-avoidance rules be introduced.

Recommendation 6

Specific anti-avoidance rules should only be introduced or maintained in exceptional circumstances when a review of the underlying policy fails to find a better way to 'fix' the problem.

Taxation of Entities

The NIA supports consistent taxation treatment of entities. The effect of taxation should not be different for different types of entities.

Any recommendations to tax entities on the same basis should be well considered, with the approach adopted taking account of all possible side effects of a change.

The RBT needs to seriously consider the impact on small business of the proposed entity tax regime and draft transitional rules that are simple and reduces the aggravation of tax reform on small business.

Recommendation 7

The Government should draft a greater range of transitional measures than what is currently proposed in the entity tax regime, especially to ameliorate the impact of the entity tax regime on small business.

A special Collective Investment Vehicle favouring small business

The current Collective Investment Vehicle (CIV) carve out from the entity tax regime represents arrangements where individuals join together in widely held investment vehicles to undertake investments delivering a full flow-through of income in each year to participants.

The purpose of allowing such an arrangement is because such funds act more as a collection of funds which small investors contribute to, to gain access to investments they would not normally be able to invest in.

As described in *A Platform for Consultation*, most CIV's in Australia are unit trusts that are widely held, distribute profits fully and offer managed portfolio investments across local and overseas equities, property and bonds. As such, CIV's are designed to provide large corporates with the resources to expand and develop. There is nothing wrong with this and many small investors benefit greatly out of such investments, but very little of the vast amount of liquidity that fund managers of CIV's hold is invested in small business.

One of the concerns of small business is that there is a lack of liquidity and investors willing to invest in small business ventures. The NIA proposes that the Government use a special small business class of CIV's to ameliorate the imbalance in the availability of investment funds.

The NIA proposes that the CIV carve out be extended to what may be termed "Small Business Investment Funds". These funds would be formed to only provide funds and invest in small business ventures. A proposal of this sort would increase the liquidity available to small business to establish and expand and would help overcome the hurdle of a lack of venture capital investment in Australia.

To facilitate the establishment of such a fund, the legislative requirement for a Small Business Investment Fund to become a CIV should be less stringent than other CIV's, in particular the funds should be able to have some kind of active role in the business, recognising the lack of management and organisational expertise in small business.

To overcome legislative boundary issues, such as what is a small business and how actively the fund could involve itself in the investment, all Small Business Investment Funds that would qualify for CIV status would need to be approved by a appropriate Government regulator. By requiring registration before being allowed to take CIV status, it is hoped that boundary issues will be avoided.

The NIA believes that such a small business focused approach by Government would assist in alleviating the problems of a lack of funds for small business, thereby providing the stimulus for a significant boost to small business economic activity, creating a growth dividend to the revenue.

Recommendation 8

The CIV carve out from the entity tax regime be extended to a special class of funds designed specifically to invest funds in small businesses.

Consolidation

The NIA maintains in principle support for allowing consolidation for the purpose of taxation and applying taxation to that consolidated group as a single entity. There are considerable longer-term compliance savings for multiple entity small businesses in the proposed consolidation regime.

The requirement that an entity must be wholly-owned before being allowed to enter a consolidated group is seen as an impediment to small business, as often small businesses will sell (or gift) shares in the entities in their business to employees as an incentive to those employees.

Recommendation 9

The Government allow entities that have a minority employee shareholding to be allowed to consolidate into a group.

Family Groups

The NIA is supportive of allowing family trusts and companies to consolidate because many small businesses are family businesses. The definition of 'family' in the trust loss measures provides a good basis for the definition of a family group.

The proposed requirement that the family group requires a head entity means that clear transitional rules need to be established to allow any restructuring of entities within a family group prior to consolidation not to trigger any taxing event (such as a trust resettlement). Transitional rules similar to the transitional rules drafted for the

Managed Investment Act should be enacted to ensure any adverse tax consequences of restructuring to become a consolidated group should be removed.

Recommendation 10

Transitional rules be enacted to prevent the triggering of a taxation event because of restructuring to become eligible for consolidation.

Recommendation 11

Family members should not have to consolidate all of their wholly owned entities in the consolidated group, as this will give family members more flexibility to structure their affairs to meet their own personal situation.

