

Ref: DH/CMB/aw



**PITCHER PARTNERS**

ADVISORS PROPRIETARY LIMITED

17 December 2012

The Board of Taxation  
C/o The Treasury  
Langton Crescent  
PARKES ACT 2600

Level 19  
15 William Street  
Melbourne  
Victoria 3000

Postal Address:  
GPO Box 5193  
Melbourne Vic 3001  
Australia

Tel: 03 8610 5000  
Fax: 03 8610 5999

www.pitcher.com.au  
info@pitcher.com.au

Pitcher Partners, including Johnston Rorke,  
is an association of independent firms  
Melbourne | Sydney | Perth | Adelaide | Brisbane

EXECUTIVE DIRECTORS

J BRAZZALE	D B RANKIN
C J TATTERSON	A R FITZPATRICK
I D STEWART	R RIGONI
M W PRINGLE	G M RAMBALDI
D A THOMSON	D A KNOWLES
M J LANGHAMMER	F J ZAHRA
M C HAY	S SCHONBERG
V A MACDERMID	M D NORTHEAST
S DAHN	P A JOSE
A R YEO	M J HARRISON
P W TONER	T SAKELL
D R VASUDEVAN	G I NORISKIN
S D AZOOR HUGHES	B J BRITTEN
A T DAVIDSON	K L BYRNE
C D WHATMAN	S D WHITCHURCH
A E CLERICI	D J HONEY
P MURONE	G J NIELSEN
A D STANLEY	N R BULL
D C BYRNE	A M KOKKINOS
P B BRAINE	G A DEBONO
R I MCKIE	R H SHRAPNEL
F V RUSSO	

By email: [taxboard@treasury.gov.au](mailto:taxboard@treasury.gov.au)

Dear Sir/Ms,

## DISCUSSION PAPER - PERMANENT ESTABLISHMENTS

Thank you for the opportunity of making a submission on the Discussion Paper ("the Paper") issued by the Board of Taxation ("the Board") in October 2012.

Pitcher Partners comprises 5 independent firms operating in Adelaide, Brisbane, Melbourne, Perth and Sydney. Collectively we would be regarded as one of the largest accounting associations outside the Big Four. Our specialisation is advising smaller public companies, large family businesses and small to medium enterprises ("SMEs") - which we refer to as "the middle market" in this submission. Thus, our main focus in writing this submission is on the implications of the proposals in the Paper for the middle market.

### General comments

In our view any adoption of the separate entity approach should be:

- on an 'opt-in' basis (by, for example, taxpayers making an irrevocable election to apply a separate entity approach on a country by country basis - i.e. to cater for the fact that a number of our trading partners have reserved their position);
- limited to taxpayers in the financial services industry; or
- limited to taxpayers with a turnover above the current Taxation of Financial Arrangements ("TOFA") thresholds.

Our reasons for making the above submission point are as follows:



- (a) the adoption of a separate entity approach is likely to increase compliance costs for most taxpayers - particularly middle market taxpayers;
- (b) the proposals in the Paper have not been suggested as being a measure essential to the integrity of Australia's taxation system; and
- (c) as many of Australia's trading partners have entered reservations in respect of the separate entity approach, the proposals are not needed to harmonise Australia's approach with global trading partners.

We appreciate that a separate entity approach may be beneficial to some taxpayers (for example domestic banks with offshore branch operations) and as such we support the ability of such taxpayers to apply this approach. However, it would be inappropriate for such an approach to be applied on a mandatory basis across all taxpayers as the compliance costs of doing would probably far outweigh any revenue that might be raised - i.e. there would not seem to be any commensurate benefit for the broader community from the increased compliance burden.

### **Consultation Process**

As stated above, in our view the potential compliance costs of introducing a separate entity approach means that it should not be applied to all taxpayers.

In the event that the Board does however consider the application of this approach across all taxpayers, we believe it is imperative that sufficient consultation occurs on the practical implications for all taxpayers - especially those in the middle market who will form the majority of taxpayers that will be affected by this measure.

In short, we believe it is crucial that sufficient testing is done using real life case study examples on how the separate entity approach will apply in practice - i.e. consultation will not advance any thinking around the practical issues with applying the separate entity approach if it merely involves very high level discussions of this measure.

