



Australian Government

The Board of Taxation

REVIEW OF SMALL BUSINESS TAX CONCESSIONS

the **board** of taxation
www.taxboard.gov.au

A Report to the Treasurer

MARCH 2019

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FOREWORD

The Board of Taxation (the Board) is pleased to submit this report to the Treasurer following its review of Australia's small business tax concessions.

The Board conducted an independent, self-initiated review of Australia's small business tax concessions. The Board's review involved assessing the effectiveness of existing concessions and, where appropriate, recommending new concessionary approaches to Government.

The Board appointed a Reference Group led by Board members Dr Mark Pizzacalla, who chaired the review, and Mr Peter Quiggin, PSM. The Board's CEO, Ms Karen Payne also led project work throughout the review.

The Reference Group comprised representatives from the small business sector, the tax profession and academia, officials from Treasury and the Australian Taxation Office (ATO), as well as members of the Secretariat to the Board. The Board would like to express its appreciation to the Reference Group members for their assistance with this review.

The Board would also like to thank the many tax professionals, industry body representatives and small business owners who participated in our consultation process. The Board received over 41 written submissions and met with over 70 small business stakeholders (including 45 small business owners).

This report makes a number of observations and recommendations to Government on ways in which the law and its administration could be improved to address a number of concerns that consultees brought to the attention of the Board during consultation. While the key focus of this report is on the review of Australia's small business tax concessions, a number of ancillary issues were also raised during consultation. The Board has considered these issues and made a number of observations.

The ex-officio members of the Board — the Secretary to the Treasury, Mr Phil Gaetjens, the Commissioner of Taxation, Mr Chris Jordan AO, and the First Parliamentary Counsel, Mr Peter Quiggin PSM — have reserved their final views on the observations and recommendations made in this report for advice to Government.



Michael Andrew AO
Chair, Board of Taxation



Dr Mark Pizzacalla
Chair of the Review

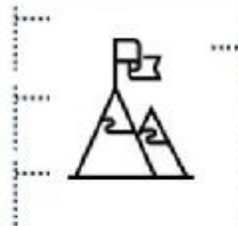
REPORT AT A GLANCE

Scope of work (Chapter One)

Determine the effectiveness of the current small business tax concessions.

Consult with the small business community.

Consider relevant international experiences.



Review whether the current mix of small business tax concessions:

- represents the best distribution of Government expenditures; and
- are commercially appropriate in the context of the small business life cycle.

Guiding principles (Chapter Two)



1. Have regard to the small business life cycle



2. Assist with small business cash flow



3. Relieve the compliance burden for small business



4. Promote growth and innovation



5. Targeted and affordable



6. Should not incentivise complex structuring

Headline recommendations

Small business definition (Chapter Three)

- Preserve the current 'small business entity' definition and apply the \$10 million threshold uniformly across all small business tax concessions.

From: Multiple small business definitions in tax



To: A single \$10m aggregated turnover definition



But only if...

Small business CGT concessions (Chapter Five)

- Repeal the maximum net asset value test; and
- Collapse the existing exemptions and replace them with one CGT exemption subject to a cap.
- Complementary reforms to improve the operation of the grouping rules and address any anomalies or integrity issues.

Unincorporated small business tax discount (Chapter Six)

- Replace the tax discount with an alternative program for unincorporated businesses.
- Alternatively:
 - Significantly increase the cap to be a meaningful incentive; and
 - Apply the tax discount on a 'per business' basis.

Supporting recommendations

Establish a working group to identify opportunities for greater alignment of the small business definition across all regulatory regimes including State governments (Chapter Three).

Simplify the small business pooling rules by having a single depreciation rate of 30 per cent (Chapter Eight).

Increase access to the instant asset write-off threshold to those small businesses that do not choose to use the small business pooling rules (Chapter Eight).

Repeal the simplified trading stock rules (Chapter Four).

Increase access to small business education by funding the development of new educational products and services. (Chapter Eight).

Re-introduce loss carry-back rules for small business companies (Chapter Eight).

A comprehensive post-implementation review of the SBRR regime to commence in the 2019-20 income year (Chapter Seven).

Allow small businesses to calculate their PAYG instalments based on real-time tax adjusted accounts (Chapter Eight).

EXECUTIVE SUMMARY

The Board believes that a well-designed regime of tax concessions and subsidies, targeted to assist with the specific challenges faced by small businesses, can play an important role in helping small businesses at all stages of their business life cycle, from the crucial inception and survival stages through to maturity and retirement of business owners.

Small businesses are currently grappling with fundamental changes to traditional ways of doing business, including the emergence of the 'gig' and 'sharing' economies, digital disruption, and associated tax and regulatory changes, all of which are creating opportunities and challenges. Achieving a level playing field for small businesses also remains a key challenge as small businesses face competition not only from their larger, more established, counterparts, but also from illegitimate operators in the black economy undercutting them on price.

Against this background, the Board considered it timely to undertake a holistic review of small business tax concessions to identify ways to improve existing concessions to ensure they remain effective, easily accessible, and well-targeted, as well as identifying new concessionary approaches. This also involved identifying opportunities for removing, or scaling back, concessions that are not working well in order to generate savings that could be redeployed in areas where they may have a greater impact.

The small business tax concessions (and indeed tax concessions more generally) are open to the criticism that they are sometimes inconsistent with broader tax and investment policy. The Board believes that such criticism stems from a lack of clear and transparent guidelines when setting policy for the small business sector. With this in mind, the Board, together with its Reference Group, considered it important to develop a set of guiding principles to review the current suite of tax concessions for small business and to assist in identifying any opportunities for improvement.

The agreed principles are explained in Chapter Two and, in summary, provide that tax concessions should be designed having regard to the small business life cycle approach, assist with cash flow, help to relieve the compliance burden, promote growth and innovation, be targeted and affordable, and not incentivise complex structuring.

Integral to the guiding principles is the adoption of the small business life cycle approach. Adopting such an approach can help policymakers understand the commercial issues facing small businesses at each stage of their business life cycle from inception and start-up, to growth and maturity, and how each of these growth stages interact with the tax system. It is clear that a successful small business tax regime requires a detailed understanding of how small businesses operate in the real world.

A threshold challenge in the conduct of the review was to address the fundamental question: what is a small business? The diverse nature of the small business population means that this is not a straightforward exercise. For example, while some small businesses pursue growth and

innovation, others are motivated by a desire to support their current lifestyle and independence.

In Chapter Three of the report, the Board considers different approaches to defining small business for the purpose of targeting tax concessions. On one view, the diversity of the sector demands multiple definitions. Arguably, this would allow for a more precise targeting of concessions to the 'intended' recipients. In the Board's view, however, using multiple definitions of small business comes at the cost of unwanted complexity and makes it more difficult for businesses to identify their eligibility status.

Having consulted extensively with small business owners, industry representatives and advisers, the Board concluded that the most appropriate approach to defining small business is one which is as simple as possible. It was encouraging, therefore, that most small business tax concessions are already tied to a definition of small business that largely fits the description; the \$10 million 'small business entity' (SBE) test. The Board supports the retention of this small business definition and has also identified opportunities to align all small business tax concessions to this definition. Specifically, the Board considers that the SBE test should be extended to the two important outliers in the concessionary framework; being the small business CGT concessions and the unincorporated small business tax discount.

In Chapter Four, the Board reviewed the existing suite of tax concessions available to small businesses. Based upon a review of the original policy rationale, the Board's guiding principles and feedback from stakeholders, it became evident that there are some shortcomings in the concessions which are required to be addressed. In addition to reviewing the tax concessions individually, the Board also took a holistic view of all the small business tax concessions to understand whether they appropriately supported small businesses through the different stages of their life cycle.

Through this lens, it became clear that further support for small business was required during the critical inception and survival stages of the business life cycle, as a significant proportion of the tax expenditures are focussed on mature businesses. The Board concluded that small business tax concessions require better alignment to ensure that the specific needs and requirements of the small business sector are being appropriately met throughout each stage of the business life cycle.

Stakeholder feedback significantly focussed on the small business CGT and the Small Business Restructure Roll-over (SBRR) concessions. Further, it was identified that the unincorporated small business tax discount was not always delivering on its original policy objectives. Accordingly, these concessions were subject to a more detailed review by the Board.

The small business CGT concessions are, arguably, the most important in the small business concessionary regime as these provide significant benefits and are, accordingly, highly valued by stakeholders. However, the generosity of the concessions is matched by equally complex legislation that leads to increased compliance costs and distortions in business decision-making. The Board's review of ATO data on the take-up of the concessions raises questions as to the sustainability of the system. The overall cost to the revenue is substantial and growing,

whilst the overall benefit is not as widely distributed across the small business sector with a larger proportion of the benefits being accessed by a relatively small number of businesses. Some of the capital gains being sheltered through the small business CGT concessions are considered to be excessive compared to what the concessions were originally meant to deliver and what the Board considers appropriate.

Drawing on its analysis of how to define a small business, the Board has identified a pathway for reforming the small business CGT concessions in a way that will make the system simpler, fairer and more sustainable. This is achieved by increasing the aggregated turnover threshold to \$10 million, repealing the net asset test, and collapsing three exemptions into a single capped exemption. This is discussed in Chapter Five.

Of the current suite of concessions, the unincorporated small business tax discount was identified as one which should be improved to better meet its intended policy rationale. The Board is supportive, in principle, of measures that promote neutrality by 'levelling the playing field' between incorporated and unincorporated businesses. However, during consultations, most business owners were either unaware of the discount or believed that it was too low to have a meaningful impact on their business. The Board considers that the issues raised in relation to the discount are significant and it should either be replaced or substantially amended. Chapter Six discusses the Board's observations on how the discount could be improved.

Chapter Seven of the report considers the SBRR which provides income tax relief to small business owners when restructuring their affairs. The Board fully supports the SBRR as it represents leading edge policy and is a unique feature of Australia's small business tax landscape. However, as enacted, it is too complex and uncertain in its operation to enable small businesses to use it with confidence. While the Board has identified certain legislative improvements to ensure the roll-over fulfils its intended purpose, ultimately, the Board has recommended that these should be considered in the context of a comprehensive post-implementation review, starting in the 2019-20 income year.

Recognising that tax law improvement is often an evolutionary process, the Board has also included in Chapter Eight of the report a range of reforms which will provide increased support to small business, which are capable of being implemented in the relatively short term. This includes changes to the instant asset write-off (IAWO) and small business pooling, and assisting with small business education by funding the development of new educational products and services.

In Chapter Nine of the report, the Board considers an issue of broader concern to the small business sector – the way in which the tax system incentivises small businesses to adopt overly complex business structures. It is clear that key features currently existing in the tax system are influencing and complicating structuring choices and taxpayer behaviours, including: the differential between the highest marginal tax rate and the corporate tax rate, the general 50 per cent CGT discount, the small business CGT concessions, as well as the use of different entity types.

In the Board's view, overly complex structuring makes businesses less efficient, increases compliance costs and red tape, and takes the business owners' focus away from their core business activities. The prevalence of complex structuring has been a perennial issue for the small business sector and a focus of recent Board reports. However, the Board recognises that the drivers of complexity are deeply embedded in the tax system and, ultimately, structural solutions are needed. This would require a holistic approach as part of a wider tax reform process.

The Board is appreciative of the opportunity to review Australia's small business tax concessions. This report achieves a number of important outcomes, including: small business policy needs to be considered in the context of the small business life cycle; re-alignment of concessions away from the maturity stage to earlier stages in the small business life cycle; identification of concessions not meeting their policy objectives; recognition of technical limitations in the law which require amendment; and consideration and recommendation of new concessionary approaches.

The Board's view is that genuine and long-lasting reform can only be achieved by adopting a small business life cycle approach which ensures that concessions will be more efficiently targeted to the right stages of the small business' growth cycle. Tax policy challenges facing small businesses are inevitably inhibited by the same obstacles facing any tax or regulatory reform, including competing vested interests from special interest groups, fears of consequences of change, and accompanying uncertainties that ensue. The Board encourages policy makers to continue to work together with the small business sector for the benefit of the whole economy.

LIST OF RECOMMENDATIONS

The succeeding chapters in this report make a number of recommendations. In addition to these recommendations, the Board has made a number of observations that are included throughout the report.

RECOMMENDATION 1

Preserve the current 'small business entity' definition and adopt the reform packages in Recommendations 4 and 6 to apply the \$10 million per annum aggregated turnover threshold uniformly across all of the current 'small business entity' tax concessions.

Future new small business tax concessions should utilise the 'small business entity' definition as the eligibility gateway.

RECOMMENDATION 2

Establish a working group to identify opportunities for greater alignment of the definition of small business across all regulatory regimes including state governments.

RECOMMENDATION 3

Repeal the simplified trading stock rules.

RECOMMENDATION 4

Reform the small business CGT concessions to make them simpler, fairer, and more sustainable, which would incorporate the following core elements:

- Integrating the eligibility criteria with the small business entity regime by raising the aggregated turnover threshold to \$10 million per annum; and
- Repealing the maximum net asset value test; and
- Collapsing the 15-year exemption, active asset reduction and retirement exemption and replacing them with one CGT exemption subject to a cap.

RECOMMENDATION 5

On the basis that Recommendation 4 is implemented, contemporaneous reforms should be considered in relation to:

- improving the operation of the grouping rules; and
- addressing any anomalies and integrity issues that are not addressed by other recommendations.

RECOMMENDATION 6

Replace the unincorporated small business tax discount with an alternative program that assists unincorporated business in a more targeted way.

Alternatively, if the Government opts to maintain the discount, it should be made more targeted and prominent to small business owners by:

- integrating the eligibility criteria with the small business entity regime by raising the aggregated turnover threshold to \$10 million per annum;
- significantly increasing the cap to be a meaningful incentive; and
- applying the tax discount on a 'per business' basis.

The Government should consider whether the tax discount continues to be made available to trusts.

RECOMMENDATION 7

Undertake a comprehensive post-implementation review of the small business restructure roll-over regime, commencing in the 2019-20 income year.

RECOMMENDATION 8

Simplify the small business pooling rules by having a single depreciation rate of 30 per cent.

RECOMMENDATION 9

Increase access to the instant asset write-off threshold to those small businesses that do not choose to use the small business pooling rules.

RECOMMENDATION 10

Allow small businesses to calculate their PAYG instalments based on real-time tax adjusted accounts.

RECOMMENDATION 11

Re-introduce loss carry-back rules for companies that are small business entities, and allow them to carry back losses against the previous year's taxable income up to a "capped" amount.

RECOMMENDATION 12

Increase access to small business education by funding the development of new educational products and services.

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GLOSSARY

The following abbreviations and acronyms are used throughout this report.

Abbreviation	Definition
ABS	The Australian Bureau of Statistics
ATO	The Australian Taxation Office
CGT	Capital Gains Tax
FBT	Fringe Benefits Tax
GST	Goods and Services Tax
IAWO	Instant Asset Write-Off
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
MYEFO	Mid-Year Economic and Fiscal Outlook
OECD	Organisation for Economic Co-operation and Development
PAYG	Pay As You Go
SBE	Small Business Entity
SBRR	Small Business Restructure Roll-over
The Board	The Board of Taxation

CHAPTER 1: INTRODUCTION

Background

- 1.1 The Board has completed an independent, self-initiated review of Australia's small business tax concessions. The review is a continuation of the Board's longstanding commitment to the small business sector and builds upon the Board's previous reviews in relation to areas such as small business tax compliance costs, Division 7A of the ITAA 1936, small business tax impediments, trust taxation, as well as the work undertaken by the Board to assist Government with the *'Re:think' Tax Discussion Paper* process.

Objectives

- 1.2 The Board's objectives in relation to this review were as follows:
- The Board will make recommendations in relation to Australia's small business tax concessions, consistent with the functions set out in the Board's charter, including:
 - to advise on the quality and effectiveness of tax legislation; and
 - to advise on improvements to the general integrity and functioning of the taxation system.
 - The Board should take account of the revenue implications of various options and, where appropriate, suggest approaches that minimise any revenue cost.

Scope of work

- 1.3 In conducting the review, the Board undertook to:
- Determine the effectiveness of the current small business tax concessions available to the small business sector.
 - Review whether the current mix of small business tax concessions:
 - represents the best distribution of current Government expenditures on small business tax concessions based upon the available data and feedback received; and
 - are commercially appropriate in the context of the various stages of the small business life cycle.

- Consult the small business community to gauge views on the current suite of small business tax concessions and gain relevant insights, experience and expertise.
- Consider relevant international experience, identifying best practice initiatives which may be applicable to Australia's tax system.

Review processes

- 1.4 The Board appointed a Working Group comprising its members Dr Mark Pizzacalla, who chaired the review and Mr Peter Quiggin, PSM. The Board's CEO, Ms Karen Payne, also led project work throughout the review.
- 1.5 The Working Group was assisted by a Reference Group comprising Michael Carruthers (Tax Director, Knowledge Shop), Professor Chris Evans (School of Taxation and Business Law, University of New South Wales), Susan Franks (Senior Tax Advocate, Chartered Accountants Australia and New Zealand), Dr Brett Freudenberg (Professor, Griffith Business School, Griffith University), Tony Greco, (Senior Director, Institute of Public Accountants), Michael Parker (Partner, Hall and Wilcox Lawyers), Shannon Smit (Director, SMART Business Solutions), and Chris Wookey (Principal, Deloitte Private). The Reference Group members were appointed on the basis of their individual capabilities and expertise, and not as representatives of particular interest groups or organisations.
- 1.6 The Board was also assisted by Paul Drum (Head of Policy, CPA) and Greg Mascaro (Partner, Shadforth Business Advisory Services).

Consultation

- 1.7 The Board's consultation process has involved:
 - the publication of a Consultation Guide describing the scope of the review and encouraging broad community participation;
 - face-to-face consultations with over 70 small business industry representatives, including 45 small business owners; and
 - targeted consultations to explore specific issues raised by stakeholders in written submissions.

Submissions

- 1.8 The Board received 41 written submissions from a range of individuals and organisations.
- 1.9 The Board recognises the significant contribution made by stakeholders in making their submissions. The Board carefully considered all submissions and have attempted, where possible, to identify the issues of most importance to stakeholders.

Board's report

- 1.10 The Board has considered the issues raised by stakeholders in their submissions and at consultation meetings, the views of the members of the Reference Group, Treasury officials and the ATO. Importantly, however, the Board's recommendations and observations reflect its independent judgment.

CHAPTER 2: A PRINCIPLE - BASED APPROACH

KEY POINTS

- The Board has developed a set of guiding principles to assist with its review of small business tax concessions, as well as to identify ways to improve the concessions and ensure that they remain effective, easily accessible and well targeted. This also assists with reviewing the concessionary framework as a whole and for developing new concessionary approaches.
- The Board's principles take as their starting point the long-established tax axioms of equity, efficiency and simplicity and extends these principles to take into account the particular challenges faced by the small business sector.
- The Board's guiding principles are as follows:
 - Concessions should be designed having regard to the small business life cycle.
 - Concessions can assist with small business cash flow.
 - Concessions should relieve the compliance burden for small business.
 - Concessions should promote growth and innovation.
 - Concessions should be targeted and affordable.
 - Concessions should not incentivise complex structuring.
- Having active participation by small business owners in the policy and law design process will better ensure that tax concessions are appropriately formulated and targeted to specifically meet the needs and requirements of small businesses.

Introduction

2.1 Upon the commencement of this review, the Board undertook to develop a set of 'guiding principles' for reviewing small business tax concessions. These principles, which are set out below, were designed with three specific aims in mind:

- to provide a benchmark for reviewing each concession;
- to provide a framework for reviewing the concessionary framework as a whole; and
- to assist with the development of new concessionary approaches.

- 2.2 In applying these principles, the Board has observed some cases where changes made to the tax concessions could have been better targeted, increased complexity, or resulted in distortions in business behaviour. Examples include the historical evolution of the small business CGT concessions over a period of more than two decades (discussed in Chapter Five) and the former entrepreneurial tax offset.
- 2.3 Having regard to the history of the development of small business tax concessions, the Board considers that its principles extend beyond this review and could, in fact, be a useful guide for government and policy makers when considering future improvements to the small business tax system.

Designing the principles

- 2.4 The Board's starting position when developing its principles was the three 'tax axioms' of equity, efficiency and simplicity.¹ It is difficult to satisfy all of these elements when developing small business policy and, quite often, some of these ideals are achieved at the expense of others. These principles have long been established and have guided the evaluation and design of reform of the Australian tax system. The *Re:think* Tax Discussion Paper² described these principles, as well as noting other important principles which can also be taken into account.

RE:THINK - PRINCIPLES FOR TAX SYSTEMS

It is accepted that a well-designed tax system will meet its revenue raising objective, while balancing the core principles of equity, efficiency and simplicity:

- *Equity* – fairness in the distribution of the tax burden;
- *Efficiency* – economy in tax collection so as to have the lowest possible cost over and above the revenue that is raised; and
- *Simplicity* – the tax system should be easy to understand and simple to comply with.

Other principles could usefully be added to this list. For example, the United Kingdom House of Commons Treasury Committee's *Principles of tax policy* added procedural principles to this list. These include certainty, stability, and proper consultation and review. The Henry tax review emphasised the importance of sustainability, where this is the ability to meet the changing revenue needs of governments, and consistency across tax laws and treatments.

¹ Commonwealth 1985, *Reform of the Australia Tax System: Draft White Paper, June 1985*, Canberra, p. 14-17.

² The Australian Government, The Treasury, 2015, *Re:think*, Tax Discussion Paper, Canberra, p. 14.

- 2.5 Having regard to the foregoing, when formulating the Board's guiding principles, it was considered important to take into account the specific needs and requirements of small businesses.
- 2.6 In Australia, and internationally, the justification for preferential treatment provided to small businesses is generally based on two considerations.³ First, concessions are aimed at levelling the playing field. Small businesses typically confront market failures that their larger counterparts do not. Examples include greater barriers to entry, difficulty in obtaining finance, and greater variability in income levels due to a lack of diversity in income sources. Second, small businesses are disadvantaged by disproportionate costs in complying with tax and other regulatory obligations relative to their size.
- 2.7 These messages were echoed consistently throughout the Board's consultations. Many small business owners noted that what they wanted most was to focus more on their business. However, they were unable to deal with the significant levels of tax and non-tax regulations due to their proportionately smaller pool of resources or lack of internal expertise.
- 2.8 The Board believes that, where possible, seeking active involvement from small business owners (as well as their advisors) during the policy and law design process will allow for the development of concessionary measures which are more relevant and useful to the small business sector.

The Board's Guiding Principles

- 2.9 The Board's guiding principles were largely endorsed by small business stakeholders, albeit some expressed concern as to how they would be practically implemented. In this regard, the Board notes that judgements will need to be made regarding the various trade-offs in adhering to, or departing from, such principles, as well as determining the requisite weighting given to each principle.
- 2.10 Significantly, in the Board's consultations, stakeholders stressed that they consider that achieving simplicity should be the primary goal of any reforms to the small business tax system. This message was front of mind when the Board reviewed the tax concessions available to the small business sector.
- 2.11 The Board's framework comprises six guiding principles, as follows:

³ OECD 2015, 'Taxation of SMEs in OECD and G20 Countries' OECD Tax Policy Studies, No. 23, OECD Publishing, Paris, pp. 60-62.

1. Concessions should be designed having regard to the small business life cycle

Small businesses typically move through successive stages from inception or start-up, through a period of growth to maturity, and ultimately to an exit stage when the proprietors will either sell or wind up. A business will value differently the various forms of tax relief available to it, depending on the stage it is at in terms of its business life cycle.

Accordingly, the business life cycle principle provides a valuable benchmark for evaluating the current suite of concessions and for identifying opportunities for improvement. The Board's aim is not to have a 'one size fits all' approach but to have a co-ordinated 'package' of concessions that provide meaningful assistance during the course of the small business' life cycle.

2. Concessions can assist with small business cash flow

Cash flow is a crucial concern for many small businesses, especially when they are at the most critical phases in their life cycle. It is particularly important during the inception stage and can also impact whether a business is able to survive a temporary downturn.

The challenges faced by small businesses in managing cash flow can often reflect a lack of financial literacy or limited access to relevant tools or expertise.

The tax system can also affect small business cash flow in a more direct way. For example, some of the most valuable concessions operate to reduce tax payable through concessional rates or increased (or accelerated) tax deductions. However, for a business in the start-up phase or undergoing a temporary setback, these concessions may merely add to the stock of tax losses rather than providing an immediate cash flow benefit.

There is scope to complement the existing suite of concessions with specific relief designed to provide targeted cash flow assistance in specific temporary situations. However, if it is identified that better solutions may be available outside the operation of the tax system, these solutions will also be explored.

3. Concessions should relieve the compliance burden for small business

The Australian tax system is complex and imposes significant compliance costs on business. It is widely accepted that small businesses, lacking the economies of scale and in-house expertise of their larger counterparts, are disproportionately affected by

the cost of compliance. This is not helped by the apparent tendency among many small businesses to adopt complex business structures, often comprising multiple entities of different types.

As the Board has previously observed, the costs of complying with tax obligations are not just measured in dollars. Small business owners can also suffer significant non-financial costs in the form of stress and lost time. Accordingly, easing the compliance burden for small business should be a primary concern in the design of concessions.

4. Concessions should promote growth and innovation

An important goal of the tax system is to ensure that businesses that wish to expand and innovate are encouraged to do so.

Under Australia's current tax system, it has been observed that the design of concessions may sometimes make small business owners reluctant to grow their businesses. This is because small business tax concessions in Australia typically operate on an 'all-or-nothing' basis depending on whether the size of the business, measured in net assets or aggregated turnover, exceeds certain thresholds. Businesses that 'outgrow' these thresholds do so at the expense of forgoing these concessions.

The practical extent of the problems associated with 'hard' cut-off thresholds is untested and should be reviewed further. However, subject to the outcome of that review, there is merit in exploring ways to design eligibility criteria for tax concessions that remove disincentives to growth.

In terms of the broader tax environment, barriers to capital investment remain a key challenge for small business. Ideally, the tax system should be designed to reduce disincentives for investing in both physical capital and technological innovation. It should also reflect the importance of human capital, by helping new businesses to take on employees, and established businesses to expand their workforce.

5. Concessions should be targeted and affordable

Tax concessions involve a significant commitment of public funds and the community expects that they will be administered responsibly, be enjoyed only by their intended recipients, and go only as far as necessary for them to meet their policy objectives.

