Australian Private Equity &
Venture Capital Association Limited

28 May 2014

Mr John Emerson AM
Review of Tax Impediments to Small Business
Board of Taxation
c/- the Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Dear John,

Submission to the Review of Tax Impediments Facing Small Business

The Australian Private Equity and Venture Capital Association Limited (AVCAL) welcomes the opportunity to comment on the Board of Taxation's (the Board) Review of Tax Impediments Facing Small Business.

AVCAL represents the venture capital (VC) and private equity (PE) industry in Australia, which has a combined total of over $24 billion in funds under management for a wide range of domestic and offshore investors, including Australian-based industry and retail superannuation funds.

VC and PE firms invest billions of dollars in a wide range of companies ranging from startups to SMEs to large businesses spanning many sectors across the national economy. These investments help to support a total of more than half a million jobs, and contribute over four per cent every year to Australia's national economic output. Small businesses comprise the majority of VC and PE investments in Australia.

In our view, this review provides a timely opportunity to look at a number of features in the current tax system, at both federal and state levels, that are imposing unnecessary costs and red tape on small business.

Privately-owned small businesses are often required to meet compliance obligations that are imposed on a large, publicly listed company. This compliance burden adds to the cost of doing business and hence, diverts funds that could be invested for growth. In addition, there are a number of current "grey" areas in the tax system that require clarification in order to free up greater access to private sector capital by small business.

AVCAL members have identified that the following areas of importance to small business that would particularly benefit from compliance and red tape reforms:

- Reducing compliance costs on Fringe Benefits Tax (FBT) reporting
- Harmonisation of state rules on payroll tax & workers' compensation
- Increasing access to capital through Venture Capital Limited Partnerships (VCLP) and Early Stage Venture Capital Limited Partnerships (ESVCLP) tax reform
- Employee Share Schemes
- R&D Tax Incentives

1. **Reducing compliance costs on Fringe Benefits Tax (FBT) reporting**

While the Board's "Scoping study of small business tax compliance costs" in 2007 found that very few small businesses pay FBT and did not appear to have significant compliance cost issues in respect of FBT (p.96), this analysis was largely focused on micro-businesses with revenues of under $2 million.

Feedback from AVCAL members confirms that FBT does impose a significant compliance burden if a broader definition of small business is used.[1] Supporting this view is the ACCI's 2013 Pre-Election Survey which identified FBT reform as the most urgent area for Commonwealth tax reform after various tax reductions and state tax reform.

FBT incurs excessive compliance costs across a range of areas. Compliance costs for minor benefits such as meal entertainment, gift vouchers and car parking are onerous, time consuming and impose a disproportionately high financial burden on small business. As a result, small businesses are required to employ considerable resources to perform data capture, examine and report large volumes of information on overall minor benefits to prepare the data required for the FBT return. Examples of such costs include:

- Searching the general ledger accounts for small value gift vouchers;
- Analysing restaurant bills and dissecting each invoice between client and staff meal costs (under the meal entertainment actual method); and
- Reviewing all car spaces, keeping log books, obtaining information on the cost of a car space within 1 km radius.

All of these activities require a significant amount of time and effort in collating small value items for the FBT return.

To address the disproportionately high compliance burden on small business relative to the amounts involved, AVCAL recommends that:

- The minor and infrequent threshold should be increased from $300 to $10,000. This would significantly reduce the compliance burden to small business. Given the very low aggregate value involved for most small businesses and hence, the low tax revenue obtained from charging FBT on low value vouchers and meals, this initiative should greatly reduce the compliance burden without any significant impact on tax revenue.
- The FBT on car spaces needs to be reformed or removed, as the hours required to collate the information can be significant.

2. **Harmonisation of state rules on payroll tax and worker's compensation**

Small businesses that operate in multiple states and territories are required to deal with different rules for payroll tax and workers' compensation. The rules on declared wages, contractors and workers compensation differ from State to State/Territory.

Geographical expansion can thus have a multiplier effect on compliance costs for small business. These costs can add up and become extremely onerous. For instance:

- Payroll tax returns are required to be lodged monthly. A small business that has operations across the country can lodge up to 8 returns each month, which translates into 96 returns per year; and
- Workers' compensation declared wages returns are required to be lodged annually. As a result, a business can lodge up to 8 different returns yearly to comply with the different state requirements.