Taxation of Physical Assets and Goodwill

(Wasting Assets)

Introduction

To measure net income, it is imperative that all expenses incurred in gaining that income, whether they are capital or revenue in nature, eventually be offset against that income, whether it is when it is incurred or over the effective life of the expenditure.

The current systems writes off capital expenditure on wasting assets in an inconsistent and confusing manner and the current system denies so-called ‘black hole’ expenditure incurred in establishing and sometimes winding down a business.

The NIA supports the adoption of a consistent approach to the writing-off of wasting assets and allowing ‘black hole’ expenditure to be written off or immediately deductible (depending on the type of expenditure). To achieve this objective, the NIA makes the following recommendations.

Who should be entitled to deductions?

The NIA supports the taxpayer that has effective control of the future economic benefits of the asset being entitled to claim depreciation of the asset, regardless of legal ownership or past expenditure.

This is consistent with the accounting standards and the NIA recommends that the accounting standards should be adopted as the basis for the computation of taxable income unless sufficient grounds exist (ie where maintaining accounting standards would be inconsistent with the proposed national tax objectives) for departing from the accounting standards, but this should be in limited circumstances and the reason for departure from the standards should be clearly explained.

The RBT would have to develop adequate tests of what taxpayer has effective control of the future economic benefits of the asset.

Recommendation 12

The taxpayer that has effective control of the future economic benefits of an asset should be the taxpayer entitled to claim depreciation on that wasting asset provided well drafted tests for what is the "effective control" are established.

What should be the appropriate base for depreciation?

Where possible, a taxpayer should depreciate the asset on the base established in the accounting standards. This leads to greater consistency between the tax and accounting treatment of an asset and will reduce the distortions the tax system builds into the economic decision to purchase assets.

Under accounting standards, the depreciable amount is the assets carrying amount less the net amount expected to be received on the disposal of the asset at the end of its useful life (the carrying amount can be revalued). If such a recommendation were adopted, it may increase the compliance burden on smaller businesses that depreciate based on the actual cost of the asset and do not factor in a scrap value. In this situation, small businesses should be given the option to elect to have a scrap value of zero (as long as this is the scrap value adopted in their accounting records).

Appropriate rules will need to be drafted to regulate the revaluation of assets and who would be qualified or allowed to perform such revaluations.

Recommendation 13

The base used in the accounting standards should be the basis for depreciation (but incidental costs of acquisition such as stamp duty should still remain immediately deductible). Small businesses can elect to have a scrap value of zero for valuation purposes if their accounting treatment of the asset has a scrap value of zero.

When should depreciation commence for taxation purposes?

As with the above recommendations, the NIA recommends that depreciation should commence when the asset is first put into use or held ready for use. The most consistent approach is to allow assets to be written-off from the time they are installed ready for use, even though those assets may not be producing assessable income at that time or be actually in use.

Recommendation 14

Depreciation of the asset should commence when the asset is installed ready for use.

Over what period should assets be written-off?

The NIA recommends that assets should be written-off over their effective life so that depreciation for tax purposes is more closely aligned with the actual reduction in value of assets.

To determine the write-off period, taxpayers should use the same effective life for an asset for taxation as they do for accounting. To assist in the determination of the effective life (for both accounting and taxation purposes) the Commissioner should publish a schedule of appropriate effective lives of various assets and give the taxpayer the option to elect to use another effective life for an asset (as long as that effective life is the same as what is used in their accounting records).

Recommendation 15

Assets should be written-off over their effective life. The effective life of an asset should be the same for accounting and taxation purposes and to assist in the determination of effective life, the Commissioner of Taxation should publish a schedule of effective lives of various assets as a guide.

Should there be immediate write-off for small items?

Recommendation 16

The $300 immediate write-off for small items should be maintained and the amount, which would qualify for immediate write-off, should be increased to $1,000 (indexed to CPI) for single items of capital expenditure.

What write-off method for depreciation should apply?

Recommendation 17

The write-off method should best reflect or match the actual decline in value of the asset. To this end, taxation should adopt the accounting standard of allowing taxpayers the choice between the prime cost method or the diminishing value method, and where appropriate, give the taxpayer an election to choose another method as *long as the method chosen for taxation purposes is also used for accounting purposes and it is the method that best matches the actual decline in value of the asset.*

How should 'black hole' expenditure be treated?