Concessions should be monitored with a view to identifying situations where concessions are being exploited, are more generous than they need to be, or are otherwise not producing the desired policy outcome originally intended.

Revenue savings generated by better targeting concessions can be redeployed in ways that will provide more meaningful assistance to small business. This will also help to ensure that the measures do not increase complexity or introduce distortions that are inconsistent with broader policy objectives.

6. Concessions should not incentivise complex structuring

Tax outcomes for business income in Australia are highly dependent on the business structure. The choice to operate a business as a sole trader, in partnership or through a trust or company involves the consideration of a myriad of commercial and tax trade-offs. The Board has noted that private businesses increasingly adopt complex structures designed to overcome these trade-offs, combining the advantages of different entity types whilst minimising any downsides to their business operations.

The incentives associated with eligibility criteria for tax concessions can be a driver of complex business structuring. Other tax considerations influencing business structuring include the tax rate on earnings, flexibility of distributions, and the tax cost of reinvesting profits as working capital. Such considerations must be weighed up against personal and family considerations, including asset protection and succession planning.

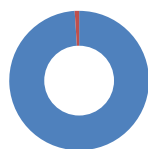
Tax concessions should be designed with the aim of reducing incentives for complex structuring.

CHAPTER 3: SMALL BUSINESS DEFINITION

KEY POINTS

- Small businesses in Australia make a significant contribution to the Australian economy. A well-designed regime of tax concessions should take into account the competing pressures, needs and requirements of the small business sector.
- Defining the small business sector to target concessions is an inherently difficult process which inevitably involves policy trade-offs.
- Throughout consultation small business owners and their trusted advisers made it clear that they put a great deal of value on simplicity.
- The \$10 million per annum 'small business entity' aggregated turnover threshold is the most sensible and practical definition for targeting small business concessions.

3.1 Small businesses are critical to the Australian economy. There are 2,622,600 small businesses, which accounts for approximately 99 per cent of all businesses;⁴ they employ 5.7 million Australians,⁵ and contribute around \$395 billion of Australia's annual economic output.⁶



■ Small Business
■ Medium and Large Business



5.7 million

Australians are employed
by small businesses



\$395 billion

contribution to the economy

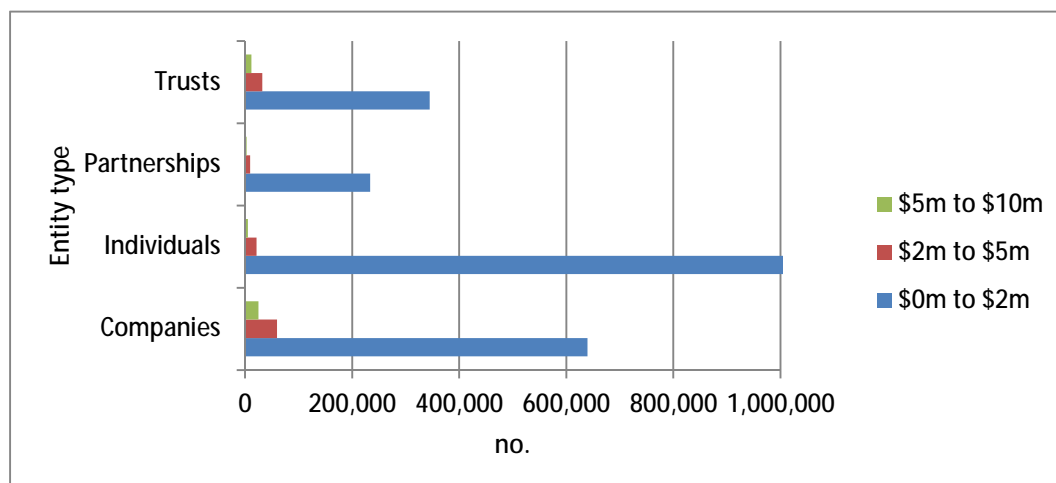
⁴ ATO data from 2015-16 (latest available) indicates there are 2,622,600 entities with aggregated turnover of up to \$10 million per annum. There are 30,500 entities with group aggregated turnover of over \$10 million. 'Aggregated Turnover' is defined in section 328-115 of the ITAA 1997. A challenge has been obtaining access to reliable population data prepared in accordance with the grouping rules in the tax law (i.e., including affiliates and connected entities). The ATO has provided this data but there are limitations in its use.

⁵ Treasury calculations on 2015-16 ATO data.

⁶ ABS, *Australian Industry*, Cat. no. 8155.0, table 5. Note that the ABS uses a different metric for measuring 'small business' compared to the ATO. Accordingly, the annual economic output figure may not necessarily be comparable.

- 3.2 Small business is commonly used as an 'umbrella' term to define businesses under a certain size. However, the reality is that small businesses represent a diverse group of taxpayers ranging from businesses used by their owners as vehicles to supplement other sources of income to support their lifestyle, to more substantial commercial enterprises with aspirations for growth and expansion. The composition of small businesses is also evolving due to the rise in the 'sharing' and 'gig' economies which are driving more individuals to start small businesses, whether through opportunity or necessity. This effectively means that it is difficult to make generalisations about the sector when setting policy.
- 3.3 Small businesses are also diverse in the ways in which they organise themselves. The majority, around 39 per cent operate as sole traders, while 9 per cent are partnerships, 15 per cent are trusts and 28 per cent are companies (refer Figure 3.1). The Board is aware that small businesses typically use a combination of these structures.

Figure 3.1 – Composition of small businesses by entity type



- 3.4 Small businesses also operate across a diverse range of industries, with construction, financial and insurance services, professional services, real estate, retail trade, agriculture, forestry and fishing being the most prevalent sectors (refer Figure 3.2 for businesses with aggregated turnover less than \$2 million and Figure 3.3 for businesses with aggregated turnover between \$2 million and \$10 million).

Figure 3.2 – Top 8 broad industries of businesses with aggregated turnover between \$0 and \$2 million in 2015-16

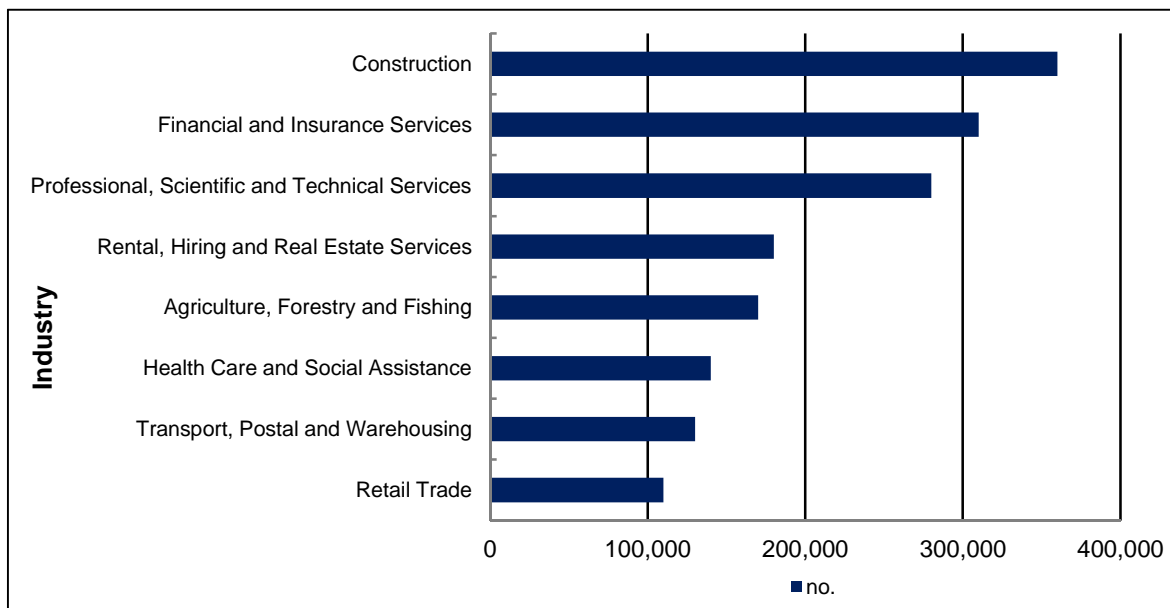
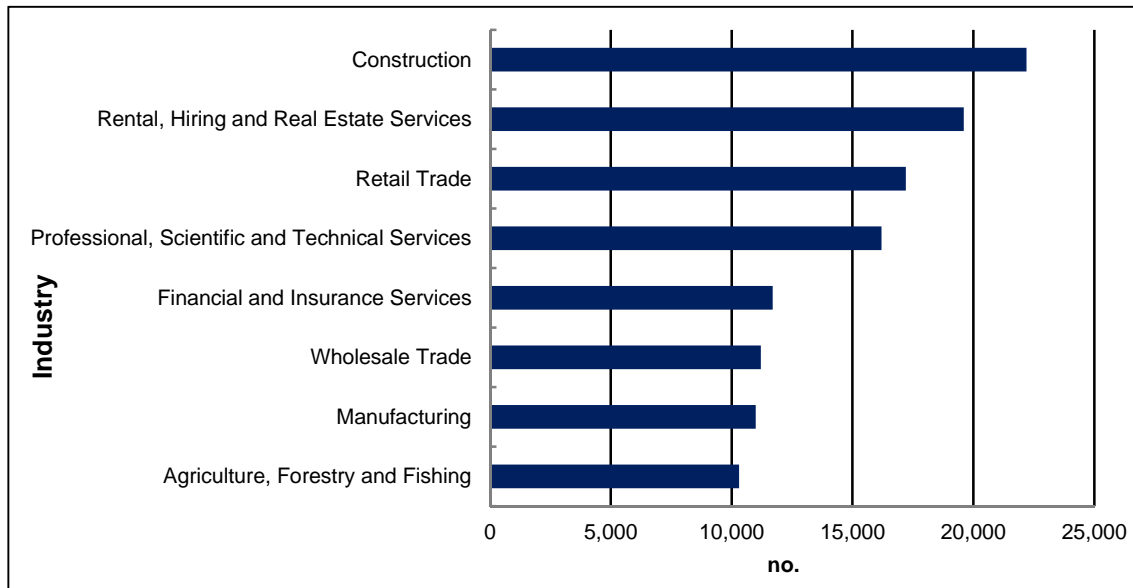


Figure 3.3 – Top 8 broad industries of businesses with aggregated turnover between \$2 and \$10 million in 2015-16



3.5 Notwithstanding the diversity of the sector, there are common fundamental challenges which impact all small businesses. Due to their relative size and resource constraints, small businesses spend a disproportionate amount of time dealing with government regulations, they encounter difficulties in accessing capital markets, whilst simultaneously grappling with fundamental changes to traditional ways of doing

business. For example, the pressure is rising for small businesses to ‘go digital’ both in the way they interact with consumers and in how they comply with their tax obligations and other regulations. Rapid technological developments and the advent of the digital economy are creating many opportunities, as well as threats.

- 3.6 The Board notes that the Small Business Digital Taskforce examined ways to promote digital awareness to assist small businesses to navigate some of these changes. The Board supports the dedicated funding in the 2018-19 MYEFO to deliver the taskforce’s headline recommendations.⁷
- 3.7 Within the tax system, there are opportunities to leverage technology to relieve the regulatory burden on small business, as demonstrated by the introduction of the Single Touch Payroll initiative. There are further initiatives that can be adopted. For example, the Black Economy Taskforce recommended a ‘Trusted Taxpayer’ program that would, amongst other things, afford small business taxpayers that are sufficiently digitally linked to the ATO the benefit of pre-filled (and eventually no) tax returns for eligible businesses.⁸ The Board’s recommendations on improving the PAYG instalment system and better delivery of business education (Chapter Eight) tap into some of the opportunities presented by technological advancements.
- 3.8 Achieving a level playing field for small businesses also remains a key challenge. They face competition not only from their larger, more established, counterparts but also from illegitimate operators in the small business sector undercutting them on price. As a result of the findings of the Black Economy Taskforce,⁹ actions are currently being taken to crack down on the black economy and level the competitive landscape.
- 3.9 A well-designed regime of tax concessions should take into account these competing pressures, needs and requirements of the small business sector, and target relief to assist with the various commercial challenges faced by small businesses during each of the stages of their business life cycle.

What is a small business?

- 3.10 Defining what is a ‘small business’ has always been problematic. The Board has taken into account a variety of different suggestions during consultations on how to best approach the issue. What the Board found was that, prima facie, whilst the various different approaches appeared to be sound, when considered in more detail, they are often difficult to apply in practice and can add to the complexity of the tax system. In

⁷ This includes \$37.3 million over four years of dedicated funding to increase the capability of industry associations to train their members in how to adopt and use digital technology that is beneficial for their business, as well as funding for the creation of a non-government entity with the overarching goal to increase digital capability.

⁸ The Australian Government, the Treasury 2017, ‘Black Economy Taskforce Final Report’, Canberra. See Recommendation 3.5.

⁹ Ibid.

reality, a range of considerations must be taken into account and there is no universally accepted benchmark. Should the definition be based on turnover, assets, number of employees, or some other factor? And how much turnover, what value of assets, or how many employees should constitute a small business?

Small business definitions

3.11 There is currently an array of metrics for determining what constitutes a ‘small business’ in Australia. By way of example, the ABS defines a small business as one employing fewer than 20 people. The ABS favoured an employment-based measure in part because a financial metric would, over time, require inflation adjustments to be made.¹⁰ Corporations law defines small business using a ‘two-out-of-three’ test by reference to employment, assets and turnover. What is evident is that there is no single accepted measure for defining a small business.

3.12 Table 3.1 outlines some of the definitions of small business used by the various regulatory regimes.

Table 3.1 – Examples of small business definitions in Australia¹¹

Metric	Threshold	Institution	Purpose
Employees	< 15	Fair Work Australia	Unfair dismissal & redundancy
	< 20	Australian Bureau of Statistics	Statistical reporting
	< 100	Workplace Gender Equality Act 2012	Equal opportunity laws
Aggregated Turnover	< \$10 million, < \$5 million, < \$2 million	ATO	Taxation
	< \$3 million	Privacy Act 1988	Privacy
Assets	< \$50 million	APRA	Prudential supervision
Wages	Varies by state	Payroll tax	Taxation
Gaming machines	< 15	AUSTRAC	Anti-money laundering and counter-terrorism financing rules

¹⁰ ABS 1999, ‘Small Business in Australia Cat. No. 1321.0’, p. 145.

¹¹ Derived from the Productivity Commission 2013, ‘Regulator Engagement with Small Business’, Canberra.

Multiple	Turnover < \$25 million	Australian Securities and Investment Corporation	Corporations Law ¹²
	Gross assets < \$12.5 million		
	Employees < 50		
	Turnover < \$10 million	Banking Code of Practice ¹³	Banking self-regulation practices
	Employees < 100		
	Total debt < \$3m		

International comparison

- 3.13 This lack of consistency in defining small business is also reflected internationally. In comparison to Australia, the definitions of small business in the OECD and G20 nations adopt similar metrics such as the number of employees, annual turnover or assets, but are equally as varied.
- 3.14 The European Union classifies micro, small and medium-sized enterprises on the basis of a two-out-of-three test, combining employee numbers together with one of either turnover or assets, but this is not always adopted by member states. In Canada, small businesses are defined to be those with fewer than 100 employees. Alternatively, the United States of America takes a targeted approach by adopting a definition of small business that varies depending on industry sector.
- 3.15 Table 3.2 lists examples of international definitions of small business identified by the OECD in 2015.¹⁴

¹² The definition for Corporations Law purposes also encompasses medium-sized businesses. The Government has announced a doubling of each of these thresholds for the purposes of reducing the financial reporting and auditing requirements of small and medium businesses. See Frydenberg, J (Treasurer) 2018, *Small and Medium businesses to save more than \$300 million over four years*, media release 16 November, Canberra.

¹³ Recommendation 1.10 of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry recommended the Banking Code being amended to define small business as any business or group with fewer than 100 full-time equivalent employees and where the loan applied for is less than \$5 million.

¹⁴ OECD 2015, 'Taxation of SMEs in OECD and G20 Countries' OECD Tax Policy Studies, No. 23, OECD Publishing, Paris.

Table 3.2 – Examples of international definitions of small business

Country	Metric	Industry	Threshold
Canada	Employees	All	< 99
European Union	Employees	All	< 50
	Turnover		≤ €10m
	Balance sheet		≤ €10m
New Zealand	Full-time employees	All	< 20
India	Investment in plant & equipment	Manufacturing	< INR 2 million
	Investment in equipment	Services	< INR 1 million
United States of America	Employees	Manufacturing	< 500 employees (up to 1,500) depending on type of product manufactured
	Employees	Wholesaling	< 100 employees (up to 500 depending on the particular product)
	Annual receipts	Services	< US\$2.5m to US\$21.5m depending on the particular service being provided
	Annual receipts	Retail trade	< US\$5.0m to US\$21.0m, depending on the particular product being provided
	Annual receipts	General & heavy construction	< US\$ 13.5m to US\$17m, depending on the type of construction
	Annual receipts	Special trade construction	< US\$7m
	Annual receipts	Agriculture	<US\$0.5 to US\$9.0m, depending on the agricultural product

Small business tax definitions

- 3.16 A standardised definition of small business was introduced into the tax system through the 'small business framework' project in 2007 which defined a small business entity (SBE) as an individual, partnership, company or trust carrying on a business with an aggregated turnover of less than \$2 million.¹⁵ Aggregated turnover in the context of small business tax measures has a specific tax meaning,¹⁶ rather than relying on ordinary or accounting concepts of turnover. The rationale for having one eligibility test to access the range of small business concessions is that it would reduce red tape and compliance costs for small businesses. The then Treasurer noted that any business meeting the new small business definition would be able to choose any of the relevant concessions that met its business needs.¹⁷
- 3.17 In the 2016-17 income year, the aggregated turnover threshold was increased from \$2 million to \$10 million per annum. While it was acknowledged that the vast majority of Australian businesses have an aggregated turnover of less than \$2 million, increasing this threshold expanded the number of businesses able to access small business tax relief.
- 3.18 However, the increase in the threshold from \$2 million to \$10 million per annum was not applied across the board, effectively fracturing the small business definition. Table 3.3 below outlines the specific statutory concessions that became available to the increased threshold of \$10 million.

Table 3.3 – SBE concessions (\$10 million aggregated turnover test)

Concession	Description
IAWO	SBEs can immediately deduct business assets that cost less than a threshold amount. From 12 May 2015 until 30 June 2019, the threshold is \$20,000. The threshold is scheduled to increase to \$25,000 until 30 June 2020. ¹⁸

¹⁵ The aggregated turnover test has its beginnings in the *Simplified Tax System (STS)*, which was introduced in 2001 in response to the *Review of Business Taxation, A Tax System Redesigned (Ralph Review)*. However, it was not the only test at that time. There remained various other eligibility tests to access CGT, FBT and PAYG concessions for small business.

¹⁶ Aggregated turnover is calculated for an income year as the sum of annual turnover (*ordinary income derived in the income year in the ordinary course of carrying on a *business - with specific exclusions) for the taxpayer, a *connected entity of the taxpayer and an *affiliate of the taxpayer. All *asterisked terms are themselves specially defined for tax purposes.

¹⁷ Costello, P (Treasurer) 2006, *Making Tax Compliance Easier for Small Business*, media release, 13 November, Melbourne.

¹⁸ Frydenberg, J (Treasurer) 2019, *Increasing and extending the instant asset write-off*, joint media release 14 February, Canberra.

Simplified depreciation rules	Assets above the IAWO are depreciated through simplified pooling arrangements at a rate of 30 per cent per year (15 per cent in the first year). The general small business pool can also be immediately deducted at the end of the income year if its value is less than the immediate write-off threshold (before deducting depreciation for the year).
SBRR	Owners of small business active assets are eligible for CGT and income tax roll-over relief for a 'genuine restructure' of their business, provided, inter-alia, the underlying economic ownership of the assets is unchanged.
Immediate deduction for certain start-up expenses	SBEs can immediately deduct a range of professional expenses and Australian government agency payments associated with starting a new business, such as professional, legal and accounting advice. Previously, these costs were deducted over a five year period.
Immediate deduction for prepaid expenditure	SBEs may immediately deduct prepaid expenditure subject to certain rules.
Simplified trading stock rules	SBEs may choose to use a simplified trading stock regime. Under this regime, small businesses may choose not to account for the changes in the value of stock for an income year if the difference between the opening value of stock on hand and a reasonable estimate of stock on hand at the end of the year does not exceed \$5,000.
PAYG: instalments based on GDP-adjusted notional tax	SBEs can elect to have their PAYG instalments calculated for them by the ATO by applying an adjustment to previously reported information.
FBT: employee car parking exemption	Car parking benefits provided to employees of SBEs are exempt from FBT if the parking is not provided in a commercial car park. The employer must not be a government body, listed public company or subsidiary of a listed public company, and the employer's total income must be less than \$10 million.
FBT: multiple portable electronic devices	An FBT exemption applies to multiple work-related portable electronic devices provided by an SBE to its employees– even if the devices have substantially identical functions. This exemption applies to portable electronic devices mainly for use in the employee's employment.
GST concessions	SBEs are entitled to three GST concessions including: the option to account for GST on a cash basis; the option to pay GST by quarterly instalments and to lodge an annual return; and the option to apportion GST input tax credits on an annual basis for acquisitions and importations that are partly creditable.
Small business excise concession	SBEs can apply to defer settlement of excise duty and excise equivalent customs duty from a weekly to monthly reporting cycle.
Two-year amendment period	An SBE will generally be eligible for a two-year amendment period for tax assessments instead of the standard four years.

- 3.19 Importantly, two of the small business concessions were quarantined from the changes to the SBE definition. These outliers are the 'suite' of small business CGT concessions and the unincorporated small business tax discount.
- 3.20 The small business CGT concessions retained the \$2 million threshold as well as the alternative \$6 million net asset test (a test that dates back to the CGT concessions' first incarnation as a 'goodwill exemption').¹⁹ The primary reason for quarantining the suite of CGT concessions was based on budgetary considerations.²⁰ Secondly, businesses with aggregated turnover greater than \$2 million were said to have greater capacity to save for their retirement and so an increased threshold was not considered necessary in tight fiscal circumstances.²¹
- 3.21 The threshold for the second outlier, the unincorporated small business tax discount, was also raised, but to \$5 million instead of \$10 million. Again, this was based primarily on budget considerations, but also because entities with an aggregated turnover of more than \$5 million 'generally find it to their advantage to incorporate' and will not access tax relief designed for unincorporated businesses.²²
- 3.22 The result of these decisions was to effectively fragment the definition of small business, for tax purposes, into three different definitions:
- \$2 million aggregated turnover test;
 - \$5 million aggregated turnover test; and
 - \$10 million aggregated turnover test.
- 3.23 Table 3.4 describes each of the outliers which have fragmented the tax definition of small business.

¹⁹ Former section 160ZZR of the ITAA 1936.

²⁰ Explanatory Memorandum to Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016, paragraph 4.26.

²¹ Ibid, paragraph 4.64.

²² Ibid, paragraphs 4.26 and 4.64.

Table 3.4 – Outliers to the SBE definition

Concession	Description	Eligibility Criteria
Unincorporated small business tax discount	<p>Individual taxpayers with business income as a sole trader, or from a trading trust or partnership, are eligible for an 8 per cent tax offset on the tax payable on that business income in the 2016–17 income year.</p> <p>This discount rate will be increased over time until it reaches 16 per cent in 2021-2022. The offset is capped at \$1,000 per individual for each income year.</p>	Aggregated turnover less than \$5 million.
CGT concessions	<p>Eligible entities may access one or more of four small business CGT concessions, as follows:</p> <ul style="list-style-type: none"> • a CGT exemption on active small business assets that have been held continuously for 15 years where the taxpayer is permanently incapacitated or reaches the age of 55 and retires; • a 50 per cent reduction of capital gains that arises from the sale of active small business assets (in addition to the general CGT discount); • an exemption, up to a lifetime cap of \$500,000, on capital gains arising from the sale of active small business assets, where the proceeds of the sale are used for retirement; • a CGT roll-over for capital gains arising from the disposal of active small business assets if the proceeds of the sale are used to purchase another active small business asset or improve an existing asset. 	Aggregated turnover less than \$2 million or, alternatively, net assets of no more than \$6 million.

Stakeholder Views

3.24 Throughout the Board’s consultations, stakeholders emphasised that having to navigate multiple definitions of ‘small business’ remains one of their biggest irritants. They believe that, at the very least, a more unified definition of small business for tax purposes would have a positive impact.

- 3.25 Of most significance, stakeholders are concerned with the different definition of small business which is used for the purposes of the small business CGT concessions. They argue that the \$2 million threshold is now out of date, forcing businesses to incur additional compliance costs in determining whether they satisfy the alternative asset-based test, and causing many deserving businesses to miss out on the CGT concessions altogether. Some also argued that the impact of the hard cut-off threshold should be minimised by allowing relief to be tapered or 'shaded out' for entities with a turnover above the threshold.
- 3.26 In consultations, small business owners urged the Board to recommend improvements to the tax system in ways that would best allow them to simply get on with doing business. Whilst they believe that it is important that concessions should be appropriately targeted and effective in supporting small business growth and sustainability, the majority of participants emphasised the importance of simplicity. They argued that having a single definition of small business would make it easier for them to understand and reduce the level of compliance costs in determining whether or not they were, in fact, a small business.