As has been raised in many other forums, AVCAL believes that further harmonisation of payroll tax administration across States and Territories is an issue for urgent reform. This would significantly reduce the complexity and the onerous compliance burden on small business looking to expand outside their home states.

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[1] For example, ASIC's definition of 'small proprietary companies' means a company with two out of these three characteristics: (i) an annual revenue of less than $25 million; (ii) fewer than 50 employees at the end of the financial year; and (iii) consolidated gross assets of less than $12.5 million at the end of the financial year.

3. Increasing access to capital through ESVCLP and VCLP tax reform

There is an urgent need for tax reform to remove a longstanding source of uncertainty for investors through ESVCLP and VCLP vehicles that are specifically designed to invest in early stage and high-growth small businesses.

These reforms were identified clearly by the Board of Taxation in its "Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime" report to the Assistant Treasurer in June 2011.

However, the key recommendations in that report relating to the provision of deemed capital account treatment for all eligible domestic investors on gains or profits made by a VCLP on the disposal of eligible investments, were rejected in an announcement by the Government on 14 December 2013.

As a consequence of the lack of action to resolve the uncertainty faced by domestic investors over their tax treatment, new funds raised through VCLP vehicles have virtually come to a standstill.

The original – and still essential – purpose of the VCLP regime is to attract increased investment into high-risk, startup and expanding businesses in the Australian venture capital sector that would otherwise have difficulty in attracting investment through normal commercial means.

The ESVCLP and VCLP regimes are vitally important to expanding the reach of venture capital and private equity to providing small business with more efficient access to private capital. Many of these small business owners are dealing with growth or succession issues, and represent opportunities where VC and Growth PE funds can assist in providing the capital and support to enable them to add value and grow further.

Examples of small businesses that have grown substantially with the help of private sector investments made through ESVCLP or VCLP vehicles include:

- Three of Anacacia Partnership 1 Fund's investees which were listed in BRW's Fast 100 list in 2012: the popular **Rafferty's Garden** brand of natural baby food (which now accounts for a 40% share of the baby food market in Australia), former winner of the Prime Minister's Exporter of the Year award **Appen Butler Hill**, and **Home Appliances**, supplier of the Euromaid and IAG cooking appliance brands;
- **Vaxxas**, developer of the Nanopatch which offers a pain-free method of vaccine delivery designed to replace needles and syringes, and to prevent needle-stick injuries during vaccination. The Nanopatch is based on technology developed at the University of Queensland and subsequently funded by a consortium of investors which included OneVentures' ESVCLP fund and other VC funds. Its work is now seen as potentially the biggest breakthrough in vaccine delivery since the invention of the syringe in 1853; and
- **Audinate**, the developer of Dante, a plug and play digital media networking technology that revolutionises the way audio systems are connected to produce pristine sound over standard IT networks. The company received early stage investment from several VC funds including Starfish Ventures and Innovation Capital's VCLP fund, and now has offices in the US and Europe in addition to its corporate headquarters in Sydney.

Given that eligible ESVCLP and VCLP investments are restricted to small to medium sized businesses with total assets of no more than $50 million and $250 million respectively, AVCAL believes that the VCLP tax reforms needed to create investor certainty would play a significant role in encouraging more investment in this sector. This would have the potential of creating economic growth opportunities that would far outweigh the minor tax reforms needed to bring about this investor certainty, with no significant loss of tax revenue.

3. Employee Share Schemes

The current legislation on employee share option plans (ESOP) and employee share schemes (ESS) came into effect in July 2009. Under these rules, gains are assessed as ordinary income and can be taxed prior to the gains being realised. These ESOP and ESS arrangements offer a far less attractive environment in which start-ups and small businesses can operate and retain highly skilled employees.

AVCAL's position is that employees of small businesses who receive benefits under ESOPs and ESSs should only be taxed when a realisation event occurs, and this should only be on capital account. The approach should also be simple to administer and have low compliance costs, taking into account the limited resources of most small businesses seeking to use such structures.