To overcome the problem of many capital expenses that are not depreciable nor amortisable (such expenses include demolition, site preparation, feasibility studies, non-integral earthworks, landscaping, stamp duty on land and other capital expenses that do not constitute plant or articles[2]), the Government should consider allowing such expenditure to be immediately deductible or depreciable (depending on the type of expenditure). For capital expenditure this would simply be resolved by defining capital expenditure for the purposes of taxation to include all costs of a capital nature.

The NIA understands that any move in the above direction would be a significant cost to revenue and that this change may well have to be deferred until later so that a 30 per cent entity tax rate can be adopted. But the adoption of such a recommendation will assist and encourage small business to expand and test new markets or establish new operations without the threat of a total or partial loss of 'black hole' expenditure if the venture proves unfeasible or unsuccessful (larger businesses on the other hand have more resources to bear the cost of lost 'black hole' expenditure).

Recommendation 18

The Government should consider a deduction or write-off (depending on the type of expenditure) of so-called 'black hole' expenditure as a means of encouraging entrepreneurial behaviour in the small business community.

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[2] Dwyer T, and Larkin K, *The Taxation of Company and Business Income* Australian Tax Research Foundation Study No 25 Sydney 1995 p.79

Accelerated Depreciation

The NIA would like to bring to the RBT's attention that it is unclear to what extent small business benefits from accelerated depreciation.

The NIA would also like to bring to the RBT's attention that the reduction in the corporate rate to 30 percent will only benefit a minority of small businesses (approximately 12 percent of small businesses are incorporated as companies)[3] therefore a trade off between the removal of accelerated depreciation and the reduction in the corporate tax rate should not have a great direct impact on small business.

The NIA understands and accepts the economic advantages of accelerated depreciation but the NIA would also like to point out that accelerated depreciation negatively distorts economic expenditure by encouraging unnecessary investment, which is often to the detriment of small businesses.

Recommendation 19

To achieve a 30 per cent corporate rate across most entity types, accelerated depreciation should be abolished in favour of a depreciation regime that is closer to the accounting treatment of depreciation and the actual decline in value of assets. By removing accelerated depreciation, the NIA realises that this will cause negative affects on many businesses therefore the Government should consider the introduction of generous transitional measures that limit the negative impact on most businesses.

Valuation of trading stock

The NIA is of the opinion that where practicable, tax law valuations of stock should reflect accounting procedures to reduce compliance costs, therefore trading stock should be valued using a method consistent with accounting standards and the method chosen by the taxpayer for taxation should be the same as the method chosen for accounting purposes.

The NIA also recommends that consumable and spare parts acquired to meet operational requirements be treated as trading stock to achieve greater consistency between taxation and accounting standards.

Recommendation 20

Trading stock should be valued according to the methods allowed in accounting standards as long as that method is the same as the method chosen by that taxpayer to calculate the value of trading stock for their accounting records. Also, consumables and spares acquired to meet operational requirements should be treated as trading stock (in line with the accounting standards).

Goodwill

The NIA would prefer to depart from adopting the accounting treatment of goodwill and maintain the current treatment because allowing businesses to amortise their goodwill will be a significant impost on the revenue and therefore the achievement of a 30 percent corporate rate is not as likely. Maintaining and modifying the current

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[3] Council of Small Business Associations, *Taxation Reform and Small Business* Canberra 6 April

treatment of goodwill (for CGT purposes) is a far better option for the small business community than allowing amortisation of goodwill in line with the accounting treatment.

Recommendation 21

The current treatment of goodwill should remain (with changes to the CGT treatment of goodwill discussed elsewhere in this submission) because it allows for favourable taxation treatment of small businesses and the impost on revenue is minor (compared to the alternative accounting treatment), providing more scope for other reforms.

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Taxation of Capital Gains

Rationalisation and extension of goodwill exemption for small business

There are currently three areas that are specific to small business in CGT:

- Div 17A – replacement of business asset roll-over relief;
- Div 17B – retirement exemption for active assets of a small business; and
- Subdiv 118-C – 50% exemption from CGT for the goodwill component of a sale of a business.

The underlying policy objective for these relief/exemptions is to provide small business with access to funds for retirement or expansion.