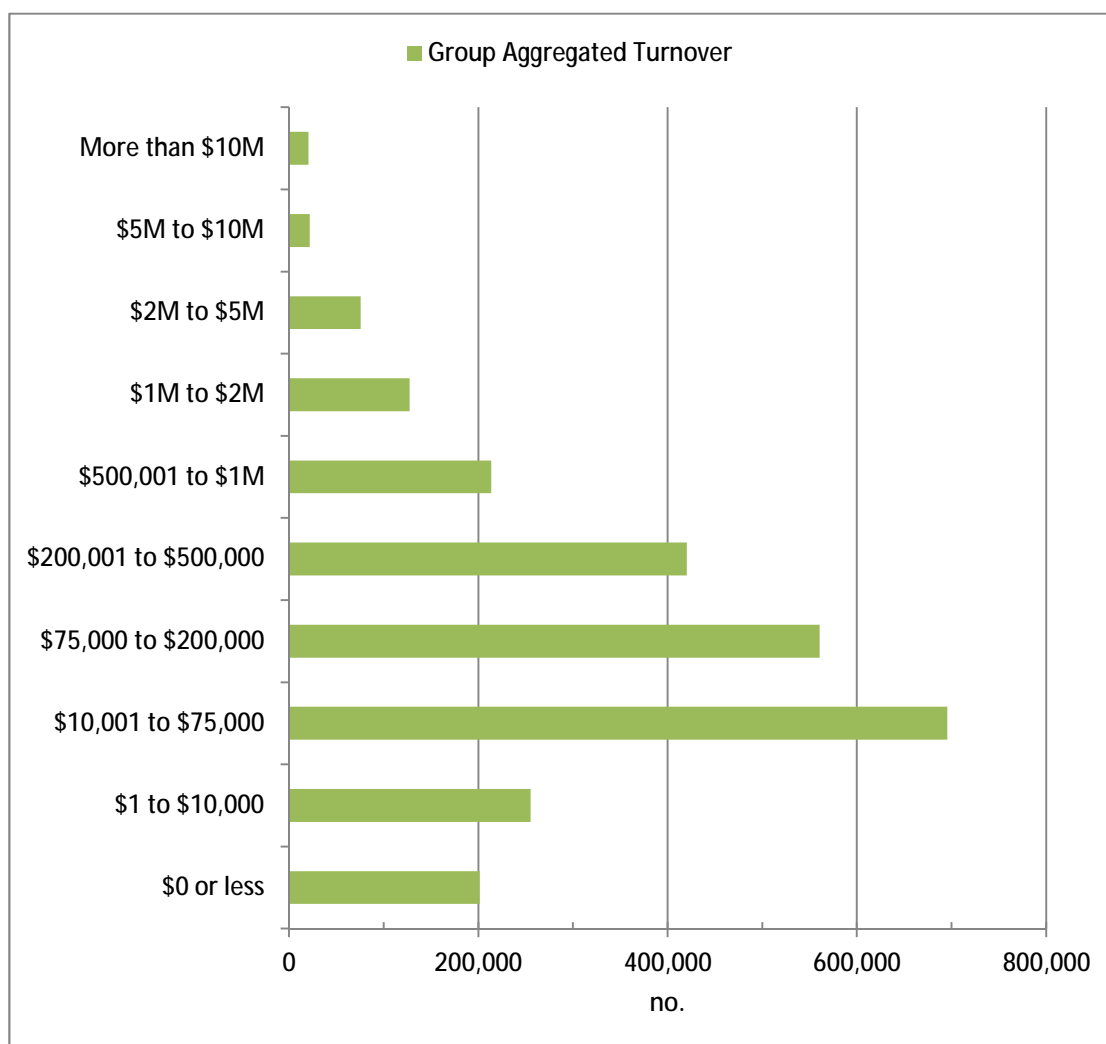
The Board's consideration – A harmonised definition for tax

- 3.27 In the Board's view, determining an appropriate definition of 'small business' for tax concessions necessitates a policy trade-off. A simple, harmonised and inclusive measure of small business is easier to understand and comply with. However, this may not allow for precise targeting of the concessions. The nature and diversity of the small business sector is such that, for example, a tax concession aimed at growing small businesses will also be open to those small businesses that have no intention of growing and/or employing more people.
- 3.28 Implicit in the policy decision in 2007 to standardise the definition of small business for tax purposes (the SBE test) is, arguably, an acceptance that some small businesses that do not wish to grow (unintended recipients) will also have access to the range of available small business tax preferences. The question is, 'does that remain the right policy outcome?'
- 3.29 The Board's view is that the approach taken in 2007 is the most appropriate way forward. The Board considers it vital to preserve the SBE test as the key eligibility criterion for accessing small business tax concessions. It reflects what small business owners value – it is straightforward, easy to comply with, and already embedded in the tax system such that it is well understood.
- 3.30 The Board considers the \$10 million threshold that currently applies to the majority of small business tax concessions to be the logical threshold for harmonisation. Importantly, the \$10 million threshold is set at a sufficiently high enough level such that the 'cut-off' does not act as a disincentive for small businesses to grow (referred to in this Report as the 'cliff effect'), relative to the current \$2 million threshold (the small

business CGT concessions) and \$5 million threshold (the unincorporated small business tax discount). This aspect is discussed in more detail in Chapter Five.

- 3.31 The Board observes that the vast majority of small businesses with an aggregated turnover of \$10 million or less, approximately 2,570,000 small businesses, also have less than 20 employees (refer Figure 3.4). Accordingly, 99 per cent of small businesses as measured by the tax metric of aggregated turnover would also meet the ABS's employee-based definition of small business.

Figure 3.4 – Counts of businesses by aggregated turnover with less than 20 employees in 2015-16



- 3.32 As an aside, the Board observes that the \$10 million threshold would also align the law with the ATO's administrative framework for categorising business sectors, whereby a 'small business' is considered to be one with business income of no more than \$10 million.

RECOMMENDATION 1

Preserve the current 'small business entity' definition and adopt the reform packages in Recommendations 4 and 6 to apply the \$10 million per annum aggregated turnover threshold uniformly across all of the current 'small business entity' tax concessions.

Future new small business tax concessions should utilise the 'small business entity' definition as the eligibility gateway.

A small business definition for all regulatory purposes

3.33 In the Board's Consultation Guide, the Board set out an ideal approach to small business tax policy as one that recognises tax as just one component of the broader regulatory environment.

3.34 Relevant to that ideal, a key theme emerging from discussions with stakeholders was the lack of a consistent definition of small business for all policy and regulatory requirements, whether it relates to industrial relations, company law or state taxes.

“...harmonisation of the definition of small business across policy and regulation, both at Commonwealth and State and Territory jurisdiction level, is critical, overdue and an unnecessary source of cost, complexity and confusion.”

Stakeholder submission

3.35 In particular, stakeholders consistently put forward payroll tax as a key source of frustration, as well as being a barrier to growth. They pointed to the different rates, thresholds and exemptions remaining despite best efforts to harmonise legislation by the states and territories. Stakeholders told the Board that navigating the various thresholds can be costly and confusing, and in some cases, discourages interstate expansion and hiring of employees.

3.36 In 2012, the Productivity Commission catalogued examples of different small business definitions in Australia (refer Table 3.1) and concluded that it was neither feasible nor appropriate to develop a standardised definition for all regulatory purposes given the different policy and regulatory objectives of each.²³

“While some progress has been made in standardising the definition of 'small business' in law, there are still large inconsistencies which make it difficult to clearly define the boundaries of the small business sector. There would be merit in exploring the broader application of a standard definition across all legislation.”

Stakeholder submission

²³ Productivity Commission 2013, *Regulator Engagement with Small Business*, Research Report, Canberra.

- 3.37 Whilst the Board agrees that a single definition of small business is not feasible across all regulatory requirements, the Board cannot ignore the strong feedback received during consultations in relation to this issue. The Board believes there should be a formal attempt made at streamlining small business definitions across industry and federal, state and territory agencies to achieve greater alignment and reduce the number of definitions as much as possible. It is apparent to the Board that this exercise, if successfully undertaken and implemented, will have a significant impact in reducing the red tape burden for small business.
- 3.38 A working group should be established to examine this aspect in further detail and undertake the necessary consultations and communications with relevant stakeholders, including government departments at federal, state and local levels. This would also require the involvement of relevant key industry and professional associations.

RECOMMENDATION 2

Establish a working group to identify opportunities for greater alignment of the definition of small business across all regulatory regimes including state governments.

CHAPTER 4: REVIEW OF THE CURRENT SMALL BUSINESS CONCESSIONS

KEY POINTS

- The Board has reviewed the existing suite of small business tax concessions against the guiding principles to this review and each concession's policy objectives.
- This process included taking into account the feedback received by the Board from stakeholders as well as objective data received from the ATO. The Board has identified certain small business tax concessions that do not meet the guiding principles and/or do not fully achieve their policy objectives.
- Reviewing the mix of small business tax concessions from the small business life cycle perspective highlights that a significant proportion of the concessions are directed towards established and mature businesses.
- Small business concessions need to be better aligned with the small business life cycle to ensure that their specific needs and requirements are being appropriately met throughout each stage of the life cycle.

Concessions under review

- 4.1 During the course of the review, to help determine the effectiveness of the current suite of small business tax concessions, the Board obtained information and data from the ATO in relation to the concessions (where available). In conjunction with the feedback received from stakeholders, each concession (as listed in Table 3.3 and Table 3.4) was reviewed against the Board's guiding principles and the relevant policy objectives and rationale.
- 4.2 Tax relief or incentives such as the lower company tax rate, the Research and Development Tax Offset, Early Stage Innovation Company tax incentive, and safe harbours (such as Thin Capitalisation), amongst others, were not included in this review. While these concessions may benefit small businesses, they are not SBE concessions. Each has unique eligibility criteria targeting a population broader than, or altogether different to, the small business sector. Equally, sector-specific concessions (such as primary producers) have not been considered.
- 4.3 The following tax concessions have been identified as not meeting the Board's guiding principles and/or policy objectives and rationale.

Small business CGT concessions

Policy	Outcome
<p>The policy of the small business CGT concessions has historically focused on addressing two key areas. First, the concessions were aimed at improving retirement outcomes for small business owners who, being typically cash-constrained, tend to invest any surplus funds back into their business. Secondly, the concessions sought to ensure that a lack of capital does not constrain the growth and development of small business (primarily through the replacement asset roll-over).²⁴</p>	<p>The small business CGT concessions should be simplified, fairer, and more sustainable. Refer Chapter Five.</p>

- 4.4 Of the suite of small business tax concessions, the small business CGT concessions received the most vocal and critical feedback from stakeholders. Consultation feedback consistently referred to the intricate level of complexity when applying the concessions in practice and the significant costs involved when seeking specialist advice. It was also acknowledged that the generous nature of the concessions have unduly influenced commercial and structuring decisions.
- 4.5 From this feedback, the Board’s practical understanding of the concessions, and the objective data received from the ATO, it became clear that the concessions did not meet a number of the guiding principles set by this review. In addition, the concessions have expanded markedly and opened up in ways which make it difficult to reconcile with their historical policy justification. Consequently, the Board decided that it was appropriate to consider these concessions in more detail (refer Chapter Five).

²⁴ Keating, P (Prime Minister) 1992, *One Nation: statement by the Prime Minister*, 26 February; Explanatory Memorandum to Tax Laws Amendment Bill (No. 1) 1997.

Unincorporated small business tax discount

Policy	Outcome
<p>Acknowledging that there are small businesses that do not operate through a company, the unincorporated small business tax discount was effectively introduced as a proxy, for unincorporated businesses, broadly equivalent to the small business company tax rate reduction. The concession was aimed at delivering lower taxes to unincorporated small businesses, improving their cash flow, helping small business secure finance, render previously marginal activities to be (more) profitable and assisting them to grow, compete and hire new workers.²⁵</p>	<p>Replace with an alternative program for unincorporated small businesses, or improve its design. Refer Chapter Six.</p>

4.6 Stakeholders noted the benefits of the unincorporated small business tax discount in providing tax relief for those small businesses that choose not to operate through a company. However, there were varying levels of criticism on whether the concession has achieved its policy objectives. More specifically, stakeholder feedback highlighted:

- the maximum \$1,000 offset amount was of limited assistance;
- the lack of awareness of the concession by many small business owners; and
- the inequitable treatment between sole traders and other unincorporated structures, such as trusts.

4.7 The Board agrees with the policy objectives underlying the unincorporated small business tax discount in relation to improving small business cash flow, encouraging investment back into the business, help in securing finance and make marginal activities more profitable. However, it is questionable whether the concession can achieve all of these objectives through its current design. Accordingly, the Board considered this concession in more detail (refer Chapter Six).

²⁵ Australian Government, Budget 2015/16, Budget paper No. 2; Explanatory Memorandum to the Tax Laws Amendment (Small Business Measures No. 3) Bill 2015, paragraph 1.5.

Small Business Restructure Roll-over Relief (SBRR)

Policy	Outcome
The SBRR enables small businesses to restructure into a more appropriate legal structure by allowing them to defer any gains which would have otherwise arisen. The rationale is to help small businesses to continue to develop and grow, avoid unnecessary compliance costs, enhance business efficiency, move to a more efficient structure for tax purposes, or adapt to current market conditions. ²⁶	There should be a post-implementation review of the SBRR. Refer Chapter Seven.

- 4.8 Stakeholders were very receptive to the SBRR and understood what it aimed to achieve. However, feedback from stakeholders also highlighted certain limitations in the operation of the law which has restricted its use in practice.
- 4.9 The Board has considered these concerns, and believes there is merit in exploring ideas on how to improve the SBRR to address the issues highlighted and to better support small business at the start of their business life cycle consistent with the Board's guiding principles. Accordingly, the Board has recommended that a post-implementation review of the SBRR be undertaken. This is outlined in Chapter Seven.

Instant asset write-off (IAWO)

Policy	Outcome
The increased immediate deduction for capital expenditures is aimed at improving small businesses' cash flow and encouraging additional capital investment by small businesses through lowering the pre-tax rate of return required to justify new investments. ²⁷	Retained and enhanced. Refer Chapter Eight.

- 4.10 The IAWO was strongly supported by stakeholders as an important mechanism in assisting with small business cash flow and promoting growth in their business. Notwithstanding, stakeholders believed that more could be done to assist small businesses such as increasing the scope of the concession through a higher threshold and removing the requirement for small businesses to use the small business pooling rules as a prerequisite to access the IAWO.²⁸
- 4.11 The Board is supportive of this concession, as well as the recent government changes to increase the threshold and extend the time frame for its operation. In line with the Board's guiding principles, small businesses have been able to derive significant benefits

²⁶ Explanatory Memorandum to the Tax Laws Amendment (Small Business Restructure Roll-over) Bill 2016, paragraph 1.5 to 1.11.

²⁷ Explanatory Memorandum to the Tax Laws Amendment (Small Business measures No. 2) Bill 2015, paragraph 1.5.

²⁸ Section 328-180 of the ITAA 1997.

from this concession by having improved cash flow and being provided with an incentive to reinvest into their business to grow and innovate.

- 4.12 The popularity of the concession is highlighted by the 311,000 business entities that claimed the IAWO in the 2015-16 income year. To further promote the benefit and reach of this concession beyond the recent changes, the Board has suggested improvements to the IAWO to help a greater proportion of small businesses gain access to this concession. The Board's approach is outlined in Chapter Eight.

Simplified depreciation rules

Policy	Outcome
Simplified depreciation was aimed at providing compliance cost savings through the removal of the need to maintain individual asset schedules and perform separate calculations for each asset for deduction and balancing charge purposes. ²⁹	Retained and enhanced. Refer Chapter Eight.

- 4.13 The simplified depreciation rules provide a simple mechanism for small businesses to recognise the depreciation expense from their depreciating assets that cost more than the IAWO threshold. Small businesses which have chosen to use the simplified depreciation rules are required to depreciate those higher cost assets at 15 per cent in the year of purchase with the remainder placed in a pool and depreciated at a rate of 30 per cent in subsequent years.
- 4.14 Whilst stakeholders were strongly supportive of the IAWO, the lower initial depreciation rate of 15 per cent for assets purchased during the year discouraged them from purchasing higher cost assets. To minimise this distinction between high cost assets and low cost assets (which are eligible to be fully deducted under the IAWO threshold), the Board has identified improvements to the simplified depreciation rules which will encourage small businesses to purchase those higher cost assets that they need most. The Board's approach is outlined in Chapter Eight.

²⁹ Explanatory Memorandum to the New Business Tax System (Simplified Tax System) Bill 2001, paragraph 5.8.

PAYG: instalments based on GDP-adjusted notional tax

Policy	Outcome
The ability to have PAYG instalments calculated by the ATO based on an adjustment to previously reported information aimed to ease the compliance burden on small businesses and eliminate large end-of-year tax bills. ³⁰	Retained and enhanced. Refer Chapter Eight.

- 4.15 The Board believes that this concessional method of determining PAYG instalments can assist many small businesses by reducing their compliance costs, as well as helping to manage their cash flow. This has proved to be popular as highlighted by the 1,930,000 entities that adopted this concession for the 2015-16 income year.
- 4.16 Notwithstanding, through stakeholder feedback, it was suggested that more could be done. Stakeholders told the Board that the method of relying on a GDP-adjusted amount based on past assessments to calculate PAYG instalments, whilst relatively simple, does not always represent an appropriate reflection of their income. This could be due to a variety of factors including seasonal changes, or having an extremely strong or difficult trading year. New small businesses are particularly disadvantaged as they do not have a tax history to base their instalments on.
- 4.17 As a result, the Board believes there may be scope to provide an alternative method to determine small businesses income, for PAYG instalment purposes, to assist those businesses in which a GDP adjusted notional tax amount is not appropriate. This is discussed in Chapter Eight.

Simplified trading stock rules

Policy	Outcome
Simplified trading stock rules were introduced as part of the Simplified Taxation System package as recommended in the Review of Business Taxation. The concession was designed to reduce compliance costs by not requiring a small business to account for any change in the value of trading stock where the difference between opening and closing stock values is reasonably estimated to be less than \$5,000. ³¹	Repeal concession.

- 4.18 The Board received mixed feedback in relation to the operation of the simplified trading stock rules. Some stakeholders noted that it can help reduce compliance costs for

³⁰ Costello, P (Treasurer) 2001, *Streamlined GST and PAYG Reporting*, media release, 22 February; Explanatory Memorandum to Taxation Laws Amendment Bill (No. 3) 2001, p. 3; Explanatory Memorandum to A New Tax System (Taxation Laws Amendment) Bill (No. 1) 1999, p. 1.

³¹ Explanatory Memorandum to the New Business Tax System (Simplified Tax System) Bill 2001, paragraph 6.2.

certain small businesses, whilst other stakeholders believed the concession was inconsequential as small businesses would continue to conduct a stocktake as part of their regular internal controls.

- 4.19 Common through all the feedback was that the \$5,000 reasonable estimate for the simplified trading stock rules meant that small businesses would still need to conduct a stocktake in order to take advantage of the concession thereby limiting any compliance relief benefits.

“As the simplified trading stock rules expect the taxpayer to have a reasonable estimate of the value of their stock on hand, it really does not provide much benefit.”

Stakeholder submission

- 4.20 The Board strongly supports concessions which mitigate the disproportionate burden imposed on small businesses to comply with their income tax obligations. This is reflected in the Board’s guiding principles.
- 4.21 The simplified trading stock concession attempts to address this issue but, from the life cycle perspective, this concession has failed small businesses on two fronts.
- 4.22 First, as highlighted by stakeholders, the need to have a reasonable estimation largely erodes the compliance saving benefits. ATO guidance on the relevant factors in making a reasonable estimate includes the type of inventory system and how accurate they are, information on previous stocktakes undertaken, and any significant changes to the type and quantity of stock held.³² Having regard to the work required on the part of small businesses to access this concession, it is difficult to understand how this policy objective is being achieved.
- 4.23 Such requirements mean many small businesses will continue to conduct a stocktake in order to obtain a reasonable estimate. In fact, many small businesses view stocktake exercises as a critical part of their internal controls to allow appropriate monitoring of stock levels, obsolescence and damage. However, the simplified trading stock rules encourage small businesses to forgo such important business practices. From the business life cycle perspective, this is particularly detrimental to new businesses which should be encouraged to implement appropriate business processes, systems and controls.
- 4.24 Second, the relatively low threshold at which the concession can be utilised further reduces any potential benefits, with one stakeholder noting that ‘\$5,000 equated to 5 iPhones for a retailer’. This threshold has not been changed since its introduction in

³² ATO, *Simplified trading stock rules*, Canberra <<https://www.ato.gov.au/business/income-and-deductions-for-business/in-detail/simplified-trading-stock-rules/#>>.

2001. The ATO was unable to obtain reliable data on the utilisation of the trading stock concession.

- 4.25 Having regard to the foregoing, the Board believes that this concession does not provide any significant benefits to small business and fails to encourage good business practices. As a result, the simplified trading stock rules do not meet the policy objectives and underlying rationale for the concession, irrespective of the small businesses stage of growth. At best, this concession would only be of assistance to the micro end of the small business sector given the low trading stock threshold, but even then, they would need to satisfy the ATO's strict guidelines.

RECOMMENDATION 3

Repeal the simplified trading stock rules.

Other concessions

- 4.26 Of the remaining concessions, the Board has reviewed their merits and has largely concluded that they both meet the guiding principles to this review, as well as their policy objectives and rationale. As such, the Board believes that these concessions should be retained on the current basis.

Immediate deduction for certain start-up expenses

Policy

The immediate deduction for certain professional expenses and certain payments to Australian government agencies (for example, fees, taxes or charges associated with setting up a business) is aimed at providing cash flow benefits for new businesses. The deduction also sought to encourage individuals to start a new business by easing the financial strain thereby leading to increased economic activity and the creation of jobs.³³

- 4.27 The feedback received from stakeholders was generally positive. Whilst corresponding data on the utilisation of this concession was unable to be obtained, the Board believes that this concession can provide an important boost for new small businesses.
- 4.28 A limitation of this concession is that the benefits are more immediately beneficial where a small business has assessable income to apply the deductions against. Notwithstanding, for those small businesses that are able to benefit, it can provide the necessary cash flow benefits during the earlier stages of the business life cycle.

³³ Australian Government, Budget 2015-16, Budget paper No. 2, *Growing Jobs and Small Business – allow immediate deductibility for professional expenses*, page 17; Australian Government, Budget 2015, Budget Glossy, *Growing Jobs and Small Business*, p. 15.

Immediate deduction for prepaid expenditure

Policy

The immediate deductibility for certain types of prepaid expenditure was introduced as part of a suite of concessions through the Simplified Tax System. A key objective of this concession was to simplify compliance costs for small businesses.³⁴

- 4.29 There was limited feedback received on the immediate deductibility of prepaid expenditure.³⁵ In addition, the ATO were unable to obtain reliable data on its utilisation.
- 4.30 A limitation of this concession is the need for SBEs to have available cash in order to make a prepayment. From the life cycle perspective, this mostly caters for small businesses in the growth stage. Notwithstanding, the Board agrees with the policy underpinning this concession and believes the ability to immediately deduct certain prepaid expenditures can serve a useful function for small businesses as part of their cash flow management.

Two-year amendment period

Policy

The introduction of a two-year amendment period was recommended through the Review of Income Tax Self-Assessment. A shorter amendment period provides finality for small businesses.³⁶

- 4.31 The Board received limited feedback on the two-year amendment period. That is not to suggest that this concession is not important as the Board believes that the two-year amendment period can provide greater certainty for small businesses regarding their tax affairs. It means that after the amendment period closes, small businesses can take comfort in the knowledge that they will not need to find material from many years ago or be subject to a large tax liability if they have inadvertently missed something.
- 4.32 Conversely, in certain circumstances this shorter amendment period can also disadvantage small businesses by limiting the time period they have to amend their tax return where they have made a mistake to their detriment. For example, if a small business determines that its expenses have been understated in preceding tax years, it only has a two-year window to amend its tax return and claim any refunds owing. However, the Board understands that this operates from the point of view of balance

³⁴ Explanatory memorandum to New Business Tax System (Simplified Tax System) Bill 2000, p. 4.

³⁵ Sections 82KZM and 82KZMD of the ITAA 1936.

³⁶ Australian Government, The Treasury 2004, *Report on Aspects of Income Tax Self Assessment*, chapter 3.

and fairness as the time period is the same for the ATO to increase a tax liability as it is for a small business to request an amendment.³⁷

- 4.33 The shorter amendment period is also aimed at improving the regulatory environment for small business. However, these benefits are limited as small businesses 'front end' compliance requirements continue to be the same in relation to preparing appropriate supporting documentation for tax purposes.
- 4.34 Understanding that the compliance burden will not be immediately reduced for tax returns in the year of preparation, the Board nonetheless views this concession as an important mechanism in providing small business certainty and 'peace of mind'.

FBT: employee car parking exemption

Policy

The FBT employee car parking exemption was provided to small business in order to remove red tape and compliance costs. Small businesses who qualify for the car parking benefit exemption are not required to keep records or calculate the taxable value of the car parking benefits. The records required for car parking fringe benefits are generally not required for any other FBT purpose.³⁸

- 4.35 Due to limitations in the data available to the ATO collected from the FBT return, reliable estimates were not available in relation to the utilisation of the FBT car parking exemption for small business.
- 4.36 There was limited feedback from stakeholders throughout consultation on this concession with feedback largely focused on the compliance burden associated with FBT. Drawing on that stakeholder criticism, the Board believes there is merit in maintaining the car parking exemption to assist small businesses in alleviating that compliance burden.
- 4.37 The Board is conducting a separate review on the compliance costs associated with obligations under the FBT legislation which will also examine the impacts on the small business sector.

³⁷ In addition, the ATO has legislative discretion to agree to an extension of time to lodge an objection where the shorter review period might otherwise deprive a small business of a legitimate claim for a credit amendment (Practice Statement PS LA 2003/7).

³⁸ Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 2) 1998, paragraph 2.16.

FBT: multiple portable electronic devices

Policy

This concession which provides an FBT exemption for employers to provide employees with more than one work-related portable electronic device was aimed at reducing compliance costs and removing the confusion which existed where there is a function overlap between different products (such as between a tablet and a laptop).³⁹

- 4.38 The Board was unable to obtain reliable data on the utilisation of the concession, with feedback from stakeholders in consultation also being limited.
- 4.39 Based upon the operation of the concession and the previously mentioned commentary on the FBT compliance burden, the Board believes that the concession can perform a valuable function in reducing compliance costs, as well as assisting small businesses in attracting and retaining staff.

GST concessions

Policy

There are a number of concessions available to small business to assist in the administration of their GST obligations. These concessions are primarily aimed at reducing compliance costs for small business.⁴⁰

- 4.40 The Board considers that the suite of GST concessions⁴¹ perform an important function in reducing the compliance burden on small business, which meets the Board's guiding principles.
- 4.41 The importance of these concessions in reducing the compliance burden and providing certainty over cash flow is highlighted by the strong levels of utilisation. For example, data received from the ATO indicated that 2,280,000 entities accounted for GST on a cash basis and 110,000 entities paid GST by quarterly instalments in the 2015-16 income year.
- 4.42 Notwithstanding the limited feedback received on these concessions, the high level of take-up indicates that they continue to be a valuable concession for small businesses.