In AVCAL's view such a regime would represent an appropriate balance between protection of the revenue, creating incentives for employees to work in Australian start-ups and small businesses, while reducing the cost and complexity associated with current ESOP and ESS requirements. Ultimately, reforming current ESOP and ESS rules would pay dividends to the Australian economy in years to come as more capital and talent is attracted to our shores.

AVCAL recommends that the implementation of reforms to unwind the negative impact of past changes to the tax rules in this area should be accelerated to help to drive greater investment in start-up businesses in Australia.

As there is a Government-led inquiry into potential reforms to the employee share scheme rules for start-ups already underway at the moment (led by the Department of the Treasury), further details on AVCAL's position are available in our submission to the Government's January 2014 consultation paper on 'Employee Share Schemes and Start-Ups' (see http://www.avcal.com.au/documents/item/781).

4. R&D Tax Incentives

5.1 Quarterly R&D Tax Credits

The Government's announcement on 14 December 2013 that the proposed introduction of quarterly R&D tax credits for small businesses would be abandoned was, in AVCAL's view, counterproductive to Australia's long-term innovation agenda.

The businesses that will be adversely affected by the policy decisions to abandon quarterly tax credits are small, cash-poor and research-intensive enterprises with annual turnover under $20 million. These businesses typically have limited access to funds other than through investors such as VCs. Banks consider them too small, too early, and too risky as they often do not have stable revenues.

It is for these reasons that the proposed reforms to the R&D tax regime to allow for the payment of quarterly credits remain valid and important. The abandonment of these vital reforms only further compounds the difficulty small start-up businesses face in implementing and commercialising vital R&D.

AVCAL recommends that the quarterly tax credits legislation should be reintroduced into Parliament at the earliest opportunity to revitalise private sector investment in innovative small businesses. The draft legislation has already been through extensive consultation with industry, and it is understood that the Bill giving effect to the quarterly tax credits for small business had broad bipartisan support when it was first introduced into Parliament in June 2013. AVCAL does not believe that there is a significant fiscal cost associated with the introduction of these reforms to the R&D tax credit regime (as the fiscal impact on the federal budget would appear to relate mostly to timing differences). In addition, this should be juxtaposed against the very significant and positive impact on the working capital of small and innovative companies in Australia.

5.2 Unintended consequences of proposed 1.5% reduction in the R&D Tax Offset

The 2014-15 Federal Budget announced that the refundable R&D tax offset for research-intensive small businesses with turnover of less than $20 million would be further cut by 1.5% to 43.5% effective 1 July 2014.

While the Budget states that this cut is "consistent with the Government's commitment to cut the company tax rate from 1 July 2015", in practice this means that (i) there is a 1-year lag between the two measures; and (ii) many small companies using the R&D tax offset are pre-revenue and operating at a tax loss, and hence unable to benefit from the cut in the company tax rate while bearing the permanent 1.5% reduction in the R&D tax offset.

The inability of pre-revenue small businesses to obtain the offsetting effect of the corporate tax reduction appears to be an unintended effect of the proposed Budget measure. As such, AVCAL proposes there should be an adjustment for small companies with turnover of less than $20 which are still at the pre-revenue stage, in order to ensure they are not unduly disadvantaged by the permanent reduction in the 45% R&D tax offset.

There are a number of other areas identified where clarification of "grey" areas in the interpretation of current tax law would be useful. For example, areas where further clarification and simplification of existing tax law include the areas of GST (where different accounting for taxed and non-taxed items requires different calculations and accounts), import duties, tariff classifications and anti-dumping provisions (where high levels of complexity require experts to be appointed to provide tax advice for all imported products).

In addition, consistent and long-term policy settings would help reduce the cost pressures of frequent changes in tax requirements that require corresponding changes to compliance and reporting systems. For instance, frequent changes to tax and superannuation policies and rates require frequent additional expenditure to external providers to update items such as the tax rate scales, superannuation rates, and Medicare rates in the payroll system.

Given the wide range of issues highlighted for tax reform by our members who actively invest in small businesses, we would welcome the opportunity to engage with the Board in a face to face meeting to discuss these issues in further detail. In addition, if you would like to discuss any aspect of this submission further, please do not hesitate to contact me or Dr Kar Mei Tang on (02) 8243 7000.

Yours sincerely,

Yasser El-Ansary
Chief Executive
AVCAL