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To overcome the legal deficiency of the definition of goodwill (for example, the meaning of ‘goodwill’ “is notoriously difficult to define” *Hepples v FCT* (1991) 22 ATR 465 per Dawson J at 483, therefore what may be commercially be considered a disposal of ‘goodwill’ is not considered legally to be a disposal of ‘goodwill’) the RBT has proposed that the goodwill exemption be replaced with a generalised exemption of 20% of all capital gains arising from disposal of active assets. This method overcomes the problem of valuation and identification of goodwill.

For many small businesses, having only 20% of their capital gain on disposal of active assets (including goodwill) exempt from CGT would still give them significant cash flow difficulties and would be against the principle of providing small business with the funds for retirement/expansion.

When the exemption for goodwill on disposal was introduced in 1985, the exemption was for only 20% of the value of the goodwill on disposal. In 1992, recognising the unique circumstances faced by small business, the then Labor Government increased the exemption to 50%. The estimated cost to revenue of such a measure was only $10 million per year.

In 1998, the High Court in *FCT v Murry* 98 ATC 4585, effectively changed how businesses account for 'goodwill' for tax purposes. Prior to *Murry*, most business sales included a significant proportion of goodwill in the sale value, leaving very little capital gains payable on other active business assets. The decision in *Murry* will mean that future sales of businesses will report lower goodwill value and higher values on the sale of active assets.

Therefore as there will be little change in the cost to revenue of exempting 50% of all assets (including goodwill) of a business from CGT (prior to *Murry* most of the sale value of a business was reported as goodwill to qualify for the 50 percent exemption, therefore extending the exemption to those active assets which were reported at a low value will not significantly impact on the revenue) the Government should follow this recommendation for the advantage of small business.

The other change would be to extend the threshold from the current $2.2 million to $5 million (indexed) to be in line with the Div 17A and 17B thresholds.

A generalised exemption would also have the advantage of overcoming the compliance and legal difficulties of determining the value of goodwill on the sale on a business.

Recommendation 22

The existing goodwill exemption be replaced with a 50% general exemption on the sale of small business active assets and the threshold for the exemption be extended to $5 million of net assets (indexed annually).

Small business CGT relief/exemption be extended further than what is currently proposed

In the Treasurer's Press release No 77 dated 13 August 1998, the Government stated that it intends to extend CGT rollover and exemption relief for small businesses in Div 17A and Div 17B to include situations where land and buildings integral to the small business are owned by an entity other than the entity operating the business.

The NIA supports such a move but the NIA queries why the extension should only apply to land and buildings held in a separate entity. Many small businesses for reasons such as asset protection, hold active assets of the operating business outside the business operating entity, therefore the proposed extension should accommodate all active assets of the operating entity held outside that entity.

Recommendation 23

For equity reasons, extend the definition of active assets for the small business rollover relief/exemption to include all assets integral to the operation of a business but held outside the operating entity by a related entity.

Extension of scrip for scrip rollover relief to non-listed companies

The NIA supports the introduction of scrip for scrip roll-over relief because it removes some of the disincentives for firms to consolidate when there are sound market and economic reasons to do so but there is no reason why scrip for scrip rollover relief should just be limited to publicly listed companies.

There is no intrinsic reason why scrip for scrip relief should not also be available for mergers and consolidations of non-listed companies. It is inexplicable why listed companies and their shareholders should have the advantage of such relief but non-listed, usually smaller businesses do not.

Another change to assist small business consolidate and expand would be to allow rollover relief for non-scrip transactions such as equity for equity mergers or consolidations. The reason for the allowance of such a change is that many small businesses are not incorporated and therefore scrip for scrip relief is not applicable.

Recommendation 24

Scrip for scrip rollover relief should be extended to all incorporated businesses (including non-listed entities) and be extended to rollover relief for other non-scrip merger and consolidation transactions for unincorporated entities.

CGT free threshold increase

The RBT has put forward a proposal to have a CGT-free threshold of $1,000 on capital gains. This threshold is primarily aimed at reducing the incidence of "Mum and Dad" investors being caught having to pay CGT. Although a significant amount of economic and legal evidence points out that tax-free thresholds are inefficient and ineffective at achieving equity, efficiency and simplicity, the proposed modification or removal of CGT averaging has to be countered by some other modification to CGT to ensure that investors are not unfairly penalised for realising a capital gain.