³⁹ Australian Government, Budget 2015/16, Budget paper No. 2; Explanatory Memorandum to the Tax Laws Amendment (Small Business Measures No. 3) Bill 2015, chapter 3.

⁴⁰ Explanatory memorandum to A New Tax System (Goods and Services Tax) Bill 1999; Taxation Laws Amendment Bill (No. 3) 2001; Costello, P (Treasurer) 2001, *Streamlined GST and PAYG reporting*, media release, 22 February.

⁴¹ The GST concessions for small businesses include: accounting for GST on a cash basis, paying GST by instalments, and annual apportionment of GST input tax credits.

Small business excise concession

Policy

Small businesses are provided a concession to defer settlement of excise duty and excise equivalent customs duty on a monthly basis rather than weekly. This aims to reduce the compliance burden for small business by reducing the number of payments from four per month to one.⁴²

4.43 Limited data from the ATO demonstrated that for the month of December 2018, this concession was utilised by 700 entities. Despite the limited feedback received by the Board regarding this concession, the Board believes that, for those users of the concession, having a longer cycle to settle their excise duty will have the benefits of lowering their compliance costs, assist with cash flow management and ensure small business can continue to focus on their core business activities.

Allocation of small business tax concessions

4.44 In reviewing the small business tax concessions, the Board considers that it is important to take a holistic view of all the available concessions. This approach can provide a better understanding as to whether the current allocation of concessions is appropriate across the various growth stages of a small business. The Board believes that the small business life cycle approach provides a meaningful way to think about concessions and the way in which concessions should be targeted in order to meet the specific challenges or opportunities which present themselves at different stages of the life cycle.

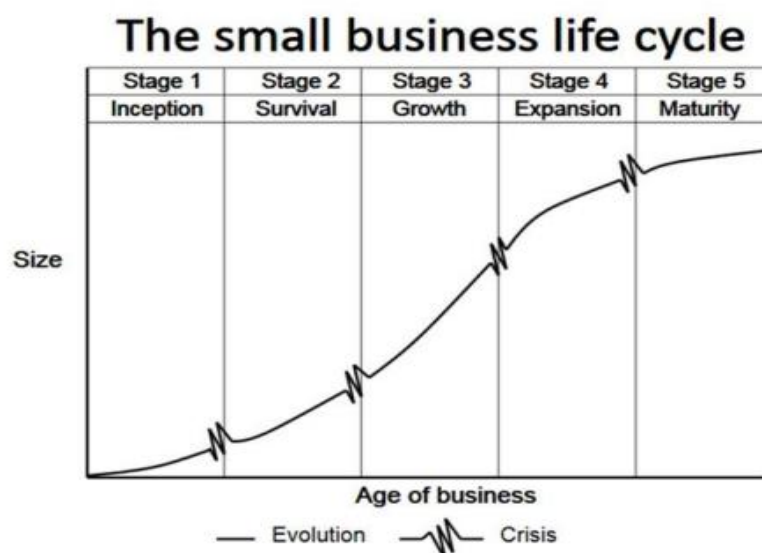
4.45 The business life cycle approach recognises that businesses pass through various growth stages, with each stage having its own distinctive and unique characteristics. Specifically for small businesses, they will typically move through five growth stages: Inception; Survival; Growth; Expansion; Maturity (refer Figure 4.1).⁴³ The needs and requirements for small businesses will differ depending on which stage of the life cycle the business is in. For example, small businesses in the inception stage will require cash and access to capital markets, whilst a small business in the maturity stage will be focused on succession planning. Add to this the various crises that a small business will encounter during its life cycle, it becomes evident that formulating tax concessions without

⁴² Dutton, P (Minister for Revenue and the Assistant Treasurer) 2007, 'Excise – reducing compliance costs for businesses', media release, 8 May, Canberra; Explanatory Memorandum to the Excise Amendment (Reducing business compliance burden) Bill 2011, chapter 1.

⁴³ The Board has adopted for this review the growth model as developed by Mel Scott and Richard Bruce, 'Five Stages of Growth in Small Business' (1987) 20(3) Long Range Planning, 45. The advantages of this model are that it identifies where crises are likely to occur, major strategies that should be considered at each stage, and the fiscal needs of the enterprise: see Pizzacalla, B.M., *Developing a Better Regime for the Preferential Taxation of Small Business*, PhD Thesis, Monash University, 2014, pp 111-112.

understanding the evolving needs of small business at each growth stage will lead to concessions that are more likely to be poorly targeted and less effective.

Figure 4.1 – The small business life cycle



4.46 From this life cycle perspective, the Board has been able to map the concessions against the various growth stages of small business. Further supporting the Board's review on the allocation of concessions, information was also drawn from the 2018 Tax Benchmark and Variation Statement to determine the amount of revenue foregone by the Government for each concession. This is outlined in Table 4.1.

Table 4.1 – Stages of business life cycle and Tax Benchmark and Variation Statement 2018 – for 2017-18

Concession	Life cycle stage	Estimated revenue foregone (\$m) ⁴⁴
CGT concession – 15 year exemption	Maturity	470
CGT concession – Small business 50 per cent reduction	Maturity	960
CGT concession – Retirement exemption	Maturity	580
CGT concession – Small business roll-over	Maturity	380

⁴⁴ * Refers to an estimate not being available due to insufficient data to produce a reliable estimate or otherwise was not included in the Tax Benchmark and Variation Statement (The Treasury 2019, 'Tax Benchmarks and Variations Statement 2018', Canberra).

Unincorporated tax discount	All	350
Immediate deduction for professional expenses	Inception/Survival	10
IAWO and simplified depreciation rules	All	500
Simplified trading stock rules	All	*
SBRR	Inception/ Survival/Growth	20
FBT: employee car parking exemption	All	*
FBT: multiple portable electronic devices	All	*
Immediate deduction for prepaid expenditure	All	*
PAYG: instalments based on GDP-adjusted notional tax	All	*
Small business excise concession	All	*
Accounting for GST on a cash basis	All	*
Apportionment of input tax credits for private use	All	*
Pay GST by quarterly instalments	All	*
Two-year amendment period	All	*

4.47 Through this exercise, it has become evident that tax concessions for small business have largely been designed without appropriate consideration for the small business life cycle. For example, many are weighted to established or mature businesses or those otherwise closer to the end of the business life cycle.⁴⁵ This is in contrast to the more limited relief that is available at the inception and survival stages. As outlined in Chapter Three, the small business sector comprises a diverse range of businesses in different industries with different growth patterns, needs and requirements. By formulating tax concessions without reference to the small business life cycle, they may not necessarily be efficiently targeted to where the support is needed the most.

4.48 Stakeholders echoed the Board's concerns with the distribution of small business tax concessions. Consultation participants highlighted that concessions such as the simplified depreciation rules and the IAWO can assist those small businesses that are profitable but have limited utility for those businesses needing support through the

⁴⁵ To some extent, the allocation of concessions towards the end of the business life cycle appears to be a deliberate policy choice, largely because the CGT concessions can be perceived as a proxy for the superannuation of small business owners.

inception stage which have limited assessable income to offset such deductions. They advocated for a better allocation of the tax concessions, particularly in the earlier years of trade, to support entrepreneurial risk-taking and encourage innovation. Some called for cash rebates to assist with start-up expenses and the cost of financial and management advice. Others called for hiring incentives and business education tax offsets.

- 4.49 The Board believes that support for newer businesses at the inception and survival stages of the business life cycle is warranted. Newer businesses have a high rate of failure and, arguably, require a higher level of support than established or mature businesses. Without a supportive environment for new businesses, individuals may be discouraged from entering the small business sector.
- 4.50 Throughout this report, the Board recommends a number of significant reforms to the existing concessions in an attempt to achieve a better balance of concessionary relief across the business life cycle. The key to this approach is the Board's recommendations in relation to the small business CGT concessions (refer Chapter Five). The recommendations, if adopted, may generate savings that can be redirected in targeted ways to help small businesses in the earlier stages of the life cycle, such as improvements to the depreciation rules and the introduction of the loss carry-back (refer Chapter Eight).
- 4.51 However, it should be emphasised that tax concessions, while they perform a useful function in levelling the playing field or reducing compliance costs, are not always the most appropriate policy lever. In particular, tax concessions can be of limited use in helping small businesses at the inception and survival stages where they are yet to generate taxable profits. The needs and requirements of these small businesses may be more appropriately supported by assistance outside of the tax system. For example, the Board observes that the \$2 billion Australian Business Securitisation Fund was recently announced to assist small businesses with better access to finance.⁴⁶ A number of business grants and subsidies also exist to help small businesses in the challenges they face including wage subsidies provided to employers with financial incentives of up to \$10,000 to hire and retain eligible job seekers.⁴⁷
- 4.52 One key area where the Board believes more could be done for businesses at the inception and survival stages of growth is in relation to business education. Small business owners are very aware that they need to continuously update their knowledge and are always looking for better ways of accessing timely, high quality training in business administration, cash flow management, and business essentials. The Board is of the view that more educational services targeted at the crucial first few years of

⁴⁶ Frydenberg, J (Treasurer) 2019, *Legislation introduced to establish \$2 billion securitisation fund*, joint media release, 13 February.

⁴⁷ Australian Government 2018, *Wage subsidies*, <www.business.gov.au/assistance/wage-subsidies>.

operation should be provided to help small business owners develop business acumen in the areas vital to the operation of a successful and compliant business (refer Chapter Eight).

CHAPTER 5: SIMPLER, FAIRER, SUSTAINABLE CGT CONCESSIONS

KEY POINTS

- The small business CGT concessions are among the most significant tax concessions available for small businesses to access and, consequently, are highly valued by small business stakeholders.
- However, the Board believes that there are a number of concerns with the concessions – they are complex and costly to comply with, they can distort business decision-making, and they are not always well targeted.
- Available ATO data on the up-take of small business CGT concessions also raises questions as to the long-term sustainability of the current regime.
- The Board has identified a reform pathway designed to make small business CGT concessions simpler, fairer and more sustainable. The Board recommends:
 - integrating the eligibility criteria with the SBE regime by raising the aggregated turnover threshold to \$10 million per annum;
 - repealing the maximum net asset value test (net asset test), thereby having a single eligibility gateway; and
 - collapsing the 15-year exemption, active asset reduction and retirement exemption, and replacing them with one CGT exemption subject to a cap.

Introduction

- 5.1 The small business CGT concessions occupy a central role in Australia's concessionary tax regime for small businesses. They are among the concessions most valued by small business stakeholders and represent one of the largest commitments of Government expenditures.
- 5.2 However, the concessions have been the subject of criticism by policy-makers, commentators, tax advisers and small business owners. The most common complaint from end users relates to their complexity, particularly the rules on eligibility. However, other observers have suggested that the concessions lack a coherent policy, are not always well targeted and are becoming increasingly unsustainable from a government revenue perspective. The Board considers that reforms to the small business CGT concessions should be a Government priority.

What are the concessions?

5.3 The small business CGT concessions are a package or 'suite' of four different concessions which enable small business owners to defer, or reduce to nil, any capital gains that would otherwise arise from the disposal of small business assets. There are complex rules regarding who is eligible, what assets qualify for relief, and what types of relief are available when the eligibility criteria are satisfied.

Who is eligible?

5.4 Broadly, the concessions are available to entities with either:

- net assets of no more than \$6 million (the 'maximum net asset value test', hereinafter referred to as the net asset test); or
- annual turnover of less than \$2 million and carry on a business (SBE test).

5.5 Both tests apply on an aggregated basis, meaning that the net assets or annual turnover of 'connected' entities and 'affiliates' (entities taken to be under the taxpayer's control or influence) are required to be taken into account when determining eligibility for the concessions.

5.6 Generally, to be connected, one entity must have a control percentage of 40 per cent of the other entity, or otherwise both must be 40 per cent controlled by a common entity.⁴⁸ The affiliate rule is a more subjective test that applies only to individuals or companies that act in concert with, or according to the directions or wishes of, another entity.⁴⁹

5.7 The net asset test and SBE test are hard cut-off thresholds, meaning that access to the concessions is lost entirely if the threshold is exceeded, even if by a negligible amount.

What assets qualify?

5.8 Small business concessions are broadly available on the disposal of 'active assets', meaning assets used or held ready for use in carrying on business or intangible assets (such as goodwill) that are 'inherently connected' with a business. Ownership interests in resident companies and trusts are also taken to be active assets provided certain additional criteria are met, including whether the company or trust has at least 80 per cent active assets by value.

⁴⁸ There are special rules in relation to when an entity has control over a discretionary trust; sections 328-125(3)-(5) of the ITAA 1997.

⁴⁹ The Board understands that, in practice, the affiliate test is applied to other entities, including trusts. Section 328-130 of the ITAA 1997 is structured such that 'an individual or company is an affiliate of *'yours'*'. Importantly, the term 'yours' is not restricted.

- 5.9 Relief is also available where an asset is held 'passively' by an entity in a small business structure but is used in an active business carried on by another related group entity. This ensures that the concessions are also available where, for example, a family group holds its farm land in a separate family trust which then leases the property to the operating entity within the group.

The four concessions

- 5.10 Three of the concessions provide a CGT exemption (the exempting concessions), while the fourth concession is an asset roll-over that defers capital gains.
- 5.11 Where the eligibility criteria are satisfied, the most valuable concession is the 15-year exemption, which provides a complete CGT exemption on the disposal of assets held for at least 15 years when the disposal relates to the actual retirement of an individual who is over 55 years of age.
- 5.12 Where the 15-year exemption is not available, eligible taxpayers may instead access a combination of the two further exemptions and the asset roll-over which operate cumulatively and can be applied in the order chosen by the entity. Typically, these concessions operate to provide relief of between 50 to 100 per cent of the capital gain, depending on the taxpayer's circumstances.
- 5.13 The additional exempting concessions are:
- a 50 per cent active asset reduction which reduces capital gains by a further 50 per cent after application of the general 50 per cent CGT discount (where available); and
 - a retirement exemption which exempts capital gains of up to \$500,000 and which does not require the small business owner to actually retire.
- 5.14 The asset roll-over provides CGT relief when a small business taxpayer disposes of some or all of the active assets and acquires replacement assets within a two-year period.

Rationale for the concessions

- 5.15 During the course of the review, the Board considered the policy rationale behind the small business CGT concessions. The conventional policy justification focuses on addressing two key areas. First, the concessions were meant to improve retirement outcomes for small business owners who, being typically cash-constrained, tend to invest any surplus funds back into their business, treating it effectively as their

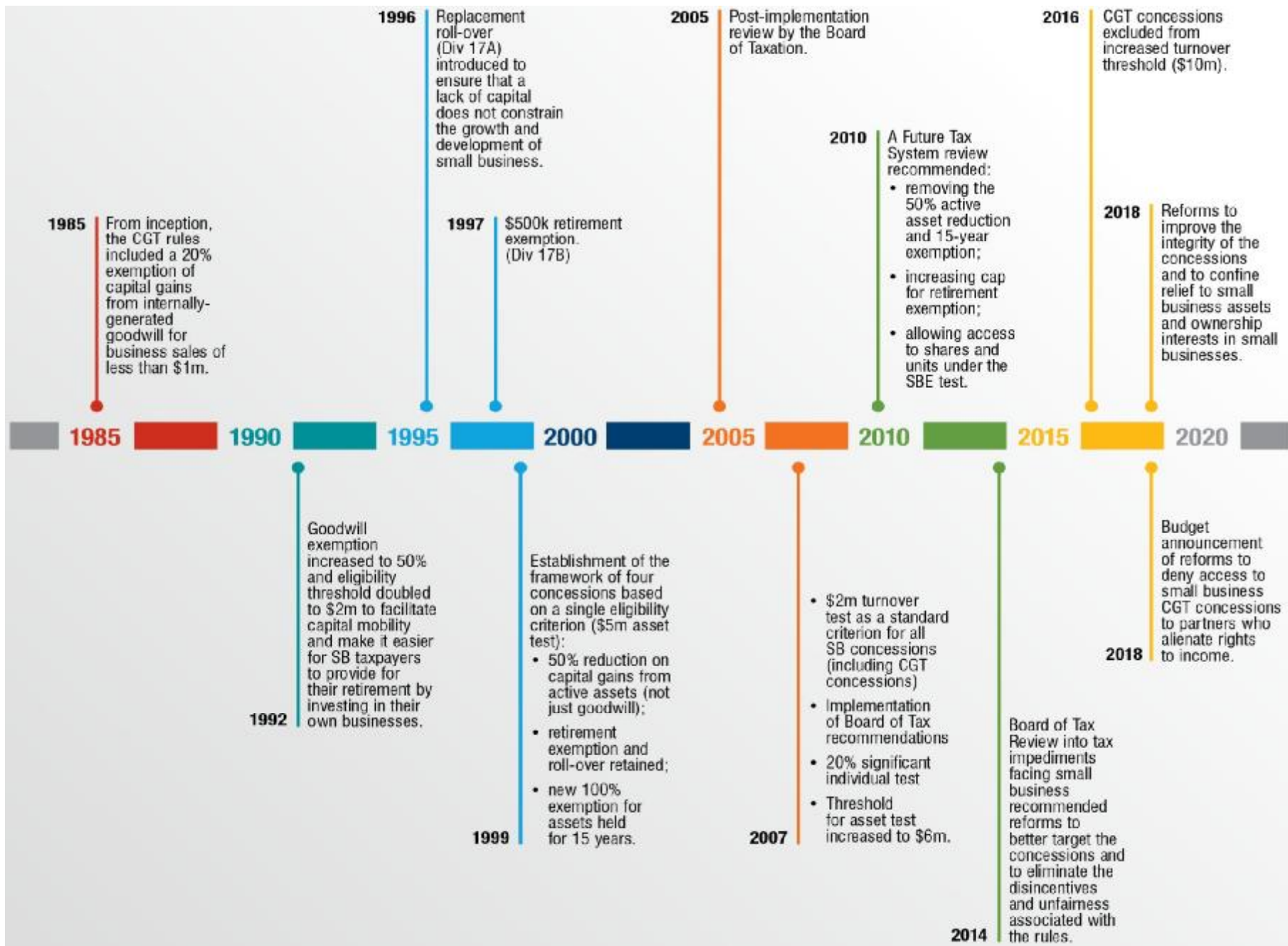
retirement 'nest egg'. In other words, this reflected the view that for many people, small business has been the way that they have saved for their retirement.⁵⁰

- 5.16 Second, the concessions were meant to 'ensure that a lack of capital does not constrain the growth and development of small business.'⁵¹ This is mainly achieved by the replacement asset roll-over which enables businesses to defer capital gains when appreciating assets are sold and replaced within two years. For example, this concession would benefit a business owner wishing to defer the capital gain from selling the business premises as part of a relocation.
- 5.17 However, the Board considers that these policy statements explain only part of the story. The concessions have evolved in their current form over a period of more than three decades. Their first incarnation was in the form of a 20 per cent exemption on gains arising from internally-generated goodwill. In the intervening decades, the concessions have expanded markedly and opened up in ways which make it difficult to reconcile with the conventional policy justification for the concessions and their emphasis on facilitating retirement savings (refer Figure 5.1 for the evolution of the small business CGT concessions).
- 5.18 To understand the complete story, it is necessary to draw inferences based on a close observation of the regime as it has operated in practice over the years. To that end, the Board has considered the implications of significant legislative changes made to the concessions in 2007, reviewed ATO data, and consulted with stakeholders across the country.

⁵⁰ Taxation Laws Amendment Bill (No. 3) 1997, Second Reading Speech, 16 June.

⁵¹ Explanatory Memorandum to Taxation Laws Amendment Bill (No. 1) 1997, paragraph 7.5.

Figure 5.1 – Evolution of the small business CGT concessions



The concessions in practice

- 5.19 Historically, access to the small business CGT concessions had only been possible through the net asset test (in one form or another), which is essentially a wealth test, applying broadly to all CGT assets, subject to certain specific exclusions.⁵² In 2007, the SBE test was introduced as an alternative way of accessing the concessions. By contrast, the SBE test is based on a business' aggregated turnover and does not take account of *non-business* wealth.
- 5.20 Put simply, the implication of introducing the SBE test was to make the concessions available to small business owners irrespective of their wealth position and, therefore, including low turnover, asset rich businesses that did not previously qualify. Such businesses would include established businesses, such as farming businesses using very valuable land or new start-up businesses which, although valuable, have not yet begun to generate significant annual turnover. As the data below demonstrates, because the concessions are uncapped, this change has had significant implications in that it has enabled much larger gains to be sheltered than was previously possible.⁵³
- 5.21 The introduction of the SBE regime was also accompanied by a relaxation of the grouping rules for determining which turnover or assets are counted towards the relevant thresholds. In particular, under the changed definition of 'affiliate', spouses and minor children are no longer automatically affiliated, and can never be affiliates unless they independently carry on business themselves.⁵⁴ This change means that spouses may conduct independent small businesses without being subject to the grouping rules, irrespective of their wealth.
- 5.22 The combination of these changes has led some commentators to infer that the CGT concessions do more than merely provide security in retirement for small business owners or encourage growth. In this regard, the Board in its 2014 review into small business tax impediments, saw a legitimate role for the small business CGT concessions in promoting entrepreneurial risk-taking, when it observed that:

“Small businesses are often exposed to greater risk than larger businesses, and there is an argument that, to compensate for this risk-taking, successful small business

⁵² The assets that are disregarded in the application of the net asset test are, broadly, personal use assets, the taxpayer's main residence, rights relating to superannuation funds and life insurance policies: paragraph 152-20 (2)(b) of the ITAA 1997.

⁵³ For example, under the net asset test, a taxpayer with net assets above \$6 million is not eligible for the concessions. In this way, the net asset test provides for a 'natural' cap in relation to eligibility. No such limitation exists under the SBE test because if the taxpayer satisfies the requirements, all of the capital gains may be sheltered.

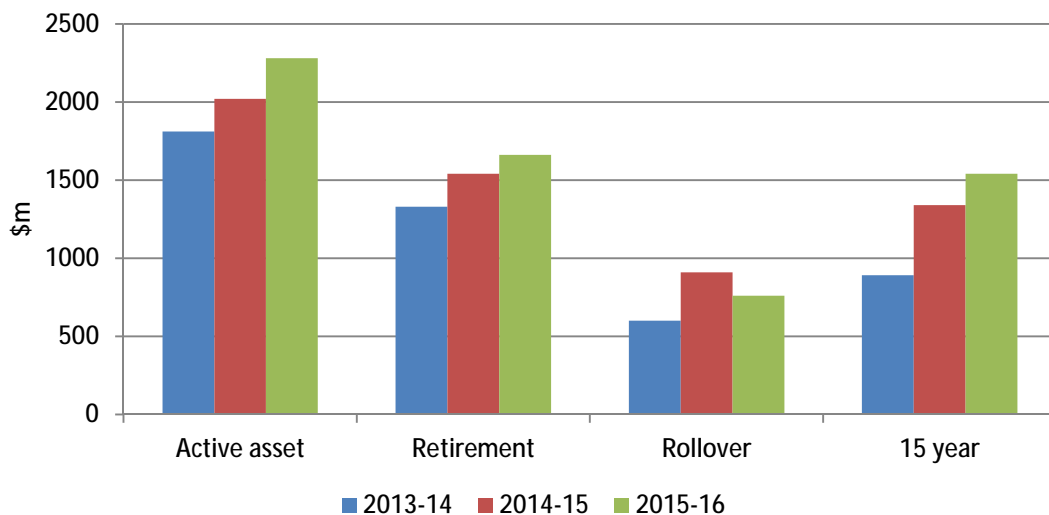
⁵⁴ In some circumstances, spouses and children are deemed to be affiliates of a taxpayer. For example, when the spouse or child uses in their business assets that are owned by the taxpayer, the spouse or child is taken to be an affiliate of the taxpayer for the purposes of calculating the taxpayer's aggregated turnover or net assets. See section 152-47 of the ITAA 1997.

*people should be allowed to keep a larger proportion of the gains from selling a successful business.*⁵⁵

Lessons from the data

- 5.23 The Board commissioned data from the ATO in relation to the take-up of the concessions.⁵⁶ The ATO data provides relevant information in relation to the use of the concessions cross-referenced against a range of variables including; the size of the claim, age of recipients, whether claimants have superannuation savings, the wealth of claimants, and by industry sector.
- 5.24 The data highlighted that the size of the concessions claimed is substantial in absolute terms; \$6.2 billion of capital gains were sheltered in relation to the 2015-16 income year. The total dollar value of claims made under the concessions is growing at 16 per cent per annum over the three-year period 2013-14 to 2015-16, which is, arguably, an unsustainable rate (refer Figure 5.2).
- 5.25 The active asset exemption has the highest value of claims over the three-year period 2013-14 to 2015-16, growing at a rate of 12 per cent per annum. Figure 5.2 indicates the dollar amount of the concessions claimed per year over the period 2013-14 to 2015-16.

Figure 5.2 – Dollar amount of the concessions claimed by year

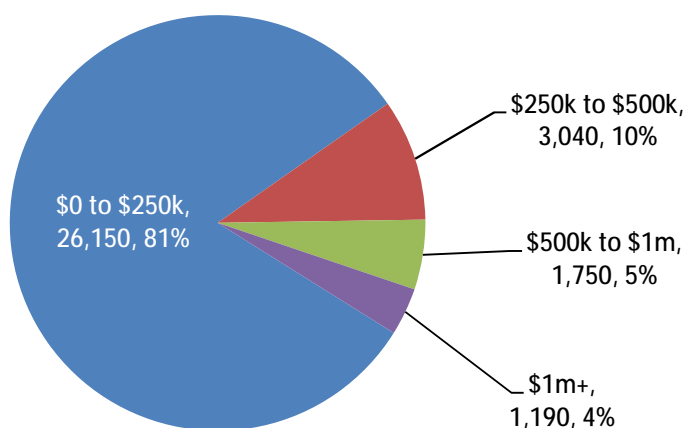


⁵⁵ Board of Taxation 2014, *Review of Tax Impediments Facing Small Business*, p. 68.

⁵⁶ The data provided in this report is based on information disclosed by taxpayers in their income tax returns and CGT schedule.