We therefore stress that any reform to the taxation of permanent establishments has to be properly tested before any commitment is taken to adopt the separate entity approach. Such case study testing needs to consider a number of issues, including (but not limited) to:

- (a) whether the separate entity approach provides appropriate outcomes in the majority of cases;
- (b) whether (practically) taxpayers will be able to comply with the separate entity approach and the impact on compliance costs;
- (c) a determination of the changes required by taxpayers in order to comply (and the cost to taxpayers on adopting the required changes);



- (d) consideration of the systems changes required from both a taxpayer and ATO perspective; and
- (e) whether small business taxpayers and their advisors will be capable of learning a new system in the time required.

**Additional comments**

Some additional comments are set out in the attached Appendix.

**Further information**

Please contact the writer on 03 8610 5401 if you would like more information on, or clarification of, any of the issues raised in this submission or to organise a meeting to discuss this further.

Yours faithfully

PITCHER PARTNERS ADVISORS PROPRIETARY LIMITED

DENISE HONEY  
Executive Director

Encl: Appendix

## Appendix - Additional comments

### Understanding the importance and difficulties of small business

Small businesses make a significant contribution to the Australian economy, accounting for almost half of industry employment (47.2%) and contributing over a third of industry value added in 2009-10 (35.3).<sup>1</sup>

Some of the major industries that small business contribute to in Australia include agriculture (82.9%) and services (40.0%), two very large segments of our economy. In particular, with respect to services, small business plays a very significant role in a number of key segments in our economy, including:

- accommodation and food services (43.4%);
- construction (55.5%);
- professional, scientific and technical services (74.1%);
- real estate services (74.1%); and
- healthcare and social assistance services (41.8%).<sup>2</sup>

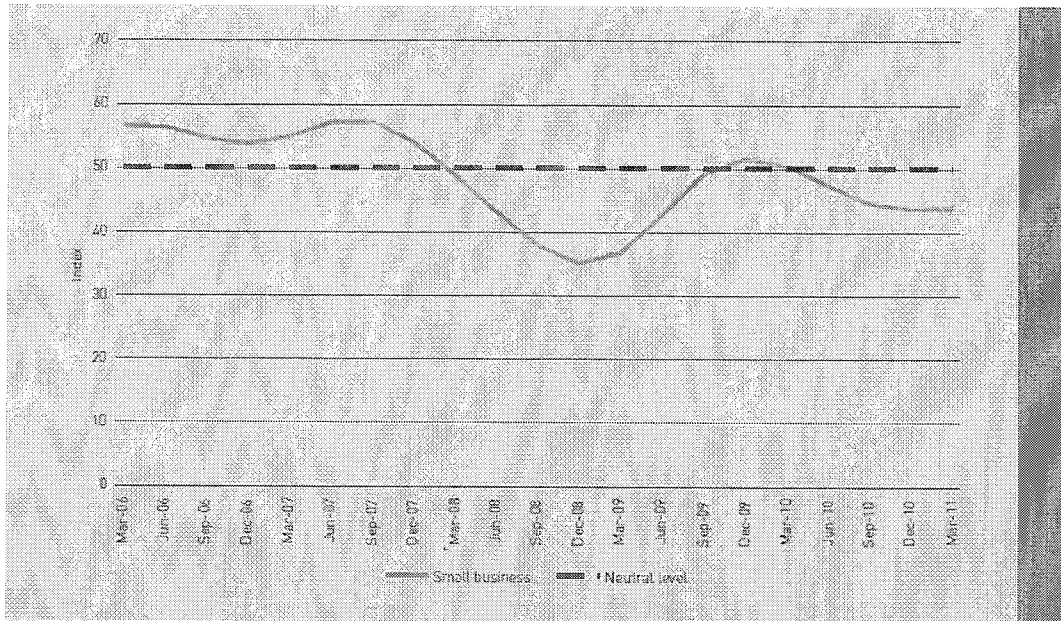
The previous paragraphs highlight the importance of small business on our economy and the importance it plays for many of our major industries. Many of these industries are significant and growing industries that are (effectively) supported predominantly by small business operators, being businesses having a turnover of less than \$2 million and employees of less than 5. The financial and labour capital resources available to such business are obviously quite restricted.

That coupled with the overall conditions for small business need to be taken into account. Since the GFC, these conditions have been steadily declining for small business. Statistically, “business condition” indices typically look at a collective index of measures including labour conditions, profits, sales, input costs and selling prices. The following ACCI Small Business survey shows a steady decline in conditions for small business.