The NIA should propose that a significant CGT-free threshold replace CGT averaging to ensure that the initial reasons for averaging being introduced is better meet but at a less cost to revenue.

Currently, the UK has a £6,000 CGT-free threshold although this threshold does depend on the type of capital gain. Australia could introduce a CGT-free threshold that is in-line with the income tax-free threshold to replace the current averaging provisions.

The advantages for the revenue is that many people who take advantage of averaging at the lower income levels will now be taxed on a basis consistent with income tax, while smaller investors will ordinarily not have to pay CGT, reducing the need for complex compliance activity for those investors (usually individuals and some small businesses).

Recommendation 25

A CGT-free threshold of the same amount as the income-tax free threshold be introduced for capital gains to replace CGT averaging.

A stepped approach to the reduction of the CGT rate based on the length of investment

Most countries provide preferential treatment of capital gains. One of Australia's main avenues for providing preferential treatment is to allow indexation of capital gains. Very few other countries provide such a benefit.

In place of indexation most countries apply a stepped approach to capital gains or do not tax capital gains at all. A stepped approach to capital gains means that the longer the asset is held, the less the applicable tax rate or the less the amount of the capital gain that is subject to CGT.

The UK recently introduced a stepped approach to CGT so as to encourage the retention of assets for longer periods. Most countries see the retention of assets for longer periods as advantageous to the economy. The UK removed CGT indexation with the introduction of CGT tapering (stepped approach).

The two models presented in *A Platform for Consultation* is the simplistic US model that reduces the CGT rate the longer the asset is held and the UK rate which reduces the amount of the capital gain subject to CGT the longer the asset is held. If Australia were to follow a model, the relatively recent experience (1998) in the UK of such reform would provide a valuable base.

Recommendation 26

The NIA supports the introduction of a stepped approach to the reduction of the incidence of CGT on longer-term assets as a replacement of CGT indexation.

Towards a Better Regime for Taxing Fringe Benefits

Introduction

The NIA supports the comprehensive review of the current taxation of fringe benefits resulting from employment because of the severe compliance burden fringe benefits tax (FBT) places on business and the inequitable treatment of such benefits for many employee taxpayers.

FBT is inequitable because it taxes fringe benefits received at the highest marginal rate yet the recipient of those benefits may well have a marginal rate below the highest marginal rate. With the proposed changes to the income tax rates, this problem of favouring one type of income over another is increased and should be remedied.

The NIA's main concern with FBT is its high cost of compliance. Research has shown that FBT is one of the most expensive taxes as a percentage of revenue collected, for employers to comply with. A number of studies have consistently shown that the FBT compliance costs consistently exceed 10 per cent of the revenue collected compared to the costs for employers of complying with New Zealand's FBT, which stands at about 1.7 percent of revenue collected.[4]

The cost of complying with FBT is a substantial impost on business and therefore a possible impediment to employment growth. In fact, in 1994/5, only the Prescribed Payment System (PPS) was a larger impost on business as a percentage of revenue

[4] Rimmer S and Wilson S, *Compliance Costs of Taxation in Australia* Staff Information Paper Office of Regulation Review Canberra 1996 p.14

collected (22 percent).[5] It is imperative that the Review consider changes that will substantially reduce the compliance costs on business and simplify the legislation. Below are recommendations to achieve such an aim.

Move the ultimate liability for taxation from the employer to the employee

Switching the liability for FBT to an employee will enhance the equity of the system by allowing the value of the fringe benefit to be taxed at the employee's marginal rate, although there seems to be no evidence of any diminution of compliance costs unless the switch is coupled with other reforms.

To put effect to the switch there is two options. The first option is to maintain the current *Fringe Benefits Tax Assessment Act (FBTAA)* 1986 and change the incidence of tax to the employee and maintain the burden of compliance with the employer.

The other possible change is to move the *FBTAA* into the *Income Tax Assessment Act (ITAA)* 1936 to be enable the *ITAA* to impose taxation on the employee on the fringe benefits they or their associate receives as a consequence of their employment. As the remittance of such taxation should be through the PAYE (PAYG) system and recorded on the employee's group certificate (similar to the reportable fringe benefits amendment), the burden of compliance will remain with the employer.

