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Board of Taxation Secretariat
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Dear Board Members

Submission regarding small business tax concessions

Introduction

- 1 I write to offer the following submissions to the Board's *Review of Small Business Tax Concessions, May 2018* (**Review**).

Comments on the principles

- 2 Of the Board's Principles for Reform set out for the Review in the Consultation Guide, I would submit that cash flow (principle 2) and compliance burden issues (principle 3) would be of greatest priority to most small businesses.
- 3 While small businesses will not wish to pay higher taxes than needed, my experience is that they are mainly focussed on the (initial) survival and (then) growth of their business.
- 4 If a small business could know that they would have their 'business income' - which I mean the business income **retained** for immediate use in the business, and to fund growth (principle 4) – taxed at the 30% (or less) company tax rate, I expect there would be reduced motivation or appetite to engage in complex structuring (principle 6). From my experience, most small business energies tend to be directed to the business, if allowed and not distracted by compliance matters.
- 5 I understand there are also capital gain tax (**CGT**) considerations that drive more complex small business structuring – as they do all tax structuring. I make some comment on the impact of these CGT matters below.
- 6 At the risk of oversimplifying (but as so to focus on what might be most productive and possible), I suggest that principals 1 and 5 would largely resolve themselves, if the focus of any concessions were to be those basics of cash flow and compliance burden.

Comments on aspects of small business tax environment generally

- 7 The company tax rate is talked about at both a political and policy level as if it is the business tax rate. It has become the de-facto business income tax rate.

- 8 To address complex structuring (principle 6), tax neutrality or 'horizontal equity' between different entity structures – sole trader, partnership, trust or company - should be sought as far as may be possible. Practically, in current times, that mainly involves differences between trusts and companies.
- 9 I appreciate there will be different political, policy and administrative views about the tax/non-tax effects and desirability of trusts. All that I seek to raise in this regard, in the context of the Board's current review, is that small businesses that use trusts should not be allowed to be 'caught in the cross fire' – so that their trusts are treated in an excessively detrimental manner that then, inevitably, also negatively impacts their businesses.
- 10 In my view, treating the company tax rate, as a de-facto business tax rate, is flawed at both the upper and lower income/wealth levels.
- (a) It is flawed at the upper income/wealth end because the company tax rate applies to all income of a company, whether business income or not. Its availability for all income encourages retention of income for non-business purposes in companies to cap tax at the company tax rate versus the 'full' progressive tax rates applying – and has led to various complex anti-avoidance rules (like Division 7A). This is not of immediate relevance here, other than to highlight that these upper income/wealth levels are given more favourable access to the company rate than are many small businesses.
- (b) It is flawed for small businesses at the lower income/wealth levels because use of a company is not a necessary or logical (non-tax) choice for a small business. A company has many non-tax features, such as full separation of identify from the small business family, inflexibility of distributions and fixed ownership shares, which do not suit many small businesses operated as a collective family enterprise – one reason why discretionary trusts remain common. But where a small business operated through a trust seeks to access the company tax rate using a company beneficiary, it is faced with the full complexity **and cash flow costs** of the Division 7A rules for funds sought to be left in the small business trust (e.g. as unpaid present entitlements or UPEs), **as if those funds were instead being used for private not business purposes.**
- 11 Trusts are also deliberately used, of course, for their CGT advantages as a flow through entities.
- 12 The desire to retain access to the general CGT discount (and other CGT concessions), where possible, on assets such as land and buildings – is typically why such assets tend to be held through trusts.
- 13 But when faced with a choice, I expect that many small business operators, would opt for 'uncomplicated' access to the company tax rate (as a de-facto business tax rate) through their trust for their ongoing business operations over these CGT effects.
- 14 This is **not** an argument for trusts to be taxed as companies (e.g. full entity taxation). Such a change is a much greater and more complex matter than what is needed to address the specific problem of providing an 'uncomplicated' way to access the de-facto business (i.e. company) tax rate for small business trusts.
- 15 As noted further below, a possible solution has already been suggested from the *Post Implementation Review of Division 7A* previously conducted by the Board of Taxation, the final report (**Report**) of which was issued in November 2014.