- 5.26 The concessions are one of the most significant tax concessions in terms of their cost to the revenue and account for a high proportion of total tax expenditures in relation to small business. In terms of revenue foregone, according to the Treasury's latest release of tax expenditures, the suite of CGT concessions for small business total \$2.5 billion in revenue foregone for the 2018-19 income year, increasing to around \$3 billion over the forward estimates period.⁵⁷ Treasury forecasts the revenue foregone under the active asset exemption alone is estimated to increase to \$1.25 billion in the 2021-22 income year.⁵⁸
- 5.27 The data shows that the large majority of claims by value (81 per cent) in income year 2015-16 were under \$250,000 as shown in Figure 5.3.

Figure 5.3 – Total number of claims by value in 2015-16

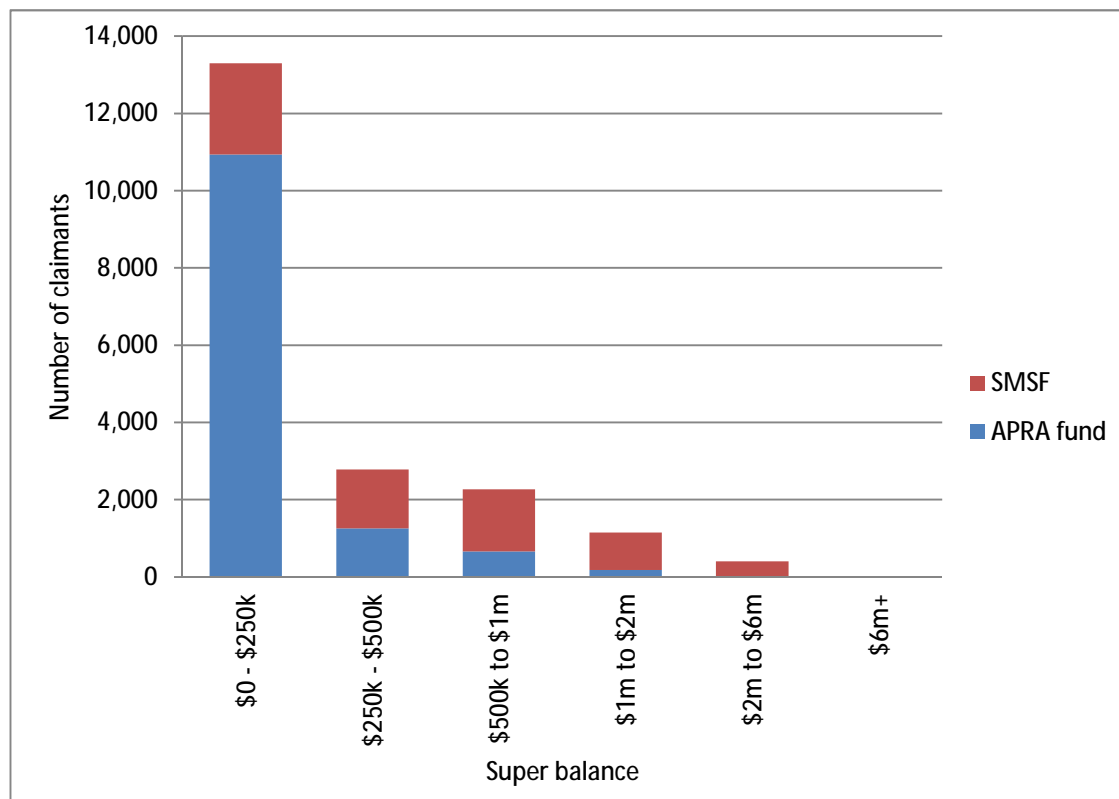


- 5.28 In relation to the age of claimants, the data indicated that around 45 per cent of the claims are being made by individuals aged 50 and over. This may be seen as inconsistent with the conventional policy rationale for the concessions, as a means of providing retirement support for self-employed business people. Figure 5.4 shows the majority of claimants (62 per cent) have access to retirement funds already, although most of them have \$250,000 or less in retirement funds.

⁵⁷ The Australian Government, The Treasury 2019, *Tax Benchmarks and Variations Statement*, Canberra.

⁵⁸ *Ibid*, page 117.

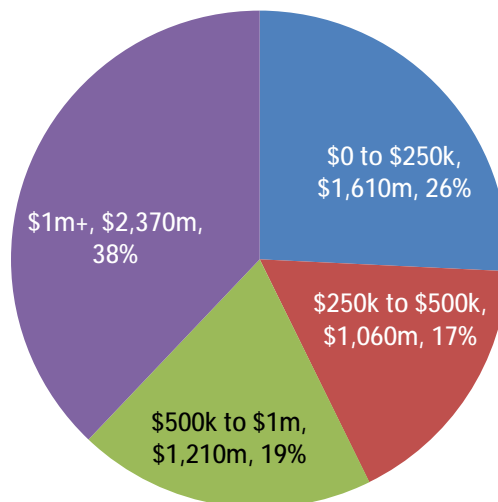
Figure 5.4 – Number of claimants in 2015-16 with access to retirement savings (by super balance and type of fund)



5.29 Prima facie, the picture that emerges is that the suite of concessions is delivering reasonably modest levels of assistance to a large number of small businesses. In this context, large claims are relatively rare, with claims over \$1 million accounting for only four per cent of all claims.

5.30 However, when the data is broken down by reference to the aggregate dollar value of claims made, a different picture emerges. Claims of \$1 million or more in income year 2015-16, while only representing four per cent of all claims (refer Figure 5.3), account for some 38 per cent (\$2.37 billion) of total amounts sheltered from tax by the concessions (refer Figure 5.5).

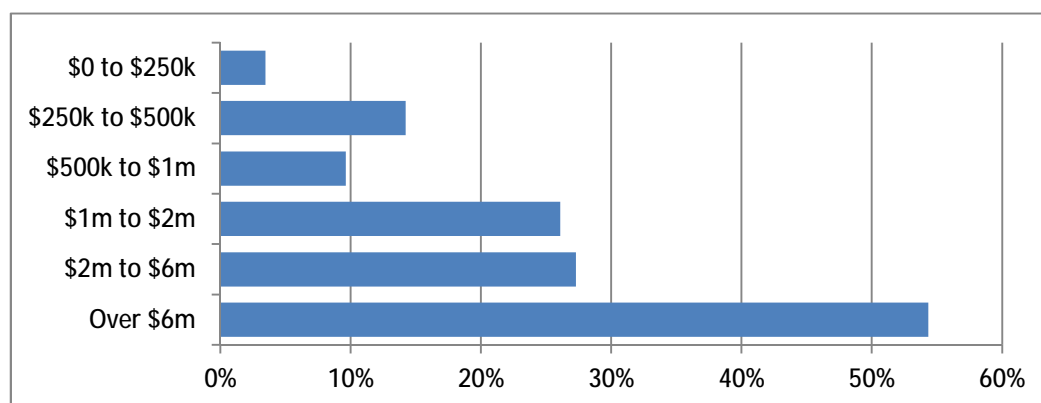
Figure 5.5 – Aggregate amount of concession claims, by size of claim in 2015-16



Total aggregate amount of concessions claimed (\$m)

- 5.31 The data shows that the CGT concessions have been accessed in relation to some very large capital gains. For example in the 2015-16 income year, there were 25 claims in relation to capital gains of between \$6 million and \$10 million and a further 15 claims on capital gains exceeding \$10 million, with an average of \$10 million per claim.
- 5.32 While there were very large claims in excess of \$20 million in the 2015-16 income year, these were not disclosed in the ATO data due to privacy considerations. However, in the prior income year (2014-15), just five claimants claimed concessions on capital gains of \$400 million – an average of \$80 million per claim.
- 5.33 While all claim sizes are growing over time, claims for capital gains of \$6 million or more appear to show the highest rate of growth in recent years, both in relation to the number of claims (from 15 in 2013-14 to 40 in 2015-16) and in the total value of those claims (from \$180 million in 2013-14 to \$400 million in 2015-16). As Figure 5.6 below indicates, the number of claims of \$6 million or more has an average growth rate of over 50 per cent per annum over the three-year period between 2013-14 and 2015-16.

Figure 5.6 - Average growth in the number of concession claims in the period 2013-14 to 2015-16



Stakeholder views

5.34 The small business CGT concessions figured prominently in the Board's discussions with stakeholders and were raised as being a particular concern by small business tax advisers. A consistent view expressed throughout the Board's consultations was that the concessions play a role in incentivising entrepreneurial activity in addition to providing for good retirement outcomes for small business. They also valued the concessions highly. However, overwhelmingly, stakeholders were highly critical of the operation of the small business CGT regime.

5.35 In summary, the views of stakeholders included:

- The provisions are extremely complex and difficult for most businesses to navigate without obtaining costly specialist advice.
- They are designed around alternative definitions of small business – \$2 million aggregated turnover and \$6 million net assets – which are arbitrary, and in the views of many, too low.
- The net asset test is a particular irritant – there is uncertainty as to its operation, a frequent cause of disputes and, in the views of some, no longer fit for purpose as a means of measuring the size of a business.
- The complexity of the provisions has created technical anomalies which operate to deny relief to some deserving taxpayers (such as when concessions available to companies become 'trapped' in the business structure).
- They can be inequitable because, for example, they lead to very different tax outcomes for businesses just below eligibility thresholds and those just above.

- They promote complex structuring and may, in some cases, discourage business growth by those who wish to avoid 'outgrowing' the concessions.

“...the policy intent for providing these concessions should be reviewed with a view to simplifying the rules and making them easier to apply and to ensure they operate to provide relief to small business owners as intended. In the process of simplifying them, consideration should be given to a broad range of options and all options should be fully explored.”

Stakeholder submission

The Board's Conclusions

- 5.36 Having regard to the foregoing, the Board considers that a CGT concessionary regime performs an important function for small business taxpayers. However, that function is not always straightforward. The Board is of the view that the current concessions are multi-purposed – they not only help business owners fund their retirement and facilitate business growth, but also incentivise entrepreneurial risk-taking.
- 5.37 The Board agrees with many stakeholders that the current system has a number of shortcomings. The alternative definitions of small business and their associated grouping rules are exceedingly complex and too confusing for most business owners (and indeed their advisers) to navigate. The concessions can also be inequitable, distort business decision making, and promote complex structuring.
- 5.38 As the data shows, the concessions can also operate to provide some businesses with benefits significantly in excess of what might be considered fair or appropriate for small business, particularly given the substantial increases in property values. Many of these claims do not relate to the goodwill or product of the business but rather the occupation of land in growth corridors. The quantum of these claims brings into question the credibility and sustainability of the concessions.
- 5.39 To increase confidence in the system, the Board considers that the current small business CGT regime requires significant reform.

The Board's approach to reform – simpler, fairer and more sustainable

- 5.40 The Board has identified an approach to reforming the small business CGT concessions based on the themes of simplicity, fairness and sustainability, which incorporates the following core elements:
- integrating the eligibility criteria with the SBE regime by raising the aggregated turnover threshold to \$10 million per annum;
 - repealing the maximum net asset value test (net asset test), thereby having a single eligibility gateway; and

- collapsing the 15-year exemption, active asset reduction and retirement exemption, and replacing them with one CGT exemption subject to a cap.

Aligning the aggregated turnover threshold

5.41 The \$2 million aggregated turnover threshold used for accessing the small business CGT concessions has been in place since 2007. Stakeholders believe that the threshold is now out-of-date, forcing businesses to incur significant compliance costs to determine whether they are eligible for the CGT concessions based on satisfying the alternative asset-based test. In addition, stakeholders stress that the lack of upwards movement on the threshold since 2007 has caused an increasing proportion of genuinely small businesses to miss out on the concessions altogether. They argue that the threshold should, at the very least, be increased.

“There is no doubt that the ‘price of growth’ can be high ... Overall, in our experience, the \$2m turnover threshold in today’s economy represents an ever diminishing segment of small business.”

Stakeholder submission

- 5.42 While the Board considered that a modest increase in the threshold would be appropriate, it believes an increase from \$2 million to \$10 million, together with other amendments noted above, provides the basis for significant reform in relation to these concessions by promoting simplicity and fairness for small business taxpayers.
- 5.43 As discussed in Chapter Three, raising the threshold will align the small business CGT concessions with the other SBE concessions in the tax system. The Board’s consultations highlighted that a simple, harmonised, and well understood threshold is important to small business.
- 5.44 A higher threshold will also reduce the number of small businesses that face compliance costs and barriers to growth because they are just above or just below the threshold. The Board notes that an entity that exceeds the threshold, even by a dollar, forfeits the CGT concessions altogether. In this context, the threshold is sometimes referred to as an eligibility ‘cliff’. The problem with eligibility cliffs is two-fold. First, they can be inequitable because businesses just above and just below the threshold, while being substantially equivalent, will have very different tax outcomes. Secondly, they can be distortionary, because they create incentives for businesses to stay on the ‘right side’ of the threshold either through tax planning or, in extreme cases, by encouraging business owners not to grow their business beyond the threshold to ensure that they do not lose out on having access to the concessions.
- 5.45 One method for dealing with the cliff effect is by providing a mechanism for concessions to be ‘tapered’ or ‘shaded out’ for businesses with aggregated turnover slightly above the threshold. A positive of such a mechanism is the reduction in the equity problems and distortionary influences of hard cut-offs by progressively reducing the benefits available by using a sliding scale. However, the Board considers having a tapered system

would significantly increase the level of complexity of the small business tax concessions and would not be reflective of the simplicity that is desired by small business owners.

- 5.46 The Board considers that a simple and inclusive definition of small business is a better way of responding to the cliff effect. Adopting the \$10 million threshold for the CGT concessions largely mitigates the issues that arise at the cliff due to the smaller number of businesses that are close to the higher threshold relative to the \$2 million threshold. For example, as demonstrated in Table 5.1, there are 188,600 businesses (or 7 per cent) with aggregated turnover between \$1 million and \$3 million. By contrast, there are only 6,300 businesses (or 0.2 per cent) with aggregated turnover between \$9 million and \$11 million.

Table 5.1 – Counts of aggregated turnover groups, by aggregated turnover for 2015-16

Aggregated turnover	Number
\$0 or \$1m	2,362,500
\$1m to \$2m	138,300
\$2m to \$3m	50,300
\$3m to \$4m	25,900
\$4m to \$5m	15,700
\$5m to \$6m	10,200
\$6m to \$7m	7,100
\$7m to \$8m	5,500
\$8m to \$9m	4,200
\$9m to \$10m	3,500
\$10m to \$11m	2,800
More than \$11m	27,700

- 5.47 In addition, the appropriate design of tax concessions should reduce the incentive for businesses to stay below the threshold, and instead encourage them to focus on growth. The advantage of a capped CGT exemption (outlined below) is that the benefit it provides, while very meaningful to businesses at the lower end of the aggregated turnover range, is far less likely to create adverse distortions at the upper end. In fact, the Board considers that for the 0.2 per cent of businesses that are close to the \$10 million threshold, a capped CGT exemption would have little effect on a business' aspirations for growth.
- 5.48 An alternative way of mitigating the hard cliffs is to differentiate between industries. This was the approach taken by the United States of America (refer Table 3.2 in Chapter Three). However, this approach is not supported by the Board as it further fragments

the small business definition, as well as being strongly opposed by stakeholders during consultations.

- 5.49 A further reason for aligning the threshold is that it will mean, in a practical sense, businesses at the lower end of the aggregated turnover range (i.e., around 99 per cent of businesses with an aggregated turnover below \$5 million) will not be required to navigate the complex grouping rules to work out whether, prima facie, they would be eligible to access the concessions. For many of these businesses, while it may not be immediately clear as to whether aggregated turnover is below \$2 million, it will be immediately self-evident that it is below \$10 million. Larger businesses at the higher end of the aggregated turnover range tend to be better equipped to navigate the rules and have better access to specialist advice needed to help them in this process. Admittedly, not all of these entities will be saved from the complexities associated with the grouping rules. For example, some businesses will need to demonstrate that entities are connected or affiliated in order to show that an asset used by a related entity is an active asset. However, this complexity will be less of a burden for these businesses as they will at least have the confidence that the \$10 million threshold has been satisfied.
- 5.50 A further benefit of aligning eligibility to the \$10 million threshold is that, based on the ATO data, many of the businesses that currently rely on the alternative net asset test should continue to qualify for the CGT concessions using the higher threshold if the net asset test is removed (further discussed below).

Removing the maximum net asset value test (net asset test)

- 5.51 The Board agrees with stakeholders that the net asset test is one of the more problematic aspects of the small business CGT concessions. The Board considers it to be the cause of significant complexity in the regime and involves a high compliance cost, often requiring expert valuations and complex matching of liabilities to specific business assets.
- 5.52 The net asset test is a frequent source of tax dispute. Indeed, the majority of cases that have proceeded to litigation with the ATO in relation to the small business CGT concessions concern the net asset test. This is mainly because it provides planning opportunities not only along the 'fringe' (close to the \$6 million threshold) but sometimes well above the threshold. For example, there have been cases in dispute before the courts that seek to claim that the value of an asset is less than \$6 million whilst the contract of sale for the asset was closer to \$9 million. The test is also structured to allow planning at both the asset side of the equation (by providing a market value approach for assets which may differ to sale price) as well as the liability side (by introducing liabilities into entities in order to lower the overall net value of a group). By contrast, planning opportunities available under the aggregated turnover test are more limited.

- 5.53 Problems with the net asset test also arise for so-called 'earnout arrangements'. These are arrangements in which a business or business assets are sold with a component of the purchase price contingent on the economic performance of the assets for a defined period after the sale (typically three to five years). Complicated rules govern how these payments are accounted for under the net asset test. These complicated rules may no longer be necessary if the net asset test is repealed, making the system simpler.
- 5.54 Additionally, the Board agrees with stakeholders who told us that the net asset test is no longer fit for purpose. The net asset test determines eligibility for concessions based on an imperfect measure of the aggregate wealth (including non-business wealth) of the business proprietor. For example, assets such as investment properties are included in the asset mix. As discussed in Chapter Three, the Board considers that access to the concessions is better determined by reference to business turnover.
- 5.55 The ATO data in Table 5.2 below indicates that there were 1,400 claimants in 2015-16 who failed the current \$2 million threshold but passed the alternative net asset test. Importantly, the vast majority (up to 1,300) of these will continue to maintain their access under the Board's proposal to increase the threshold, notwithstanding the removal of the net asset test.

Table 5.2 – Number of claimants who passed the asset test but failed the aggregated turnover test, in 2015-16

Aggregated turnover	no.
\$2m to \$5m	1,000
\$5m to \$10m	300
\$10m+	100
Total	1,400

Collapsing the 15-year exemption, active asset reduction and retirement exemption and replacing them with a single CGT exemption subject to a cap

- 5.56 The third component of the Board's proposal involves placing a 'cap' on the amount of relief available under the concessions. It is a critical component of the proposal for three reasons. It will eliminate what the Board considers as being inappropriate claims; it will ensure the longer term sustainability of the system; and critically, it will facilitate the increase in the aggregated turnover threshold to \$10 million per annum. In addition, it may also generate savings that could be redirected in targeted ways to assist small businesses in the inception, survival or growth phases of the business life cycle.
- 5.57 The Board has considered a number of different ways to cap the capital gains. Moving to a capped regime creates an opportunity to achieve further simplification benefits (in

addition to the primary benefits associated with raising the aggregated turnover threshold and repealing the net asset test). This is because the Board considers that implementing a cap would be best achieved by collapsing the three exempting concessions into a single, inclusive and straightforward concession. Doing so will streamline and simplify the current 'mix and match' approach, as well as eliminating some of the peculiarities that exist with the current suite of concessions.⁵⁹

- 5.58 Importantly, the Board does not propose to cap or change the replacement asset roll-over that exists as part of the current suite of CGT concessions. This is consistent with the conclusions reached in the report on *'Australia's Future Tax System: Report to the Treasurer'*.⁶⁰ Specifically, the Board considers that the tax liability relating to a capital gain reduces the amount of capital available to buy replacement business assets. The roll-over acknowledges this by allowing small businesses to reinvest the capital which would otherwise have attracted tax. This is designed to assist with the growth and development of small businesses.
- 5.59 The Board notes that the prominence of the asset roll-over in the broader concessionary framework may increase as a result of the proposed cap. This is because capital gains in excess of the cap may be rolled into replacement active assets.⁶¹

Summary

- 5.60 In summary, the adoption of the Board's approach will make the concessions simpler, fairer, and more sustainable by:
- allowing the eligibility criteria to be streamlined and opened up to more deserving small businesses;
 - delivering greater certainty to the vast majority of small businesses who will benefit from a 100 per cent exemption (up to a cap) and avoid the confusing 'mix and match' approach of the current regime;
 - removing the disincentive for businesses that are close to the current \$2 million CGT SBE aggregated turnover threshold to grow beyond that threshold;

⁵⁹ For example, market uncertainty exists with the requirement in the 15-year exemption that it be in '*connection with your retirement*', whilst the Retirement Exemption does not require retirement. Stakeholders are unclear about what constitutes retirement. Confusion also exists where entities with multiple CGT concession stakeholders apply the 15-year exemption, especially where one CGT concession stakeholder is less than 55 years of age and the others are older than 55. For example, this causes practical issues with trust distributions and taxpayers being forced to choose between the correct ordering of concessions.

⁶⁰ The Australian Government, The Treasury 2009, *Australia's Future Tax System: Report to the Treasurer*, Canberra, p. 81.

⁶¹ In this regard, the Board notes that there may be other impediments to using the small business roll-over. For example, where a vendor entity grants indemnities under a sale agreement, it may be preferable for replacement assets to be purchased by a different entity such as a newly-established shelf company. Currently, the roll-over cannot be accessed in these circumstances.

- generating savings that can be used to fund greater relief to small business entities at the earlier stages of the life cycle when they struggling to survive and grow;
- continuing to provide the same level of support to those businesses who are most reliant on the concessions for security in retirement;
- continuing to provide appropriate incentives for entrepreneurs in a measured way; and
- eliminating excessive claims that are incommensurate with what may be considered reasonable for small business.

Refer Table 5.3 for a comparison between the current law and the Board's proposal.

RECOMMENDATION 4

Reform the small business CGT concessions to make them simpler, fairer, and more sustainable, which would incorporate the following core elements:

- Integrating the eligibility criteria with the small business entity regime by raising the aggregated turnover threshold to \$10 million per annum; and
- Repealing the maximum net asset value test; and
- Collapsing the 15-year exemption, active asset reduction and retirement exemption, and replacing them with one CGT exemption subject to a cap.

Table 5.3 - Comparison of current law to the Board's recommended approach

Existing CGT Concessions				Board Proposal			
Eligibility \$2 million aggregated turnover or \$6 million maximum net asset value				Eligibility \$10 million aggregated turnover			
Concessions	Description	Limit	Extra Conditions	Concessions	Description	Limit	Extra Conditions
<i>15-year exemption</i>	Full exemption from tax on the disposal of active assets owned for at least 15 years.	Unlimited	<ul style="list-style-type: none"> The asset is owned for at least 15 years; and The taxpayer is 55 or over and the event happens in connection with their retirement. 	<i>Small Business CGT exemption</i>	100% exemption, up to a cap of capital gains on disposal of active assets.	Cap \$1-\$2m. Determined having regard to: <ul style="list-style-type: none"> Fiscal considerations; Policy setting; and Nature of the cap (lifetime or other limit). 	None specified. <i>* Additional Conditions will depend on policy choice as to whether younger claimants (e.g. under 55) should be required to pay CGT exempt amounts into superannuation.</i>
<i>50 per cent active asset reduction</i>	50% reduction (in addition to the general CGT discount) which effectively exempts 75% of capital gains on the disposal of active assets.	Unlimited	None				
<i>Retirement exemption</i>	Exempts \$500,000 of capital gains on the disposal of active assets.	\$500,000 lifetime limit	If the taxpayer is under 55 at the time of using the concession, the exempt amount must be contributed to a super account. <i>* No requirement for disposal to be in connection with retirement.</i>				
<i>Roll-over</i>	Defer capital gains made on the disposal of active assets where there is a replacement asset.	Unlimited	Must purchase a replacement asset, or make capital improvements to an existing asset, within two years.	<i>Roll-over</i> <i>*Unchanged</i>	Defer capital gains made on the disposal of active assets where there is a replacement asset	Unlimited	Must purchase a replacement asset, or make capital improvements to an existing asset, within two years.

Implementation Considerations

5.61 Moving to a capped regime for small business CGT concession involves a number of implementation considerations, including:

- At what dollar amount should the cap be set?
- Should the cap be applied over a taxpayer's lifetime or should it be limited in some other way?
- How, if at all, should the regime be integrated into the broader superannuation and retirement savings system?
- How should the cap apply to multiple business owners in respect of the same business?
- What transitional arrangements should be put in place?

5.62 Ultimately, these implementation decisions will depend on fiscal considerations, and more importantly, a policy choice by Government as to the most appropriate function that the proposed CGT exemption should have within the broader small business concessionary framework. As outlined earlier, the concessions have changed over a period of three decades, and now appear to serve a number of functions. The policy framework should be restated for the Board's proposed CGT exemption. The principal issue to be resolved is the relative importance of improving retirement outcomes for small business within the broader policy intent of the concessions. On this topic, the Board listened to a number of views. At one end of the spectrum is the view that the CGT concessions are primarily about retirement and, therefore, the proposed exemption should be fully integrated into the superannuation system. At the other end of the spectrum is the view that the concessions have significantly evolved such that they are, in essence, more about incentivising entrepreneurial activity. This view suggests that the proposed exemption should not be tied to retirement policy.

5.63 The Board is more inclined to take the view that the policy driver of the proposed CGT exemption should be to promote entrepreneurial activity, such that a young entrepreneur, for example, would not be required to pay the capital gain from the disposal of eligible assets into a superannuation fund. It should be noted that, under this approach, small business owners that are retiring will continue to have access to a larger after-tax pool of funds which they could use or invest in retirement however they choose. In this sense, the Board's proposed CGT exemption would still have a role in providing small business owners with financial security for their retirement.

5.64 The Board sets out below a number of observations in relation to the various approaches the Government could take. Importantly, the Board's main proposals above (to align the threshold, repeal the net asset test, and streamline the exemptions) can be implemented irrespective of which approach is taken.