The NIA supports the abolishing of FBT and its placement into the *ITAA*. If the *FBTAA* was re-drafted along similar lines to the Tax Law Improvement Project (and

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[5] Evans et al, *A Report Into Taxpayer Costs of Compliance* Australian Taxation Office, Canberra 1997 p.57

the basic policy is reviewed) it would mean far simpler legislation but also collect approximately the same revenue. Also, by removing the need for FBT returns, it will reduce some of the compliance requirements on business. But most importantly, the change improves the integrity of the tax system by making the person who receives the benefit ultimately liable for the taxation on that benefit.

Recommendation 27

FBT should be abolished and taxation of benefits provided to employees and their associates in connection with the rendering of services should be captured within the Income Tax Assessment Act, thus shifting ultimate liability for such taxation to the employee. Remittance and compliance should be the responsibility of employers and remittance should be made through a modified PAYE (PAYG) system.

Aligning the FBT and income tax years

Failing the Government or the Review of Business Tax accepting the above recommendation, the NIA supports the aligning of the FBT year and the income tax year.

The alignment of the years may cause difficulties for some taxpayers and be disadvantageous. To overcome this problem, the Review should consider allowing FBT payers the option of making an election to remain on the current FBT year.

Recommendation 28

The FBT and the income tax years should be aligned but that an option remains for FBT payers to remain on the existing FBT year if it elects to do so.

Entertainment Benefits and car parking benefits

As is discussed in *A Platform for Consultation*, the application of FBT to entertainment and on-site car parking adds considerable complexity and compliance costs for employers.

Therefore, if the first recommendation is not accepted, the Review should consider the removal of entertainment from FBT and revert to its pre-1995 treatment. By removing the tax deductibility of entertainment (in most circumstances), this would assist in offsetting the cost to revenue of removing entertainment from FBT.

The NIA also agrees with the statement in paragraph 38.21 of *A Platform for Consultation* that keeping on-site car parking in FBT is "*an annoyance to business*" and therefore should be removed from FBT. The loss in revenue should be weighed against the reduction in compliance cost and the resultant increase in taxable income (because of lower compliance costs) and the more time small businesses will have for business.

Recommendation 29

Entertainment and car parking benefits should be removed from FBT to reduce complexity and compliance costs and as an offset against the lost revenue, the tax deductibility of entertainment (in most circumstances) should be denied.

Valuation of car fringe benefits

As one of the core concerns of the Review of Business Tax is revenue neutrality, the NIA supports the removal of the concessional valuation of car fringe benefits so that the valuation of those benefits provide a closer approximation to the actual value of the benefit provided.

The NIA believes the best method for valuing car fringe benefits is to use the schedular method proposed in *A Platform for Consultation* subject to rules for determining the business use percentage.

Recommendation 30

The valuation of car fringe benefits should be altered to a method that is closer to the actual benefits provided. A schedular method suggested by the RBT should be adopted with appropriate rules for determining business use percentage.

Simplification of FBT

If first recommendation is not accepted by the Government, then the Government should devote resources to the simplification of the language of the legislation along similar lines to the Tax Law Improvement Program (TLIP) and where possible, look at simplification of policy in far greater detail than the RBT has done.

Recommendation 31

If the FBT legislation is to be retained, it should be rewritten, simplifying language and policy.

OTHER TAXES

Payroll Tax

Recommendation 32

As part of overall tax reform, the NIA recommends it is necessary to reduce the costs of business inputs, and as payroll tax is a tax on inputs (labour), to enhance the effectiveness of removing other taxes on business inputs, the NIA supports the abolishing of payroll tax. As with other indirect taxes, payroll tax adds to the cost of an item, making Australian goods and services less price competitive.

Research and Development

The NIA supports the removal of the current 125% R & D special deduction and its replacement with a system of direct grants. As one of the major concerns with the R & D concessions is the abuse of the system, a system of direct grants from a specialised area within Government allows for greater control over R & D and allows the Government to specifically target certain industry sectors or areas of concern for R & D grants.

A system of grants replacing the current R & D concession will also benefit small business because they will be able to gain access to a grant before any R & D project has begun rather than having to wait until the expenditure is incurred to claim it through the tax system, thus they will have the resources ‘up front’ to begin any R & D.

Recommendation 33

The 125 percent R & D concession be removed in favour of a system of direct grants equivalent to the amount that would have been received under the special concession.

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