Specific submissions

Division 7A – Business Income Election

- 16 I have recently made a separate submission to Treasury about its *Targeted amendments to the Division 7A integrity rules Consultation Paper, October 2018 (Consultation Paper)*.
- 17 I repeat some of those submissions here where those Division 7A issues are directly relevant to the cash flow and compliance burden of many small businesses operated through trusts.
- 18 The Report acknowledged the concerns of the ATO about UPEs owed to companies.
- 19 But it also acknowledged the financial tensions and pressures for small businesses structured by way of trusts, arising from working capital funded by UPEs owed to company beneficiaries.
- 20 In principle, it would be desirable for small business to be able to access the company tax rate, as the rate that has become the de-facto business tax rate.
- 21 But the Report understood that trusts have an advantage in accessing the company tax rate by way of corporate beneficiaries – by still also accessing the general 50% CGT discount.
- 22 Accordingly, the Business Income Election (**BIE**) recommended in the Report is a way that small business can be given the choice to either give up that advantage by choosing the BIE (where, alternatively, a full restructure of the business to a company may be costly and disruptive, even with possible CGT roll-over relief) or live with the 'full' complexity of Division 7A.
- 23 Because it is a self-selection, no complex transitional or other provisions are needed – and small businesses that do not choose the BIE cannot validly then complain about the 'full' Division 7A complexity.
- 24 Accordingly, the BIE has merit in terms of reducing tax complexity for small businesses (in exchange for small businesses giving up certain tax advantages) **and** in reducing the cash flow pressures of making principal repayments (under the Division 7A rules) of monies otherwise used in a small business operated through a trust.
- 25 The BIE should have been considered in the Consultation Paper as a balance to the stronger rules around treating all UPEs as loans. Those stronger UPE rules should not be adopted without also making the BIE available.
- 26 If there are concerns the BIE could provide opportunities 'leakage' in terms of the Division 7A rules (e.g. by allowing UPEs treated as company to company loans to be forgiven) those concerns should and can be addressed by further consultation. (For example, my recollection is that the BIE was recommended to only apply to the loans – not debt forgiveness – to allow the working capital to be retained but not to open up wider opportunities.)

Loss carry back

- 27 There is an underlying unfairness in denying the (reasonable) carry back of losses to taxpayers.
- 28 If tax is to be assessed on a taxpayer's true income, that fails to be done where an artificial year end date can cause a taxpayer to be taxed in one year on income without taking account that that income was lost in an immediately following period year.

- 29 The disadvantage is particularly relevant to small businesses that both may suffer greater variations in income/losses (having less diversification) and often have less capacity to weather the cash flow implications of paying tax on monies subsequently lost.
- 30 Accordingly, a useful concession would be to allow carry back of tax losses for small business. Even if the extent of carry back allowed needs to be limited for 'cost to revenue' purposes, some carry back of losses would be better than no carry back of losses.

Tax consolidations small business

- 31 The withdrawal of any grouping rules for losses and CGT purposes outside of 'full' tax consolidations unnecessarily complicates the affairs of small businesses where they operate multiple companies sharing common ownership.
- 32 The Board had made certain recommendations from its *Post Implementation Review of certain aspects of the Consolidations Regime* in 2012 – recommendations 6.1, 6.2 and 6.3 – relating to small business. The compliance burden for small business from the tax consolidations regime would be removed or reduced by implementing those recommendations.
- 33 The Government's response at the time (14 May 2013 Press Release) had been that - *'The Government will consider this issue further, as legislative priorities and fiscal constraints allow'*.
- 34 It seems appropriate that those earlier recommendations be refreshed in the context of the current Review.
- 35 Alternatively, other measures - to restore some ability for small businesses groups to share losses and to roll-over assets between commonly owned entities – should be considered as a means of removing inappropriate tax costs and compliance complexity associated with what are 'internal' transactions.

Small Business CGT concessions now too hard – reconsider?