A CGT exemption independent of the superannuation system

- 5.65 One option is to implement a capped small business CGT exemption that operates entirely independent of superannuation settings. This option would reflect the Board's preferred model, and acknowledges the view that the proposed CGT exemption should function more as an incentive for entrepreneurial activity.
- 5.66 The simplicity of this approach has obvious appeal. It provides the freedom for small business owners to reinvest their funds as they see fit, whether that be to reinvest into another business asset, superannuation, or some other investment. It minimises interactions with superannuation rules and avoids the inefficient 'lock-in' distortion of maintaining business assets until age-based tests are satisfied.

Integrating the small business CGT exemption into the superannuation system

- 5.67 The alternative option is to integrate the proposed CGT exemption into the superannuation system in the same (or similar) manner as the current retirement exemption does. Under this approach, an additional condition would be applied requiring an eligible taxpayer that is under 55 years of age (or otherwise a 'preservation age') to pay the exempt amount into a complying superannuation fund.
- 5.68 This option reflects the view that the proposed CGT exemption should maintain the conventional justification for the CGT concessions and recognise that small businesses use the equity in their business to fund their retirement. The Board notes that superannuation is just one pillar of three in Australia's retirement income settings; the others being voluntary savings supported by tax concessions as well as the Age Pension. Currently, there are no impediments to small business owners availing themselves of concessional contributions to a complying superannuation fund and also accessing CGT concessions at the end of the business life cycle.
- 5.69 The Board also considered whether, in addition to requiring exempt gains of small business owners under the age of 55 to be paid into a complying superannuation fund, that the amount of the eligible gain be linked in some way to superannuation fund balances. The Board cautions against this approach. First, it would require complex rules to determine how much of the concession is available for this purpose. Second, those small business owners who have managed their cash flows diligently and taken advantage of the concessional superannuation scheme, arguably, would be at a disadvantage as compared to those who rely solely on a windfall gain upon sale of their business.

Interaction of the CGT cap and the total super balance cap

- 5.70 Whichever policy option is adopted by government, a further consideration is the interaction of the existing lifetime CGT cap and the Total Superannuation Balance cap. For the 2018-19 income year, the lifetime CGT cap is \$1.48 million and indexed annually.

Currently, small business owners are able to make non-concessional contributions using this CGT cap over and above the \$1.6 million Total Superannuation Balance cap where the proceeds are from the use of the retirement exemption or the 15-year exemption. Whether this interaction remains appropriate requires further consideration as part of the implementation process.

What should the cap amount be?

5.71 The Board's approach requires a cap to be set. In this regard, the Board makes the following observations:

- The cap amount should have regard to the fact that the majority of claimants (96 per cent of small business owners) claimed concessions of under \$1 million in 2015-16 (refer Figure 5.3). The Board considers these claimants to be the 'mainstream' users of the concessions. Accordingly, the minimum amount of the cap should be \$1 million, as this would not impact the majority of current claimants.
- The upper limit of the cap amount should be low enough to eliminate what the Board considers to be excessive claims whilst also giving effect to the policy objectives. Excluding the 15-year exemption, a retiring small business owner would currently be able to eliminate entirely the CGT on gains up to \$2 million using the general CGT discount, the active asset reduction and the retirement exemption. ATO data indicates that, based on 2015-16 figures, additional tax would only be payable by around 330, or 1 per cent, of the 32,000 claimants. Accordingly, the Board considers that \$2 million should be the upper limit.
- Ultimately, the cap should have regard to fiscal considerations and the extent to which the Government wishes to generate savings that could be redirected in targeted ways to support small businesses in the earlier stages of the life cycle when they are seeking to establish themselves, survive and grow.

5.72 In the course of the Board's consultations, the superannuation system's 'Transfer balance cap' of \$1.6 million was suggested as a possible benchmark amount. The advantage of using that benchmark is that it is considered the appropriate level that balances sustainability of the system and retirement incentives.⁶² It would also provide for a mechanism for the cap to be periodically increased in line with inflation.⁶³ However, the Board notes that adoption of this cap may be problematic if the decision is made not to closely link the proposed exemption to superannuation.

⁶² Australian Government, Budget 2016 Superannuation Fact Sheet 02, *Introducing a \$1.6 million transfer balance cap*, p. 1.

⁶³ *Ibid*, 5.

Should there be a lifetime cap?

- 5.73 Further consideration should also be given as to whether the cap is a 'lifetime cap' or some other time-limited cap. A 'lifetime' cap may have the benefit of avoiding distortions in behaviour and manipulation of the system. For example, it may avoid opening up the tax planning opportunity of drip-feeding out capital gains from the sale of business assets over time. Lifetime caps may also be easier for the ATO to track and administer when exempt CGT amounts are paid into superannuation funds.
- 5.74 An alternative to a lifetime cap may be a rolling cap over, say, a five-year time period. Other regulatory frameworks use this approach. For example, a five-year rolling cap has been recently applied to enable members of self-managed superannuation funds to make 'carry forward' concessional super contributions.

Access by multiple business owners in respect of the same business

- 5.75 An existing feature of the small business CGT regime is that up to eight taxpayers who are 'CGT Concession Stakeholders' in a business (carried on by a company or a trust) may access the CGT concessions.⁶⁴ The concessions were extended to these taxpayers because they 'tend to have an active interest in running the business.'⁶⁵ A taxpayer is a CGT concession stakeholder if they own at least 20 per cent (a 'significant individual') of the company or trust, or are a spouse of a significant individual.
- 5.76 The concession stakeholder rules also allow interposed companies and trusts to access concessions where the concession stakeholders have a small business participation percentage in the company or trust of at least 90 per cent.
- 5.77 The Board considers that these taxpayers should maintain their access to the CGT concessions. However, there are two important implementation considerations that arise having regard to the Board's approach.
- 5.78 First, one of the effects of removing the net asset test is that it would deny CGT relief to these individuals on the disposal of their ownership interest because, generally, they are not carrying on a business in their own right⁶⁶ and, therefore, fail the first hurdle of the SBE test. The Board considers that this can be dealt with by removing the 'carrying on a business' requirement of the SBE test for such taxpayers. The Board notes that this

⁶⁴ In 2018, amendments were passed that ensure a CGT concession stakeholder can only access concessions on shares and units where the company or trust in which they are held satisfies either the net asset test or the SBE test in its own right. See *Treasury Laws Amendment (Tax Integrity and Other Measures) Act 2018*.

⁶⁵ Costello, P (Treasurer) 2006, 'Capital Gains Tax: Government response to the Board of Taxation's Report on the Post-Implementation Review of the Small Business CGT Concessions and Other Improvements', media release, Canberra, 9 May.

⁶⁶ Under the current law, access to concessions on shares and units through the aggregated turnover test is possible, but only where the shareholder or unitholder carries on a separate unrelated business. Such arbitrary requirements have encouraged some small business owners to find a way to conduct a separate small business themselves in order to pass the aggregated turnover test.

change would also implement a further recommendation made in *'Australia's Future Tax System: Report to the Treasurer'*, which was to *'allow[ing] taxpayers who sell a share in a company or an interest in a trust to access the concession via the turnover test'*.⁶⁷

- 5.79 The second implementation consideration is how the proposed CGT exemption will operate when a company or trust owned by CGT concession stakeholders disposes of the relevant active assets. In this regard, the Board considers that the existing 15-year exemption and the Retirement Exemption can be used as a model. The Board's proposed exemption would operate as a hybrid of the two, whereby the company or trust claims the exempt amount in proportion with the concession stakeholder's percentage interest⁶⁸ in the company or trust and up to the cap. That amount must then be paid to the individual. Accordingly, each concession stakeholder's CGT exemption would be limited by both the stakeholder's percentage ownership of the company or trust, as well as the individual's cap.

Transitional Arrangements

- 5.80 The Board's recommendations, if adopted, represent a significant change to the operation of the concessional small business CGT regime. However, the Board notes that under the proposed changes the majority of small businesses, particularly those who rely on the concessions for security in retirement, will be no worse off. Indeed, they will have better and more certain access without the need to obtain costly specialist advice.
- 5.81 Accordingly, the Board recommends that there be no transitional arrangements put in place and that the changes operate on a prospective basis for CGT events occurring on or after the date of announcement. This represents a clean break from the current provisions and avoids the inherent complexity of the usual 'phase-in' and 'grandfathering' approaches. However, having no transitional arrangements may be somewhat contentious and, accordingly, should be appropriately considered and managed.

Other Observations

- 5.82 The reforms recommended above address what the Board regards as the most pressing issues in relation to the operation of the concessions. Ideally, these reforms would be implemented as a package directed at ensuring that the small business CGT regime is simpler and fairer for the vast majority of small businesses, and more sustainable into the future.

⁶⁷ Recommendation 17 of The Australian Government, The Treasury, *Australia's Future Tax System: Report to the Treasurer*, December 2009, p. 86.

⁶⁸ This is referred to in the legislation as a 'small business participation percentage': section 152-65 of the ITAA 1997.

5.83 However, there are other issues that have come to the Board's attention during the course of this review. The Board considers that specific attention should be given by Government to the operation of the 'connected entity' and 'affiliate' tests in the grouping rules. The Board has not made recommendations on these rules because they are not confined to small business concessions – they also operate in other areas of the tax system, most notably the Base Rate Entity rules. Notwithstanding, based on stakeholder feedback, the Board makes its observations in relation to some of these matters below.

Aggregating indirect interests

5.84 An important issue identified by the Board during the course of this review relates to calculating the relevant ownership interests for the purposes of determining whether an entity is a 'connected entity'. The way that the rules are currently drafted means that not all indirect control interests are actually taken into account.⁶⁹ This is despite there being a clear intention for all indirect interests to be included. Accordingly, an otherwise controlling entity may be able to fragment that control by structuring their affairs so as to fall within the relevant thresholds (whether it be the \$10 million SBE test, or the \$50 million Base Rate Entity threshold) and the ability to access concessional treatment.

The affiliate test

5.85 During the course of the Board's consultations, stakeholders told the Board that they saw the affiliate rules⁷⁰ as being a particular irritant. An 'affiliate' is an individual or company who acts 'in accordance with the wishes of' or 'in concert with' an entity in relation to the affairs of the individual or company's business.

5.86 Consultations highlighted that, in many cases, whilst the affiliate rule does not apply to the taxpayer's circumstances, the process of navigating through the provisions to prove this conclusion can be a very complex and costly exercise. Even when taxpayers and their advisers are satisfied the test is met, it continues to be a source of uncertainty because it relies on subjective factors which can be open to interpretation. For example, whilst the test technically applies to individuals and companies, in practice, it has also been applied to other entities.⁷¹ In addition, concepts such as '*reasonably be expected to act*' and '*in concert with*' are difficult to apply in practice and lead to 'grey' positions being taken.

5.87 One stakeholder noted that, as a matter of practice, the affiliate rule is confined in its operation to close family relationships. He advocated for the removal of the affiliate test

⁶⁹ For ownership interests in companies and trusts, recent amendments have lowered this control percentage to 20 per cent when testing the object and downstream subsidiary entities (as defined).

⁷⁰ Section 328-130 of the ITAA 1997.

⁷¹ The section (namely section 328-100 of the ITAA 1997) is structured such that 'an individual or company is an affiliate of *yours*'. The term '*yours*' is not restricted.

and adopting instead a ‘close family group’ test under which the interests of spouses and dependent children are aggregated when applying the 40 per cent connected entity test.

“The affiliate definition is ... almost redundant and usually only catches family members as business relationships are generally ignored.”

Stakeholder submission

- 5.88 The affiliate rule can also distort business structuring, by creating an incentive for family businesses to maximise access to concessions by splitting ownership interests of less than 40 per cent between unaffiliated family members.
- 5.89 The Board believes there is merit in excluding entities in a purely business relationship from having to comply with the affiliate test. However, automatically grouping close family members may be more problematic as it could interfere with the policy that spouses can *independently* conduct a separate small business that separately qualifies for tax concessions.
- 5.90 A further complicating factor in identifying improvements to the affiliate provisions is that the rules can operate both adversely (by requiring turnover to be aggregated) and favourably (by extending concessions to certain passively-held assets used in a business carried on by an affiliate). Retaining the affiliate test, but exploring ways to confining it to close family members, may ensure that it continues to perform both of these functions.

A pro-rata grouping rule

- 5.91 The ‘connected entity’ tests in the grouping rules centre on the concept of ‘control’, creating an obvious ‘cliff’ effect. Put simply, a taxpayer with an interest of less than the prescribed control threshold of 40 per cent is not required to include any part of the other entity’s turnover. However, where the interest is 40 per cent or more, the grouping rules generally require a taxpayer to include 100 per cent of the other entity’s turnover as part of the SBE aggregated turnover calculation.⁷²
- 5.92 It was suggested that the grouping rules may deny access to some deserving small businesses by requiring a controlling owner to group an entity’s entire turnover even where it is owned by unrelated parties. For example, a collaborative business venture where two unrelated parties own 50 per cent of the shares in a company are required to individually aggregate all of the company’s turnover when determining whether they each qualify for the small business CGT concessions. Some stakeholders viewed this

⁷² Taxpayers may seek the Commissioner’s discretion to confirm whether or not there is a controlling percentage where their interests in the entity are between 40 per cent and 50 per cent (refer subsection 328-125(6) of the ITAA 1997).

approach as not appropriately reflecting the ownership interest an individual may have in a small business.

- 5.93 The grouping rules can also distort business structuring, by creating an incentive for family businesses to maximise access to the concessions by splitting ownership interests of less than 40 per cent between unaffiliated family members.
- 5.94 As the Board observed in its 2014 *Review of Tax Impediments Facing Small Business*, the concessions might be significantly better targeted and less open to abuse if grouping rules were modified to ensure that turnover in controlled entities is based on a pro-rata calculation. Whilst this would provide for a fairer reflection of the 'business wealth' controlled by the taxpayer, the Board notes that this is a wider reform issue.

RECOMMENDATION 5

On the basis that Recommendation 4 is implemented, contemporaneous reforms should be considered in relation to:

- improving the operation of the grouping rules; and
- addressing any anomalies and integrity issues that are not addressed by other recommendations.

CHAPTER 6: RE-EXAMINE THE UNINCORPORATED SMALL BUSINESS TAX DISCOUNT

KEY POINTS

- The unincorporated small business tax discount is an important concession as it promotes greater neutrality between business structures by providing unincorporated businesses with benefits akin to those afforded to companies that are eligible for corporate tax rate reductions.
- However, in the Board's view, the discount suffers from three major issues:
 - It has a low profile because, for most claimants, the amount of the concession available is too low to make a meaningful impact.
 - It does not necessarily encourage small business owners to reinvest the funds into their business, particularly those operating out of trust structures.
 - It is not well-targeted because the amount of relief available varies widely depending on the business structure.
- The Board considers that the issues identified in relation to the discount are significant and should be addressed either by replacing the discount with an alternative program targeted at the unincorporated sector or by making legislative improvements to the existing regime.
- The Board has identified certain areas of concern that, if the discount is maintained, would need to be addressed in order for this concession to better achieve its intended policy objectives.

- 6.1 The unincorporated small business tax discount (the tax discount) was introduced in the 2015-16 Budget. The rationale behind the concession was to provide for a reduction in the tax payable by unincorporated small businesses that were not eligible to access the small business corporate tax rate, as they were not operating out of a company

structure. This concession provides a tax benefit of up to \$1,000 to the more than 70 per cent of small businesses⁷³ that operate as unincorporated businesses.

What is the unincorporated small business tax discount?

- 6.2 The tax discount is a non-refundable tax offset calculated at eight per cent of the tax payable on the business income of an unincorporated business, and capped at \$1,000 per individual taxpayer. The discount rate is set to increase in line with the cuts to the corporate tax rate, albeit with the \$1,000 cap remaining in place. The offset is worked out based on the proportion of tax payable that is related to business income.
- 6.3 The tax discount was originally estimated to cost \$550 million in the 2016-17 income year rising to \$650 million in 2018-19.⁷⁴ However, the most recent 2018 Tax Benchmarks and Variations Statement has reduced these estimates significantly (refer Table 6.1).

Table 6.1 - Tax Benchmarks and Variations Statement: B59 Unincorporated small business tax discount (\$m)

2014-15	2015-16	2016-17	2017-18	2018-19	2020-21	2019-20	2020-21
-	-	250	350	350	350	400	500

Who is eligible?

- 6.4 To be eligible for the offset, an individual must be carrying on a business as a sole trader, or have a share of net small business income from a partnership or trust. The small business must have an aggregated turnover of less than \$5 million for the 2016-17 income year onwards.
- 6.5 Importantly, an individual who is a partner or beneficiary is entitled to the discount at the same rate and using the same \$1,000 cap as a sole trader. This effectively means that partnerships and trusts can deliver a separate benefit of up to \$1,000 to multiple individuals.
- 6.6 More specifically, in relation to trusts, whilst the discount is available to an individual beneficiary that has a share of net small business income from a trust, an individual cannot claim the discount on distributions from a trust that is interposed between the trust and the active business entity. Accordingly, an unincorporated business structured as a partnership of trusts would not qualify for the discount. Similarly, the tax discount cannot be claimed by a beneficiary who receives a distribution that has passed through a 'chain' of two or more trusts.

⁷³ Australian Government, *Tax discount for unincorporated businesses*, <http://www.budget.gov.au/2015/16/content/glossy/sml_bus/html/sml_bus-07.htm>.

⁷⁴ Explanatory Memorandum to the Tax Laws Amendment (Small Business Measures No. 3) Bill 2015, p. 7.

Comparison with lower company tax rates for small business

- 6.7 When originally legislated, the tax discount was designed to be broadly in line with the 1.5 per cent tax cut for small business companies. Accordingly, subsequent changes to the small business company tax rate have been (or are proposed to be) accompanied by corresponding increases to the tax discount rate. These changes are summarised in Table 6.2.

Table 6.2 – Progressive decrease in company tax rate and mirroring increases to the unincorporated small business tax discount

Year	2019	2020	2021	2022-2027
Company tax rate	27.5 per cent	27.5 per cent	26 per cent	25 per cent
Unincorporated tax discount	8 per cent	8 per cent	13 per cent	16 per cent

- 6.8 Importantly, the changes to the rate of the tax discount will not be accompanied by corresponding increases to the cap. That is, the cap will remain at \$1,000.
- 6.9 The practical effect of increasing the percentage discount without increasing the cap is to lower the amount of taxable income required to reach the maximum \$1,000 benefit. This means that individuals who already qualify for the maximum discount at the lower rate will not benefit from the percentage increase.

Rationale

- 6.10 The tax discount is designed to provide owners of unincorporated small businesses with a tax benefit that broadly mirrors company tax rate reductions available to small companies, on the basis that *'all small businesses are entitled to a tax cut, irrespective of how they are structured'*.⁷⁵
- 6.11 By reducing their tax burden, the rationale is to enable eligible small business owners to have *'money back in [their] hands'* to enable them to *'reinvest to grow their business and employ staff'*.⁷⁶ Notwithstanding, however, the discount does not require the recipient to apply the funds to a business purpose in order to qualify.

⁷⁵ Commonwealth, *Parliamentary Debates*, House of Representatives, 24 June 2015, 7373, Bruce Billson, Minister for Small Business.

⁷⁶ Australian Government, *Tax discount for unincorporated businesses*, <http://www.budget.gov.au/2015-16/content/glossy/sml_bus/html/sml_bus-07.htm>.

6.12 At the time of its introduction, the government acknowledged that small businesses play a significant role in the Australian economy. The Explanatory Memorandum outlined that:⁷⁷

- 70 per cent of small businesses are not companies and would not benefit from a company tax cut.
- Providing a tax discount for unincorporated small businesses, which broadly mirrors the small company tax cut, will help to improve the cash flow of small businesses by reducing the amount of tax payable in the income year, and help to alleviate the problem of higher regulatory costs.
- The tax discount will result in unincorporated small business owners having higher after-tax earnings which they can reinvest in their businesses. To the extent this occurs, it will tend to increase growth and productivity in the small business sector.

Stakeholder views

6.13 Feedback to the Board through consultations suggests that the tax discount has not had as positive an impact in the small business sector as might have been originally expected. During the Board's consultation process, it was clear that small business owners had little or no awareness of the tax discount relative to their awareness of the lower company tax rate and the IAWO concession.

6.14 Advisers were aware of the tax discount but believed that the \$1,000 cap meant that the concession was too low to make any meaningful difference to their clients. However, some advisers noted that the concession could represent a more substantial benefit for trading trusts that, depending on their circumstances, might be able to deliver a separate \$1,000 benefit to numerous beneficiaries from a single trading business.

“[The unincorporated small business tax discount] seems like a token to match incorporated businesses. We are not sure it receives the positive response that it should or could. The tax discount could be better positioned as equal to the company rate reduction [to] match the same tax outcome.”

Stakeholder submission

6.15 This apparent lack of awareness of the concession is in contrast to the high take-up rate. The ATO has advised the Board that, according to data for the 2015-16 income year, approximately 830,000 taxpayers accessed the tax discount. This is not unexpected given that the tax calculations are performed at year-end as part of the tax return process.

⁷⁷ Explanatory Memorandum to the Tax Laws Amendment (Small Business Measures No. 3) Bill 2015.

- 6.16 Some stakeholders believed that the concessions should be available to a greater range of unincorporated business structures, drawing particular attention to the inability to preserve the discount through chains of trust.
- 6.17 For those small business owners that are aware of the tax discount, the idea that a maximum \$1,000 benefit will translate into greater business growth and employment opportunities is considered to be unrealistic. The amount of the concession, they argue, is too low to be a meaningful driver of business growth.

The Board's observations

- 6.18 In principle, the Board supports the delivery of tax benefits to those small businesses operating in an unincorporated structure (and therefore not eligible for the small business company tax reductions). It may not be in the interests of small business owners to adopt a corporate structure for a variety of reasons, whether it is a desire to keep things simple or for commercial, legal, or family reasons. The Board is particularly supportive of incentives to encourage small business owners to invest in growing their business (as reflected in the Board's guiding principles).
- 6.19 However, while the tax discount can assist to reduce the distortion in making a choice as between the various entity types through which small businesses operate, the Board questions whether it is doing so in a way that is either targeted or effective.
- 6.20 The Board considers that the issues associated with the tax discount are significant. First and most obviously, business owners were largely unaware of the tax discount. This is partly because of how the tax discount is administered, as it is provided to recipients upon lodging their return. This means that the tax discount is mostly calculated by the accountant/tax adviser or otherwise automatically by the ATO, which explains the high take-up but low awareness. In addition, it means that the tax discount is unlikely to be factored into business planning and modelling, especially in relation to trusts (as the tax discount is effectively received outside the books of the business). Importantly, the limited awareness is due to the fact that the benefit available is, for most recipients, simply too low to be meaningful.
- 6.21 This may also be partly explained by the tax discount's branding. Business owners, industry associations and tax professionals all pointed out that small business awareness would be significantly improved by renaming the tax discount to better reflect what it does and better communicating how it can help small business.
- 6.22 The low profile of the tax discount also contributes to its second major issue – it does very little to encourage small business owners to reinvest in their business. The tax discount confers a permanent benefit to the business owner that can be enjoyed irrespective of how the funds are used. In contrast, the company tax cut is a temporary benefit in the sense that it only continues to be enjoyed as long as the profits remain

invested in the company. If the company subsequently pays a dividend or salary, full rates of personal tax are imposed.

- 6.23 The third and related issue with the tax discount is that it is not appropriately distributed. A sole trader irrespective of the income earned is entitled to a maximum amount of \$1,000. However, a partnership or trust with a similar business can deliver the same concession to multiple partners or beneficiaries, irrespective of whether or not such partners or beneficiaries work in the business. The current system provides greater rewards to businesses with more elaborate structures at the expense of sole traders.
- 6.24 Extending the tax discount to trusts has the effect that the benefit can be enjoyed by individual beneficiaries who have a purely passive relationship with the business being carried on. Even more incongruously, a trading trust is not prevented from delivering the tax discount to multiple individual beneficiaries and also distributing surplus income to a corporate beneficiary, ensuring that, overall, the tax on trust income is capped at the company tax rate.

The way forward

- 6.25 Having regard to the significant tax expenditures associated with this concession, the Board considers that the issues raised should be addressed as a priority to ensure that the concession meets its original policy rationale. Some suggested approaches are considered below, however, the most appropriate course of action is a matter for the Government.
- 6.26 One option would be to replace the tax discount. Based on the Board's consultations, the Board considers that repeal of the program would be broadly (if not universally) accepted by the sector, but only if it were to be replaced by an alternative proposal for redirecting the expenditure back into unincorporated small businesses in a more targeted way.
- 6.27 Alternatively, the Board believes that, if the Government opts to maintain the tax discount, it should be significantly amended to ensure that it is properly targeted to promote greater neutrality between incorporated and unincorporated businesses and between different types of unincorporated businesses. Consequently, reforms to the tax discount could better align the design of the concession to fulfil its purpose of improving business cash flows, compensating businesses for higher regulatory costs and encouraging investment in growth.
- 6.28 The first step in reforming the tax discount would be to address its low profile. This problem could be addressed by raising the cap to a more meaningful amount. Subject to fiscal considerations, the Board considers that the cap should be increased significantly to act as a meaningful incentive. Arguably, however, this may exacerbate the problem in that such savings may not be reinvested back into the business.

- 6.29 Second, so that the concession is appropriately targeted, the Board considers that it should be redesigned so that it is available on a 'per business' basis. Under this approach, a sole trader, partnership and trading trust in similar circumstances would be entitled to the same amount of relief. For example, if the \$1,000 cap is retained, two equal partners would receive a tax offset of \$500 each or five beneficiaries receiving an equal distribution of business income would each receive a tax offset of \$200. Calculating the concession in this way may also have the benefit of generating Budget savings that could be used to finance an increased cap.
- 6.30 The Board understands that reforming the tax discount so that it operates on a 'per business' basis could raise complex issues of design and administration. On this point, the Board considers that the existing rules for investments in an Early Stage Innovation Company by a trust or partnership⁷⁸ could be an appropriate model.
- 6.31 A further consideration in targeting the concession is whether the discount should be confined to sole traders and partnerships of individuals. Trusts, while not benefiting from the lower company tax rate, nevertheless enjoy a number of tax advantages including the benefit of lowering their overall tax burden by distributing income to beneficiaries on low marginal rates of tax. Moreover, as noted above, trusts allow the tax discount to be accessed by beneficiaries whose relationship with the business may be purely of a passive nature. For these reasons, the Board considers that the case for a tax discount for trusts may be weaker than it is for sole traders and partnerships.
- 6.32 In the event that the tax discount for trusts is retained, a further issue for consideration is whether there should be amendments to enable the concession to be distributed through to ultimate beneficiaries via tiers or chains of trusts. The Board considers that family businesses with more complex structures are a lower priority among the intended recipients of the tax discount.