---

<sup>1</sup> The Department of Innovation Industry, Science and Research “Key Statistics – Australian Small Business”, 31 October 2011, page 3.

<sup>2</sup> *ibid*, page 5.



Data source: ACCI Small Business survey, Thomson Reuters EcoWin

These statistics demonstrate the difficulties that small business face, which takes into account some of the significant increases in regulation that have occurred for small business over the last few years. There has also been a significant gap that has emerged as between small business conditions and large business conditions.<sup>3</sup>

### Number of small business taxpayers

Australia has almost three million micro enterprise taxpayers according to the ATO (which defines micro enterprises as businesses with an annual turnover of under \$2 million or superannuation funds with less than \$2 million in assets).

These taxpayers employ one in five Australian workers and account for more than a quarter of tax revenue collected, including approximately \$14 billion in pay as you go (“PAYG”) withholding tax for their employees.

Mostly operating as sole traders or family businesses, micro enterprises rely on around 29,000 registered tax agents and BAS agents to help manage their tax affairs - with around 90% of micro enterprise returns and 50% of activity statements lodged through agents.

According to the ATO there are also around 183,000 businesses in Australia with an annual turnover of between \$2 million and \$250 million - which the ATO classify as SMEs.

### General tax compliance burdens (already) faced by small business

<sup>3</sup> ACCI Small Business Survey, Commonwealth Bank-ACCI Business Expectations Survey, Thomson Reuters EcoWin.

In September this year the Institute of Chartered Accountants in Australia issued a media release stating that the:

*... cost of tax compliance has more than doubled for small businesses, according to new research conducted by tax professionals and academics across Australia.*

*The rise and rise of tax compliance costs for the small business sector in Australia, is the first installment of a three-year research project into the viability of Australia's tax system.*

*The Institute of Chartered Accountants' tax counsel, Paul Stacey, says it costs small businesses an average of \$32,389 a year to comply with the multitude of state and federal taxes in Australia.*

*"For small businesses, the cost of tax compliance has more than doubled over the last 17 years. On average, it costs small businesses \$11,950 just to collect GST, bringing to light the question of whether they are acting as unpaid tax collectors for the government. In addition, small businesses are spending four times as many hours per year complying with tax obligations as they did 17 years ago." he says. ...*

*"The tax compliance burden placed on small businesses has serious impacts on their long-term sustainability, particularly when the cost and time required for compliance is still growing. The federal and state governments need to address this issue in order to ensure the tax system can meet Australia's social and economic needs in the future," he says.*

*Small businesses indicated that to ease the compliance burden, new measures needed to be simple.*

*"Rather than complicating compliance with anti-avoidance rules, small businesses indicated they would simply like a lower tax rate," Mr Stacey says.*

### Extra tax compliance burdens if the functionally separate entity approach is introduced

If the functionally separate entity approach is introduced, taxpayers in the middle market will (somehow) have to find the resources to undertake, firstly, a functional and factual analysis to determine:

- the attribution to the permanent establishment, as appropriate, of the rights and obligations arising out of transactions between the enterprise of which the permanent establishment is a part and separate enterprises;
- the identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the permanent establishment;
- the identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the permanent establishment;
- the identification of other functions of the permanent establishment;

- the recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognised; and
- the attribution of capital based on the assets and risks attributed to the permanent establishment.

Having undertaken the above initial analysis, a middle market taxpayer will then have to price any transactions with associated enterprises attributed to the permanent establishment in accordance with the guidance of the OECD Transfer Pricing Guidelines.

In our view most middle market taxpayers will struggle to find the resources to undertake even the first step (i.e. a functional analysis) in the two step process set out in the 2010 OECD Model Commentary for determining the profits / losses attributable to a permanent establishment - asking / expecting them to then go on and undertake the second step in the process by pricing all qualifying internal dealings using accepted transfer pricing guidelines is completely unrealistic in light of the resourcing constraints faced by the middle market.

In comparison, the current relevant business activity approach is (relatively) easier to comply with given that it uses the profits actually earned by the enterprise as its starting point. As a result the compliance costs under the relevant business activity approach will usually be cheaper - i.e. there is no need to look at notional income or expenses from intra-entity dealings as under the functionally separate entity approach.