- 36 The recent changes to the Small Business CGT concessions (**SBCGTC**) by *Treasury Laws Amendment (Tax Integrity and Other Measures) Act 2018* highlight concerns held by Treasury/the ATO over these concessions - and intensify the level of complexity associated with small businesses being able to access these concessions.
- 37 If effect while some of these recent changes may be directed to specific strategies seen as tax avoidance, other amendments - like the object entity maximum net asset value (**MNAV**) test - seek to 'roll back' changes specifically introduced back as early as 2007. Accordingly, they appear to represent a changed thinking about the scope of the SBCGTC.
- 38 The 'all or nothing'/absolute nature of eligibility (or ineligibility) for the SBCGTC in terms of satisfying the various associated tests – for example, the MNAV test(s) – does not sit well in terms of equity and simplicity.
- 39 Having been directly involved in litigation over (as finally determined, a successful - but only by some \$20,000 or so) satisfaction of the MNAV test, it has seems to me small businesses that seek to access the SBCGTC suffer significant stress and material uncertainty while the ATO seeks to verify and challenge the absolute availability of the concessions.
- 40 By introducing a series of further 'absolute' tests, the most recent amendments will only increase this stress and uncertainty.
- 41 I would urge a reconsideration of the SBCGTC in terms of:

- (a) some phased access to the SBCGTC (e.g. 50% exemption at 50% of some maximum MNAV threshold, and further 'phase in' from there) – to make less absolute the benefit, or loss of benefit, flowing from the MNAV and other tests. This structure would reduce the consequences of errors in the practical application of the concessions by taxpayers and in the administration of the concessions by the ATO; and
 - (b) given the complexity that will remain, even if there were a phased access to the SBCGTC – whether some alternative mechanism should be adopted to allow small business owners to access their business value as their retirement savings.
- 42 Consultation about a possible alternative mechanism to the SBCGTC could be conducted but - as I have understood the SBCGTC to compensate for the inability of most small business owners to extract the value of their business (as retirement savings) until sale of the business – alternatives could involve a high 'lump sum' concessional superannuation contribution to offset any capital gain on sale. The level of 'lump sum' concessional superannuation contribution could perhaps be linked to the number of years of operating the business – to recognise the years during which 'regular' periodic superannuation contributions (e.g. as an employee) were not feasible.
- 43 Other alternatives will exist.
- 44 My point is that the level of complexity involved in the SBCGTC (for both taxpayers and the ATO) has reached the stage – when combined with the absolute nature of eligibility (or ineligibility) – that an alternative model may better serve the majority of small businesses.
- 45 It may be a more useful direction of resources to explore such alternative models than to continue to legislate, and for the ATO to seek to administer, the sort of ongoing amendments to the 'old model' as recently implemented under the *Treasury Laws Amendment (Tax Integrity and Other Measures) Act 2018*.

Comments on existing concessions

- 46 I provide the following brief feedback on some of the other existing small business concessions listed in the Review's Consultation Guide:
- (a) Lower company tax rate – the mechanics involved in implementing these company tax rate changes (including the introduction of new and difficult concepts such as 'passive income') are widely recognised as unnecessarily complex for small business and their advisers. An early opportunity should be taken to simplify these rules.
 - (b) Unincorporated small business tax discount – the value of this concession is so limited (capped at \$1,000), it is unlikely to have a meaningful impact on encouraging small business.
 - (c) Restructure roll-over relief – is a valuable roll-over. But the way the ATO chooses to administer these rules (e.g. in terms of defining what is a 'genuine restructure') can and does limit its usefulness. Also, the roll-over is not as useful in moving out of a company structure, due to potential dividend stripping issues. There is not, but perhaps there should be developed, a similar concept to a 'demerger dividend'. There are also some technical issues around discretionary trusts that could be clarified.

- (d) Simplified trading stock rules – of limited usefulness, given it is conditional on a \$5,000 stock on hand threshold which would require that some type of stocktake be undertaken in any case.

Yours sincerely

A handwritten signature in cursive script that reads "Mark West".

Mark West
Principal