Interaction with the small business definition

- 6.33 The \$5 million aggregated turnover threshold used for accessing the tax discount has been in place since 2017 when it was increased from the \$2 million threshold (that applied in the 2016 year). As discussed in Chapter Three, stakeholders argue that the fragmenting of the small business definition causes unnecessary confusion and complexity. The Board's view is that the small business definition for tax purposes should be harmonised wherever possible.

⁷⁸ Section 360-30 of the ITAA 1997.

- 6.34 Consistent with its broader position but subject to fiscal considerations, the Board considers that, as part of any process for improving the operation of the tax discount, including applying it on a 'per-business' basis, consideration be given to extending the concession to small business entities under the Board's proposed \$10 million SBE test.

RECOMMENDATION 6

Replace the unincorporated small business tax discount with an alternative program that assists unincorporated businesses in a more targeted way.

Alternatively, if the Government opts to maintain the discount, it should be made more targeted and prominent to small business owners by:

- integrating the eligibility criteria with the small business entity regime by raising the aggregated turnover threshold to \$10 million per annum;
- significantly increasing the cap to be a meaningful incentive; and
- applying the tax discount on a 'per business' basis.

The Government should consider whether the tax discount continues to be made available to trusts.

CHAPTER 7: IMPROVING THE SMALL BUSINESS RESTRUCTURE ROLL-OVER

KEY POINTS

- The enactment of the small business restructure roll-over (SBRR) has made a significant contribution to the small business concessionary environment by reducing tax impediments that might otherwise prevent small businesses from adopting a more appropriate structure.
- However, while the SBRR promises flexibility, it is complex to apply in practice, imposes a high compliance cost, and has technical limitations which restrict its usefulness, all of which have led to a low user take-up.
- The Board has identified improvements to the regime and considers that reforms to the SBRR should be undertaken as part of a comprehensive post-implementation review to commence in the 2019-20 income year. The Board has outlined a number of key focus areas for consideration as part of such a review.

Introduction

- 7.1 The SBRR is one of the most significant recent innovations in small business taxation. It is intended to facilitate flexibility for small business owners by removing income tax impediments that arise when restructuring their business to a more suitable structure. It does this by providing a comprehensive deferral of income tax consequences (and resultant adverse cash flow consequences) associated with the restructuring of a small business.

Background to the SBRR

- 7.2 In the 2014 *Review into Tax Impediments Facing Small Business*,⁷⁹ the Board considered the merits of a flexible CGT roll-over for *new* small businesses. Indicatively, it was considered that a business would be regarded as *new* if it had been in operation for no longer than three years.

⁷⁹ Board of Taxation 2014, *Review into Tax Impediments facing small business*.

- 7.3 The Board envisioned a roll-over that would be much more flexible than other CGT roll-overs; one that provided tax relief so long as the destination structure was one that would have been open to the business from its inception. This meant that tax relief could be accessed for restructures involving transfers of assets to discretionary trusts, a significant departure from other CGT roll-overs which are typically premised on the strict continuity of underlying economic ownership.⁸⁰

The SBRR in brief

- 7.4 The SBRR came into effect on 1 July 2016, and is contained in subdivision 328-G of the ITAA 1997. The stated object of the regime is to ensure that 'there are tax-neutral consequences for a small business entity that restructures the ownership of the assets of the business, without changing the ultimate economic ownership of the assets'.⁸¹
- 7.5 For present purposes, it is useful to set out a high level overview of the key features of the SBRR focussing on *what types* of restructures are eligible for relief, *who* can qualify, *what assets* are covered and the *nature of the relief* provided.

When is the roll-over available?

- 7.6 The first overarching requirement is a type of continuity of ownership test. It requires that, in order to be eligible for the SBRR, the restructure must not 'materially change' the underlying economic ownership in the assets for which roll-over is claimed. Importantly, however, there is a special deeming rule that provides that economic ownership will be taken to be maintained for certain 'family trusts' for which a family trust election is made.
- 7.7 The second overarching requirement is that restructure transactions must be, or be part of, a 'genuine restructure of an ongoing business'. This is, according to ATO interpretation, a restructure 'that could be reasonably expected to deliver benefits to small business owners in respect of their efficient conduct of the business'.⁸² On this view, a restructure which is unduly motivated by tax considerations, or which is undertaken to facilitate a sale of business assets or succession planning, would not qualify for relief.
- 7.8 To mitigate some of the inherent uncertainty in satisfying the 'genuine restructure' principle, the SBRR includes a 'safe harbour' rule, which is intended to provide a small business owner with a simpler way of satisfying the ATO that the restructure is genuine.

⁸⁰ It is widely acknowledged that economic ownership of discretionary trusts cannot be determined as distributions of income and capital of the trust are declared at the discretion of the Trustee.

⁸¹ Objects clause, subdivision 328-G of the ITAA 1997.

⁸² Law Companion Ruling LCR 2016/3, paragraph 6.

This rule operates as a bright-line test, under which a restructure is taken to be 'genuine' if, for three years following the roll-over:

- there is no change in the ultimate economic ownership of any of the significant assets of the business (other than trading stock) that were transferred under the transaction;
- those significant assets continue to be active assets; and
- there is no significant or material use of those significant assets for private purposes.

Who can access relief?

7.9 The SBRR is subject to technical limitations in relation to the types of entities that may access relief and the types of assets for which relief may be claimed.

7.10 Although eligibility for the SBRR is tied to the SBE regime, there are effectively four categories of entity that may be eligible:

- an SBE;
- an entity that has an 'affiliate' that is an SBE;
- an entity that is 'connected' with an SBE; and
- a partner in a partnership that is an SBE.

What assets are eligible for relief?

7.11 The types of assets that can be transferred depend on the type of eligible transferor. The general rules are as follows:

- an SBE is entitled to relief on the transfer of 'active assets' (that is, assets used or held ready for use in carrying on business);
- entities who are 'connected' or 'affiliated' with an SBE are entitled to relief on the transfer of an active asset they hold passively but which are used in the business;⁸³ and
- a partner in a partnership that is an SBE is entitled to relief for the transfer of an active asset and an interest in the relevant partnership.

⁸³ In other words, an active asset in relation to which section 152-10(1A) is satisfied. Section 152-10(1A) is a special rule applicable only to certain passively-held assets used in business by a related entity such as when a family farm holds its land in a special purpose entity that is separate from the 'business' entity.

- 7.12 Importantly, provided the relevant asset test is satisfied, there is no requirement that the asset is held on capital account or that it be taxable as a CGT asset. It can apply to CGT assets, trading stock, revenue assets and depreciating assets.
- 7.13 It should also be noted that, although shares and units (ownership interests) can be active assets, relief is not generally available for the transfer of ownership interests in business entities. This is because the owner of a connected or affiliated company or trust would not satisfy the requirement that the shares or units are 'used in the business'. However an entity that is an SBE in its own right is not subject to this limitation.

Consequences of roll-over

- 7.14 The basic principle underlying qualifying restructures is that there will be 'tax neutral consequences'.
- 7.15 The major income tax consequences from a qualifying business restructure are:
- capital gains and other assessable income that would arise from the transfer of assets are disregarded;
 - to ensure that the relief operates as a deferral rather than a permanent tax benefit, the transferee is taken to acquire the asset at the transferor's tax cost base.
- 7.16 Another important feature of the SBRR is that it provides an exemption for the 'direct tax consequences' that would otherwise arise from a restructure involving distributions from companies and trusts. This means, for example, that a dividend or deemed dividend that might otherwise arise when an asset is transferred by a company to a shareholder (or associate) can be disregarded if the relevant conditions are met.
- 7.17 The SBRR does not affect other tax liabilities (for example, FBT or GST), or prevent any liability for stamp duty from arising under state legislation.

Observations on policy

- 7.18 While the SBRR has features in common with the Board's original vision of a 'new business roll-over', the SBRR is more ambitious in scope. According to the Explanatory Memorandum, one of the functions of the SBRR is to allow a new small business to change 'an initial legal structure that it later finds inappropriate'.⁸⁴ But the SBRR goes further. It also reflects the policy that what is an appropriate structure for a business may change over time, and that businesses should be able to adapt and move

⁸⁴ Explanatory Memorandum to Tax Laws Amendment (Small Business Restructure Roll-over) Bill 2016, paragraph 1.6.

seamlessly between structures to facilitate their business needs and requirements without incurring any additional tax imposts. As a result, relief under the SBRR can be accessed by a business at any stage of its life cycle, instead of only being available for new businesses.

- 7.19 Further, the roll-over is not confined to CGT but provides tax relief for all income tax consequences applying to all asset classes, including trading stock, depreciating assets,⁸⁵ and other revenue assets. It is also more extensive in that the roll-over provides an exemption for dividends and other assessable distributions that may otherwise arise when an asset is transferred by a company or trust in the course of a qualifying restructure.⁸⁶

Stakeholder concerns

- 7.20 Feedback provided to the Board during consultations with small business owners and advisers was negative in relation to the strictness and impracticality of the measures. Stakeholders welcomed the *idea* of a flexible roll-over for small business but they believed that the SBRR is too difficult to apply in practice. They said that, as enacted, it is simply too complex and uncertain in operation to enable small businesses to use with confidence. They considered the overall legislative complexity coupled with the uncertainty associated in satisfying the 'genuine restructure' principle made it too difficult for small businesses to navigate the rules without expensive specialist advice. Further uncertainty arises as a result of the potential operation of the general anti-avoidance rule⁸⁷ which, if applied, would operate to reverse or 'claw back' the relief previously accessed under the SBRR.

- 7.21 The following key themes emerged in the Board's consultations with stakeholders:

- The 'genuine restructure' requirement (including the safe harbour alternative) is a source of complexity and uncertainty and is not well targeted.
- The ATO's interpretation of the genuine restructure requirement is overly restrictive and its assertion that Part IVA of the ITAA 1936 has residual application is not warranted.
- The legislation is unnecessarily limiting on the types of restructures that qualify.

⁸⁵ The treatment of depreciating assets is modified by CRP 2017/2, a determination made pursuant to the Commissioner's Remedial Power in section 370-5 of the *Tax Administration Act 1953*. The determination ensures that the relief available for the transfer of depreciating assets extends to 'all direct consequences under the income tax law'.

⁸⁶ For example, a restructure involving the transfer of assets by a company might give rise to ordinary dividends or deemed dividends by virtue of Division 7A of Part III of the ITAA 1936.

⁸⁷ Part IVA of the ITAA 1936.

- Small business owners are prevented from restructuring to 'plain vanilla' structures (such as a company owned by a discretionary family trust).
- There is an overly restrictive and defective 'ultimate economic of ownership' rule for restructures involving discretionary trusts.
- There is an inconsistent approach to restructures involving the transfer of pre-CGT assets.

Lessons from the data

7.22 Given that the SBRR is relatively new (the 2016-17 income year being the first in operation), there is inadequate data to properly assess its take-up.⁸⁸ Further, the ATO does not yet have a record of compliance activity upon which to base any reliable conclusions. Rather, the ATO's experience of the SBRR is limited to advice, having actioned around 20 private rulings and 30 'early engagement' requests.⁸⁹

7.23 A review of the ATO private rulings provides some useful insights into the operation of the SBRR. While some rulings provide evidence of business owners successfully navigating the provisions, there is also evidence that some cases are failing to qualify for relief on technical grounds. The rulings also suggest that one of the key factors motivating potential users of the SBRR is to give effect to family succession arrangements in relation to mature businesses. This is significant given that family succession, according to the ATO's interpretation, is incompatible with the genuine restructure principle.⁹⁰

Board's recommendation

7.24 Having reviewed the SBRR provisions, and having listened to stakeholder concerns, the Board considered a range of incremental reforms to improve its operation. Some of the reforms considered were removing or streamlining the genuine restructure requirement for some users, targeted changes to the eligibility criteria, as well as various amendments to address technical limitations.

7.25 However, while the Board considers that incremental changes to the SBRR may have merit, it has concluded that ultimately any reforms should be considered in the context of a holistic 'root and branch' review of the regime. Commencing a review in the 2019-20 income year should ensure that there is sufficient empirical data upon which to

⁸⁸ ATO Taxation Statistics for the 2016-17 income year are not expected to be released until mid-2019.

⁸⁹ Small businesses are able to request an 'early engagement' discussion with the ATO, prior to applying for formal advice such as a ruling, regarding a complex transaction they are considering or have implemented, <[https://www.ato.gov.au/general/ato-advice-and-guidance/ato-advice-products-\(rulings\)/early-engagement/](https://www.ato.gov.au/general/ato-advice-and-guidance/ato-advice-products-(rulings)/early-engagement/)>.

⁹⁰ Law Companion Ruling LCR 2016/3, paragraphs 56-59.

base more reliable conclusions. A full review will also enable the broader policy implications to be properly evaluated.

7.26 With these observations in mind, the Board considers that the post-implementation review should focus on the following key questions:

- What should be the function of a flexible small business roll-over in the context of the broader small business tax system?
- How could the SBRR be improved so that it fulfils its purpose while ensuring that complexity and compliance costs are minimised and integrity in the provisions is maintained?

RECOMMENDATION 7

Undertake a comprehensive post-implementation review of the small business restructure roll-over regime, commencing in the 2019-20 income year.

Scope of a post-implementation review of the SBRR

7.27 The Board has identified a number of focus areas for consideration as part of a post-implementation review and has set out its observations below to assist in that process.

Improving the 'genuine restructure' rule

7.28 The genuine restructure requirement is clearly the most contentious aspect of the SBRR. It is seen by stakeholders as increasing complexity and compliance costs, and creating uncertainty. There was a general view that, because of the genuine restructure requirement, it would be prudent for any potential user of the SBRR to obtain a private ruling from the ATO.

7.29 Criticism was also directed at the ATO's interpretation of the genuine restructure requirement as set out in its Law Companion Ruling LCR 2016/3. Some stakeholders saw the interpretation as being unduly narrow and restrictive. For example, some stakeholders view that considerations of family succession are, contrary to the ATO's interpretation, compatible with the genuine restructure requirement.

7.30 The Board has noted that the genuine restructure requirement was not a feature of the original Exposure Draft legislation for the SBRR. It was only added after the decision was made to extend the relief to provide an exemption for assessable distributions (such as

Division 7A dividends) which might otherwise arise from a business reorganisation.⁹¹ This suggests that expanding the relief available has necessitated a policy trade-off in the form of strict rules that place greater limitations on which arrangements can qualify for relief.

- 7.31 While this uncertainty in the application of the genuine restructure requirement is partly addressed by the safe harbour alternative, stakeholders advised that this provision creates its own complexity and uncertainty, relying as it does on novel and uncertain concepts such as ‘significant assets’ and ‘significant or material use’. Moreover, accessing the safe harbour requires a potential user of the SBRR to predict with certainty that, among other things, the ownership and use of significant assets will not change. And even if these hurdles can be overcome, there remains the possibility that relief might still be denied under the general anti-avoidance provisions. This combination of factors led some stakeholders to describe the safe harbour as an ‘unsafe harbour’.

“It is ironic that there are as many uncertainties in the application of the safe harbour rule as there are uncertainties in the genuine restructure integrity rule which the safe harbour rule was meant to alleviate.”

Stakeholder submission

- 7.32 A more fundamental question in relation to the safe harbour is whether maintaining ownership and use of significant assets is necessarily a good proxy for ‘genuineness’ as that concept is interpreted by the ATO. Arguably, the safe harbour undermines the key integrity principle of the SBRR in that taxpayers wishing to undertake ‘non-genuine’ restructures need only wait three years before disposing of assets transferred under the SBRR, subject to the risk of the general anti-avoidance rule applying.
- 7.33 ‘Safe harbours’, by their nature, should improve the taxpayer’s experience of the system by providing an easier pathway through complex rules. Given the issues identified above, a post-implementation review could consider whether there may be a case for eliminating the existing three-year safe harbour altogether.

Applying a life cycle approach

- 7.34 As a part of the Board’s guiding principles, the Board considers it important to view the SBRR through the business life cycle approach. Through this perspective, there are differing reasons why businesses seek to restructure depending on their stage of growth:
- A new business in the start-up or survival stage will most likely want to use the roll-over to move into a more appropriate structure as it may have either not

⁹¹ Exposure Draft, Tax and Superannuation Laws Amendment (2015 Measures No. 6) Bill 2015: Small business restructure roll-overs.

originally sought structuring advice due to cash constraints or received incorrect advice in relation to its current structure.

- A business in the expansion or growth stage is likely to restructure in order to facilitate that expansion.
- A mature business at the retirement or exit stage is likely to restructure so as to facilitate a sale of the business or by giving effect to family succession arrangements.

7.35 In principle, the Board is supportive of an SBRR model whereby relief is available to a business at any stage of its life cycle. However, this presents complications and opportunities because, as a business moves through the different stages of its life cycle, the potential for tax arbitrage arising from a restructure can become more pronounced. As such, it may be inevitable that more mature businesses seeking to access relief will have to deal with a degree of complexity. However, whilst it may not be possible to eliminate altogether the complexity associated with the genuine restructure requirement for more established businesses, the Board considers that *new* small businesses should be provided with a much simpler pathway for accessing relief.

7.36 Simplifying access to the SBRR for new businesses could be achieved by way of an additional safe harbour under which a new business would be taken to satisfy the 'genuine restructure' requirement, subject only to the condition that the restructure is one that results in a structure that would have been open to the small business owner at the commencement of their business.

7.37 The advantage of a more flexible access to the SBRR for new small businesses is that it will assist small businesses who adopted an inappropriate structure at the start of their business (possibly because of incorrect advice or no advice at all) to take corrective action.⁹²

7.38 In this regard, consideration should be given as to how to appropriately quarantine small businesses that are new. For example, the Early Stage Innovation Company definition of a new small business could be used as a basis for making this determination.

Period of review and the three-year safe harbour

7.39 For the existing three-year safe harbour, it should be noted that there is an unfortunate interaction between the safe harbour rule and the time limit the Commissioner has to amend a small business assessment. Generally, the Commissioner may amend a small business assessment for the income year within two years of the small business lodging its tax return. This means that the period of review may end before the three year test

⁹² ATO surveys indicate that nearly 30 per cent of small businesses don't seek business advice or information at all when starting their business.

in the safe harbour rule is concluded. This may reduce the integrity of the safe harbour and may limit the Commissioner's ability to administer the safe harbour in the most sensible way.

- 7.40 The Board recommends that, as part of a post-implementation review of the SBRR, consideration be given to addressing the interaction between periods of review and the three-year safe harbour rule.

OBSERVATION

The recommended post-implementation review of the SBRR should:

- evaluate the operation of the genuine restructure requirement in relation to three categories of business: new or start-up businesses, growth businesses and mature stage businesses;
- consider amendments that would provide new businesses with simplified access to SBRR relief; and
- consider issues arising from the interaction of the three-year safe harbour with the Commissioner's periods of review.

Expanding eligible restructures

- 7.41 The Board has been provided with two possible explanations as to why shares and units (ownership interests) are not generally transferrable using the SBRR. The first is that the policy of the SBRR is to facilitate the transfer of active business assets, and not the *structures* through which assets are held.
- 7.42 It is not clear to the Board why a restructure comprising the transfer of assets is necessarily any more compatible with the policy of the SBRR than one involving the restructure of ownership interests. Moreover, as noted above, the denial of relief on transfers of shares and units does not apply in a consistent way. Entities that are SBEs in their own right are able to restructure ownership interests under the SBRR provisions.
- 7.43 The second explanation for denying relief to transfers of shares and units is to deny potential planning opportunities that would undermine the integrity of the SBRR.
- 7.44 Small business stakeholders do not accept that the denial of SBRR relief on shares and units is justified on integrity grounds and, in fact, believe that the opposite may be true. For example, the current limitation on the SBRR creates an incentive for owners of small companies to instead restructure by transferring the underlying assets. Arguably, this approach increases the integrity risk because it is more likely to involve tax arbitrage opportunities in relation to the operation of Division 7A, or the 50 per cent CGT discount. Stakeholders also believe that transferring underlying assets exposes the small business owners to a certain level of prudential risk (for example, under the

Corporations Act or insolvency rules), may have adverse stamp duty implications, as well as increased compliance costs.

- 7.45 The Board considers that providing a consistent approach to whether, and in what circumstances, transfers of shares or units should be eligible for relief under the SBRR should be a key aim of the proposed post-implementation review.

OBSERVATION

The recommended post-implementation review should consider whether, and in what circumstances, SBRR relief should be made available to small business taxpayers on the transfer of company shares and trust units.

Ultimate economic ownership for discretionary trusts

- 7.46 One of the conditions of relief under the SBRR is that the transaction must not materially change the 'ultimate economic ownership' of the transferred asset.⁹³ The term 'economic ownership' is undefined and there is some uncertainty as to its precise meaning. However, despite the uncertainty, the conventional view is that it would be practically impossible (or extremely rare) for arrangements involving trusts to satisfy the economic ownership test.
- 7.47 As noted above, the SBRR addresses this issue by including a special rule that deems the economic ownership requirement to be satisfied for certain restructures involving discretionary trusts for which a family trust election is made.
- 7.48 This special deeming rule represents a significant departure from the constraints associated with business reorganisation roll-overs which are typically predicated on strict maintenance of ownership interests.⁹⁴ However, the deeming rule is arguably too limited in its application. This is because the rule is only enlivened if the transferred asset constitutes property of a discretionary trust *just before* and/or *just after* the transfer. This means that relief is not available if the relevant asset is owned by the trust *indirectly* (either just before or just after the transfer).
- 7.49 The Board considers that the current treatment of discretionary trusts may be inhibiting small business from restructuring using the SBRR even where there are genuine commercial reasons for having a discretionary trust in their structure.
- 7.50 There are different approaches to addressing the issue. One solution would be a targeted extension to the deeming rule to allow economic ownership to be traced

⁹³ Paragraph 328-430(c) of the ITAA 1997.

⁹⁴ For example, to be entitled to a roll-over under Subdivision 122-A of the ITAA 1997, the transferor of the asset must own all of the shares in the company just after disposal of the asset.

through a single wholly-owned company or unit trust. This would ensure that the SBRR is available for the most in-demand structures without adding unwanted complexity.

- 7.51 However, the Board notes that some stakeholders are advocating a broader extension to the rule to ensure the SBRR allows more complex restructures, particularly for business groups involving layers of discretionary trusts. The Board considers that allowing tracing only through wholly-owned unit trusts and companies would strike an appropriate balance between flexibility and simplicity. Further extensions to the deeming rules should be approached with caution, especially if they would add undue complexity to the practical operation of the law.

OBSERVATION

The recommended post-implementation review of the SBRR should consider whether the special deeming rule for continuity of ultimate economic ownership in transactions involving discretionary trusts should be expanded so that it can apply to property that is wholly-owned directly or indirectly through one or more companies or unit trusts.

Case studies – the “trust-company structure”

- 7.52 One of the practical implications of the technical limitations of the SBRR is that it prevents small business owners reorganising the business as an operating company owned through a discretionary trust. This is regarded by many practitioners as the optimal small business structure from both a tax and commercial perspective.
- 7.53 The following examples illustrate how the technical requirements of the SBRR prevent the adoption of the trust-company structure in different scenarios.

EXAMPLE 1 – FORMATION OF A TRUST-COMPANY STRUCTURE

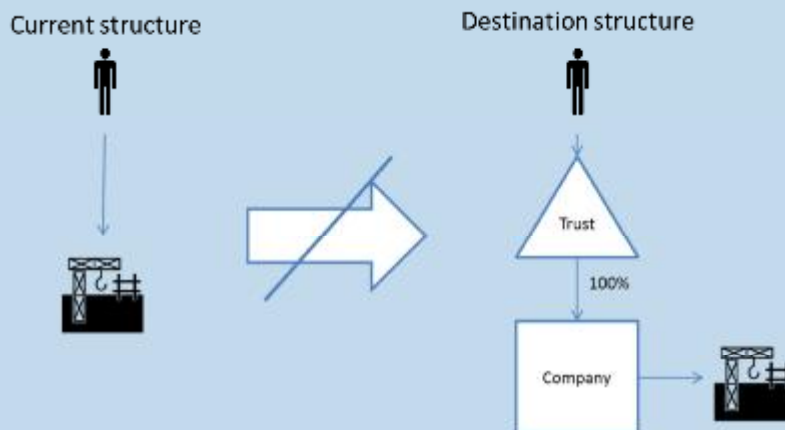
Ivan is an SBE who carries on a walking tour business as a sole trader.

Ivan is advised to move his business to a structure in which the business is owned by a company which, in turn, is owned by a family trust.

To achieve this, Ivan establishes a new trust for which he makes a family trust election. He proposes to incorporate a shelf company which is wholly-owned by the trust and then transfer all of his business assets, including goodwill, to the new company.

As the business assets are transferred to a company owned by a discretionary trust, the transfer does not meet the requirement for continuity of economic ownership on its facts.

The restructure does not enliven the operation of the special deeming rule for continuity of economic ownership. This is because the business assets are not included in the property of a non-fixed trust either just before or just after the transfer.



EXAMPLE 2 – TRANSFER OF OWNERSHIP INTERESTS TO FAMILY TRUST

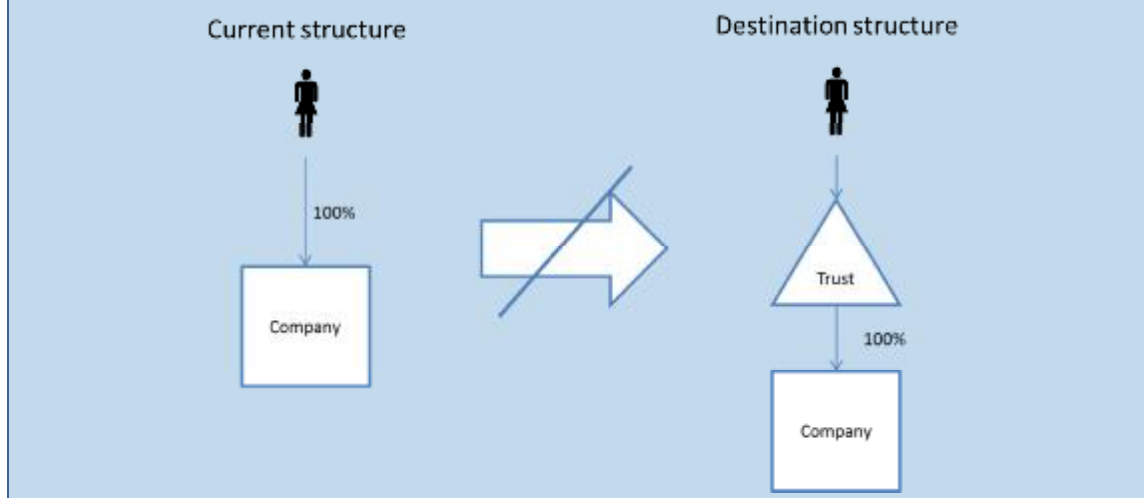
Debbie is the sole director and shareholder of Anders Pty Ltd. Anders Pty Ltd carries on a walking tour business and is an SBE.

Debbie would like to interpose a newly established trust between herself and the company.

To achieve this, Debbie establishes a new trust. She then proposes to transfer her shares in Anders Pty Ltd to the trustee.

As Debbie is a person 'connected with' an SBE (Anders Pty Ltd) she can only claim SBRR relief on an asset *in relation to which subsection 152-10(1A) of the ITAA 1997 is satisfied*. Subsection 152-10(1A) requires, among other things, that an SBE that is a connected entity or affiliate 'carries on business ... in relation to the CGT asset'. Although the shares in Anders are likely to be active assets, they do not satisfy the further requirement in subsection 152-10(1A).

Debbie will not be entitled to the SBRR roll-over.



- 7.54 Although there is general agreement that the trust-company structure is common among small businesses, opinions differ on whether facilitating this structure is (or should be) a legitimate function of the SBRR.
- 7.55 While accepting that the trust-company structure offers certain tax advantages, the Board notes that it also offers a range of commercial advantages, principally asset protection. More importantly, the Board understands that this structure is freely available to small businesses that are properly advised at the start-up stage. In addition, the tax law contains other provisions that explicitly allow the adoption of this structure without adverse tax consequences arising. For example, subdivision 122-A of the ITAA 1997 allows a trading trust to interpose a company. The Board maintains that a principal objective of the SBRR should be to enable small businesses to adopt a structure that would have always been available to them at the commencement of the business.

OBSERVATION

The recommended post-implementation review should consider whether, and in what circumstances, the SBRR should facilitate the adoption of a trust-company structure for small businesses.

The SBRR and pre-CGT assets

- 7.56 The SBRR is not intended to be prescriptive in the way that restructures are undertaken. Rather, the SBRR affords small businesses the flexibility to alter the way their business assets are held on the proviso that the restructure is genuine, the business is ongoing, and the ultimate economic ownership is unchanged (or deemed to be unchanged).

- 7.57 One type of restructure the SBRR contemplates is where there is a transfer of business assets in exchange for shares in a company or units in a trust. In this scenario, the SBRR rules produce anomalous tax outcomes where the transaction involves pre-CGT assets.
- 7.58 More specifically, when a pre-CGT asset is transferred in exchange for scrip, the replacement shares or units are treated as newly-acquired assets and, therefore, not assigned pre-CGT status. However, the replacement shares or units are also deemed to have a zero cost base. This treatment is in contrast to the treatment afforded under other CGT roll-overs which would typically deem that assets are taken to be acquired at market value when they lose their pre-CGT status.⁹⁵
- 7.59 The application of the SBRR to exchanges of pre-CGT assets for scrip is difficult to reconcile with the policy framework for the SBRR, which in other respects, allows pre-CGT status to be maintained. For example, if a restructure were to be undertaken by way of a sole trader transferring pre-CGT assets to a trust, the asset would be taken to be a pre-CGT asset in the hands of the trustee.⁹⁶ This limitation is not well-understood by small business owners and their advisers.⁹⁷
- 7.60 The Board considers that the SBRR needs to be consistent in the way it applies to pre-CGT assets. As currently enacted, differing treatment of pre-CGT creates a potential trap for users who are not properly advised.
- 7.61 One approach for addressing this would be to ensure that when pre-CGT assets are transferred in exchange for scrip, the shares or units should maintain their pre-CGT status. However, the Board would question this approach. While the 'grandfathering' of pre-CGT assets may have been viewed as necessary at the time of the introduction of the CGT regime, it is a noted source of complexity and inequity and maintaining it in the tax system some 33 years on is problematic.⁹⁸ While not committing to a longer-term solution to this problem, the Board does not believe that perpetuating the exemption of pre-CGT assets, and thereby allowing for indefinite tax deferral, is either a necessary or appropriate function of the SBRR.
- 7.62 If the SBRR were amended to remove the grandfathering of pre-CGT assets, potential users of the SBRR would be on notice that the 'price' of using the SBRR is that the pre-CGT status of transferred assets is lost. However, small business owners should also be reassured that there will be appropriate cost base adjustments to ensure that only gains accruing after the transaction would be subject to tax. This would align the SBRR with

⁹⁵ See for example section 124-800 of the ITAA 1997 which concerns the treatment of interests received for pre-CGT interests under qualifying 'scrip for scrip' arrangements.

⁹⁶ This results from the operation of section 328-460 of the ITAA 1997.

⁹⁷ For example, a fully-informed user may choose instead not to undertake the restructure, use a different roll-over provision, or undertake the restructure in a different way (i.e. by capitalising the company and using this entity to purchase the assets).

⁹⁸ The Treasury 2009, *Australia's Future Tax System: Report to the Treasurer*, Canberra, p. 82.

certain other concessional roll-over provisions, notably the scrip-for-scrip roll-over in subdivision 124-M of the ITAA 1997.

- 7.63 Irrespective of the approach taken in a post-implementation review, as a minimum, the Board considers that the ATO should issue clear guidance so that this aspect of the rules is clearly communicated to small businesses.

OBSERVATION

The recommended post-implementation review of the SBRR should review the current treatment of pre-CGT assets.

CHAPTER 8: IMPROVING SUPPORT FOR SMALL BUSINESS

KEY POINTS

- During consultations, small business owners emphasised the importance of simplicity in the tax laws as being a priority. Small businesses also pointed to the need for additional support in cash flow management and relevant business education as important pillars to support the survival and success of small business.
- The Board has identified opportunities to improve the effectiveness of several existing tax concessions to better meet the needs of stakeholders whilst continuing to meet the policy objectives of the concessions.
- There are opportunities to provide greater relief to small businesses in relation to the critical start-up and survival stages of the small business life cycle.

8.1 Throughout the course of the Board's consultations, the following key messages were consistently raised by small businesses:

- The tax system is too complex. Small business owners believe that they are unnecessarily 'tied up' in excessive red tape when they should be focussing on their business operations. Many see themselves as 'unpaid tax collectors' for the Government.
- Cash flow is critical. Small business owners understand the importance of cash flow. They have less diversity in their sources of revenue, greater sensitivity to changing market conditions and less access to external finance, particularly in relation to the start-up and survival stages of the business life cycle.
- Education is critical to business success. Small business owners are very aware that they need to continuously update their knowledge and are always looking for better ways of accessing timely, high quality training in business administration, cash flow management, and business essentials.

8.2 These key messages, together with the Board's review of the current suite of small business tax concessions (in Chapter Four), made it evident to the Board that there was a real need to improve the current tax concessions. In addition, the Board identified opportunities to provide relief which would better support small businesses at earlier stages of their business life cycle.

Improvements to current tax concessions

Small business pooling rules

RECOMMENDATION 8

Simplify the small business pooling rules by having a single depreciation rate of 30 per cent.

- 8.3 The Board considers there is a simple lever available to promote greater neutrality in small business investment decisions by reducing the distortion which currently exists in favour of lower cost assets.
- 8.4 Currently, small businesses have access to a simplified depreciation regime whereby assets are pooled and written off at a flat rate of 15 per cent in the year of purchase, and 30 per cent per year thereafter. Those that opt in to the regime are required to place depreciating assets that cost \$20,000 or more (i.e. the IAWO threshold amount) into this small business pool.⁹⁹
- 8.5 Whilst the Board supports the IAWO, the threshold at which amounts can be immediately deducted can create an incentive to favour the purchase of assets below the threshold rather than higher cost assets that businesses may need for the efficient operation of their business.
- 8.6 The Board considers that a relatively simple change to the depreciation rate can help to reduce this distortion. Accordingly, the depreciation rate should be doubled from 15 per cent to 30 per cent for assets purchased during the year and allocated to the small business pool.
- 8.7 The Board believes streamlining the initial deduction in this way will have a positive impact on small business investment as this will:
- provide immediate cash flow benefits;
 - be of particular benefit to small businesses operating in capital intensive industries (such as agriculture and manufacturing); and
 - help to ensure that commercial decisions, and not tax treatment, drives investment.
- 8.8 A further benefit of increasing the depreciation rate in the year of purchase is to simplify the pooling rules for small business by only requiring a single depreciation calculation. Having a simplified system would streamline the arrangements for small business whilst

⁹⁹ At the time of writing, the Federal Government announced an increase to the threshold to \$25,000.

also meeting the Board's guiding principles to drive reinvestment and increase the growth potential for small businesses.

- 8.9 The Board notes that there may be some fiscal implications in relation to this recommendation over the forward estimates. However, the Board believes the impact should be minimal given the relevant assets would be fully depreciated over a four-year period in any case.

Instant asset write-off

RECOMMENDATION 9

Increase access to the instant asset write-off threshold to those small businesses that do not choose to use the small business pooling rules.

- 8.10 The Board believes that changes to the operation of the IAWO could further boost business activity and investment whilst continuing to achieve its policy rationale.

- 8.11 Throughout the Board's consultations, small business owners and advisers supported the increased threshold to the IAWO. Small business owners indicated to the Board that the concession is easily understood and provides an immediate boost to their business. It has improved small business cash flow whilst also encouraging investment in the assets that they need to help grow their business, consistent with the policy rationale of this concession.¹⁰⁰ This anecdotal evidence is supported by empirical evidence from the United States¹⁰¹ and Australia¹⁰² which have indicated that accelerated or special depreciation can lead to increased business investment.

- 8.12 Notwithstanding, stakeholders noted that there were limitations to the concession and suggested improvements to help it better achieve its policy objectives, including:

- Extending the IAWO to assets that cost \$20,000 or more – Small business owners did not understand why they could immediately deduct multiple assets purchased under the \$20,000 threshold, but were denied the same treatment for higher cost assets. At the time of writing, the Federal Government announced an increase to the threshold to \$25,000.¹⁰³

¹⁰⁰ Explanatory Memorandum to the Tax Laws Amendment (Small Business measures No. 2) Bill 2015, paragraph 1.5.

¹⁰¹ Zwick, E and Mahon, J, 2017, Tax policy and heterogeneous investment behaviour, *American Economic Review*, vol. 107, no. 1, pp. 217-248.

¹⁰² Rodgers, D and Hambur, J 2018, *The GFC Investment Tax Break*, Reserve Bank of Australia.

¹⁰³ Frydenberg J (Treasurer) 2019, *Increasing and extending the instant asset write-off*, joint media release, 14 February.

- Decoupling of the IAWO from the 'simpler pooling' requirement – To access the IAWO, small businesses must choose to use the small business pooling rules for depreciating assets. Accordingly, some small businesses cannot access the IAWO because they have decided that pooling of depreciating assets is not suitable for their business.
- Make the concession permanent – This would enable small businesses to better plan for future investment decisions which they require to operate and grow their business.

8.13 The Board agrees with increasing the benefits of this concession to a greater proportion of the small business sector and, in particular, providing increased assistance to capital intensive small businesses (such as farms and businesses in the motor vehicle service and repair industry). The Board notes that a higher threshold would also reduce the distortion in favour of lower cost assets outlined in Recommendation Eight. Recent announcements to increase the threshold to \$25,000 will go some way in assisting those capital intensive small businesses and all small businesses to purchase higher cost assets they need most to help their business grow. Whilst some overseas jurisdictions have allowed for significantly higher amounts to be immediately written-off (such as the United States, which has a threshold of \$1 million), the Board understands the threshold amount is a matter for Government as there may be fiscal constraints on setting the threshold at higher levels.

8.14 Notwithstanding the recent increased threshold, the Board believes there is value in expanding the reach of the concession to more small businesses by allowing access to the IAWO irrespective of whether small businesses use the small business pooling rules. This will provide all small businesses the opportunity to invest in the assets they need and simplify their purchasing decisions without having to concern themselves about whether the small business pooling rules are appropriate for their circumstances.

8.15 In relation to stakeholder feedback to make the concession permanent, the Board is of the understanding that part of the aim in having a restricted timeframe for the higher threshold is for the concession to act as a stimulatory measure to encourage the bringing forward of capital investments. Ultimately, this is a matter for Government. However, the Board believes that the government should consider making this concession permanent.

PAYG Instalment system

RECOMMENDATION 10

Allow small businesses to calculate their PAYG instalments based on real-time tax adjusted accounts.

- 8.16 Stakeholders emphasised that small businesses experience more volatility and lumpiness of cash flows and income compared to larger businesses. This instability can be compounded by the current system of calculating PAYG instalments which takes into account estimates based on the previous year's tax return. For some small businesses, such estimates have no relevance to actual cash flows throughout the year, and can leave small businesses paying either too much or too little in instalments. For example, a small business which found short-term success in a previous year may find their PAYG instalment payments set too high in relation to their current year.
- 8.17 Whilst the current PAYG system does allow small business to vary their instalment amounts downwards, many small business owners choose not to as they find this process daunting and fear that adjusting their instalments will expose them to significant penalties and undue scrutiny by the ATO.
- 8.18 The current PAYG Instalments system was identified throughout consultations as one that needs improvement, particularly for new small businesses in their first 18 months of operation. The shortcoming for new small businesses is the lack of prior tax history on which to base instalments. Accordingly, new small businesses are then faced with a significant tax liability upon lodging their first tax return alongside the need to pay instalments for the subsequent income year. The reality is that many new businesses will not have provisioned appropriately for this liability.
- 8.19 To address these issues, the Board considers that there is scope to introduce a real-time PAYG system based on a small business' current tax adjusted accounts. Having the choice for an alternative method of calculating PAYG instalments that reflects the income small businesses actually earn, rather than based on estimates, will:
- increase the accuracy of the required instalment payments by more closely reflecting the actual financial positions of small businesses;
 - provide businesses with a clearer indication of their end of year tax liability; and
 - relieve stress on small business owners by taking the guess work out of estimating the correct amount of PAYG instalments.
- 8.20 The Board acknowledges that having this alternative option will not completely alleviate all the issues associated with determining PAYG instalment amounts as some small businesses may simply choose not to adopt this method. For example, a new business may not have the desire or resources to invest into the relevant systems, or otherwise a small business may not choose a real-time option as they believe they have appropriate cash flow systems in place to deal with tax liabilities as they occur. Despite this, those small businesses which see value in having more certainty around their financial position and being able to appropriately provision for their tax liabilities would be positively impacted by having a choice to adopt this method.

- 8.21 A similar approach has recently been adopted in New Zealand, referred to as the Accounting Income Method system, which could be used as a basis to model such a system.

Additional relief

- 8.22 As previously discussed in Chapter Four, many of the current small business tax concessions are weighted towards mature small businesses and those that are at the end of the business life cycle. The Board believes that increased support for newer small businesses at the inception and survival stages of the business life cycle is warranted. However, the Board also made observations in that Chapter that newer small businesses may be more appropriately supported outside of the tax system. Taking this into consideration, the Board has identified new tax concessions and support programs to help small businesses in the earlier stages of the business life cycle.

Loss carry back

RECOMMENDATION 11

Re-introduce loss carry back for companies that are small business entities and allow them to carry back losses against the previous year's taxable income up to a 'capped' amount.

- 8.23 Small businesses may incur losses for a variety of reasons, including macro-economic shocks (for example, the GFC), specific market sector issues (such as an increase in the cost of inputs), or as a result of operating out of a particular location (like the retailers in George Street affected by the Sydney tram works).
- 8.24 Whatever the cause, the impact of incurring losses can be devastating for small businesses vis-a-vis larger businesses. This is because small businesses, by comparison with their larger counterparts have much tighter cash flows, less diversity in their sources of revenue, as well as greater sensitivities to changing market conditions.
- 8.25 Accordingly, the re-introduction of a loss carry back regime can provide an important 'safety net' for small businesses during such crises that can occur at various stages of the business life cycle. A loss carry back would work by allowing companies to use a current year tax loss against taxable income in previous years, resulting in a refund for all or part of the tax value of that loss to the extent of taxes paid in previous periods. By giving them access to a refund of tax paid in the previous year, this can provide an automatic cash flow injection when it is critically needed.
- 8.26 The increased cash flow under a loss carry back can also assist with business growth by encouraging small businesses to take risks with the knowledge that funds may be available where there is a temporary period of losses. This may occur while it is upgrading, refurbishing, or modernising its operations. For example, a guesthouse or

restaurant closing down while it undertakes renovations. It can help credit constrained small businesses to make new investments and recover more quickly from periods of crisis without the need for direct government intervention.

- 8.27 Importantly, loss carry back rules have been implemented in a number of overseas jurisdictions¹⁰⁴ and were advocated for as part of the Henry Tax Review.
- 8.28 Loss carry back was previously made available to Australian companies in 2013 on the recommendation of the Business Tax Working Group and enabled all Australian companies to carry back losses of up to \$1 million against the preceding two income years, allowing for a cash refund of up to \$300,000.
- 8.29 Data obtained from the ATO identified that 3,800 taxpayers took up the concession in the 2012-13 income year (refer Table 8.1), with the top five industries accessing the concession being construction, professional services, real estate services, financial and insurance services and retail trade (refer Table 8.2). Notably, the majority of the businesses that previously benefited from loss carry back would meet the SBE definition with 3,600 of these taxpayers having an aggregated turnover of less than \$10 million.

Table 8.1 - Number of businesses with loss carry back amounts by aggregated turnover bands in 2012-13

Aggregated turnover	No.
\$0 to \$1m	2,400
\$1m to \$2m	500
\$2m to \$5m	500
\$5m to \$10m	200
\$10m+	300
Total¹⁰⁵	3,800

¹⁰⁴ These include the United States of America which has a two-year carry back rule, Canada with three years, while Germany, Japan, Netherlands, Singapore and the United Kingdom each having a one-year carry back rule.

¹⁰⁵ Numbers in this table have been rounded to the nearest 100. Due to rounding, the total may not sum.

Table 8.2 – Top five broad industries of businesses that claimed loss carry back amounts, in 2012-13

Industry	No.
Construction	700
Professional, Scientific and Technical Services	500
Rental, Hiring and Real Estate Services	300
Financial and Insurance Services	300
Retail Trade	300

8.30 The Board understands that the previous iteration of loss carry back was repealed not on policy grounds, but because the cost of the measure was funded by revenues raised through the former Minerals Resource Rent Tax.¹⁰⁶ As such, the Board considers that there is scope to implement the loss carry back measures in a different way - one that would minimise the cost to revenue whilst still providing targeted support to small businesses in line with the guiding principles. Indicatively, this could involve:

- providing relief only to companies that are SBEs;
- capping the quantum of losses eligible for carry back; and
- limiting the carry back period to the previous income year.

8.31 Under this model, eligible small business would be able to access a refund of tax of up to the capped amount (for example, a capped loss carry back amount of \$250,000 would enable, a small business company to access a maximum tax refund of \$68,750 at a company tax rate of 27.5 per cent). This would provide a vital lifeline to the most cash-constrained small businesses at critical points in their business life cycle. In this regard, it has been suggested that a more limited cap would, arguably, better target relief towards the most viable small businesses, rather than potentially propping up failing business models. The merits of such arguments should be considered as part of the policy setting process.

8.32 In relation to implementation, the Board does not recommend extending loss carry back immediately for sole traders, partnerships and trusts due to the numerous law design considerations that will need to be resolved (such as integration with the progressive tax rate schedule that applies to individuals). A re-introduced loss carry back that is initially limited to companies would benefit from previous experience and, therefore, could be re-introduced relatively simply and quickly as many of the complex law design and

¹⁰⁶ Explanatory Memorandum to Minerals Resource Rent Tax Repeal and Other Measures Bill 2014, paragraph 2.4.

implementation challenges have already largely been addressed in the development of the former regime.

- 8.33 However, the Board considers that re-introducing loss carry back in a more targeted way could set a platform for future reform involving raising capping thresholds or extending relief to different entity types (such as sole traders, partnerships and trusts).

Business education

RECOMMENDATION 12

Increase access to small business education by funding the development of new educational products and services.

- 8.34 During consultations, stakeholders consistently emphasised that business education is a top priority for small businesses and any government assistance to help them increase their business knowledge would be greatly welcomed. Small business owners told the Board they wanted more support in helping them to run their business effectively. This was echoed by practitioners who wished their clients would have a better understanding of the various aspects of running a small business.
- 8.35 Launching a new small business requires more than a marketable product or service. It also requires skills in business administration and cash flow management, as well as a basic understanding of income tax, GST, and superannuation. Acquiring this knowledge is one of the biggest challenges facing new small business owners. New small business owners may find the process of managing and implementing effective business systems to deal with such issues particularly challenging.
- 8.36 The Board recognises the endeavours of government in this area, particularly with the information, services and tools provided through www.business.gov.au and www.australia.gov.au/smallbusiness.
- 8.37 However, the Board was advised by stakeholders that there were a number of gaps in the current suite of government business education initiatives, as follows:
- Much of the content is of an ‘informational’ nature delivered passively via the various government department websites. For small business owners this presented a two-fold problem. First, the perceived disparate nature of the content made it difficult for them to find the right information. Second, ATO research indicates that even when time-poor business owners receive the information, many do not understand it, or cannot confidently apply the information to improve their day-to-day business administration and operations.

- Much of the available information is focussed on the start-up of a small business, whereas new small business owners ideally need continued support through their first few years of operation – from the inception to the survival and growth stages of the business life cycle.
- There is a general lack of awareness of the government's educational offering. For example, www.business.gov.au only has around 25,500 subscribers. By contrast, the ATO's small business newsroom reaches 2.4 million subscribers. In addition, ATO research indicates that nearly 30 per cent of small businesses do not seek business advice or information at all when commencing business, and those that do are more likely to seek advice from accountants and industry associations.¹⁰⁷ Business owners told the Board that they would have taken up government-funded educational opportunities if they were made aware of them and prompted to do so when receiving their ABN for the first time.

8.38 Based on this feedback, the Board considers that the Government should fund the development of new educational products and services. Stakeholders noted that new business education products would be best designed by a partnership of key industry and professional associations with adult learning experts, accountants, tax agents, bookkeepers and the ATO.

8.39 Small business owners would benefit from services and products that are:

- designed by experts which have deep knowledge of the diversity of small businesses, partnering with adult learning experts;
- developed into short modules addressing the specific needs at various stages in the small business life cycle (for example, employing workers). Small business owners want to be told what they need to know, when they need to know it and, in most cases, shown how to do it; and
- clearly different from standard training courses, which are generally too long and insufficiently tailored to the real world challenges faced by small businesses.

8.40 The products should cover the first few years of the business life cycle and include the engagement of professionals and industry associations to deliver the products face-to-face, as well as the development of online instructional modules that meet the relevant standards in adult learning. The ATO has successfully adopted a similar development and delivery model through their 'Cash flow coaching kit' for small business which aims to assist tax agents advise their small business clients how to improve their cash flow and business performance.

¹⁰⁷ ATO 2017, *Small business engagement research 2017* <<https://www.ato.gov.au/about-ato/research-and-statistics/in-detail/general-research/small-business-engagement-research-2017/>>.

- 8.41 As part of this education package, the Government also should consider funding for digital delivery offerings (such as apps) for those small businesses at the 'micro' end of the spectrum to better reach those sectors. These would be offered through industry associations and not limited to tax. For example, the hairdressing associations have developed and delivered a basic payroll service, designed to specifically help small business owners avoid the pitfalls of breaching workplace awards relevant to that sector.
- 8.42 Once implemented, broadcasting of the service could leverage off the ATO's small business newsroom, reaching a far greater proportion of small business owners (and their advisers) – approximately 2.4 million subscribers – in order to raise awareness of the Government's educational products and services.

CHAPTER 9: COMPLEX STRUCTURING

KEY POINTS

- In the small business sector, complex structuring is driven by a variety of factors including commercial reasons, tax planning, family group relationships, and succession planning. As a result, complex business structures are prevalent as small business owners try and cater for their specific needs and requirements.
- Key features in the tax system including the differential between the company tax rate and the top personal tax rate, access to tax preferred amounts such as the general 50 per cent CGT discount, and the ways in which profits can be distributed using different types of entities can unduly influence and further complicate small business structuring decisions.
- Stakeholders put forward various solutions to address such complex structuring arrangements. The Board has made some observations in relation to these solutions.
- Ultimately, these matters are not confined to small business. Accordingly, further consideration should be given to these issues in the context of a wider tax reform process.

Introduction

- 9.1 Due to their closely held nature, complex structures are particularly prevalent in small business. A range of personal, family and commercial considerations are relevant in informing the choices of a small business to enter into a certain business structure. However, tax considerations also contribute significantly to the way in which small businesses are structured.
- 9.2 During the consultation process, the role that tax concessions play in encouraging small businesses to use complex structures became readily apparent. Stakeholders told the Board that tax concessions, such as the small business CGT concessions, had an effect in incentivising such complex arrangements in order to enable them to access and maximise the benefits available.
- 9.3 As outlined in Chapter Two, one of the Board's guiding principles for the design of tax concessions is to minimise the incentive for small businesses to enter into complex structures. The Board has identified positive improvements to the design of small business tax concessions. However, these will not entirely eliminate complex structuring. The Board considers it important to understand the broader underlying tax considerations which are driving small business structuring decisions.

Tax incentives as drivers for complex structuring

- 9.4 The way the tax system currently operates means that utilising different types of entities can result in economically similar activities having significantly different tax outcomes. Table 9.1 outlines how the choice of entity type has an impact on tax outcomes.

Table 9.1 - Certain characteristics of various entity types

	Sole trader	Partnership	Discretionary trust	Company
Taxable income	Taxed at individual's marginal rate	Taxed at partner's marginal rate	Taxed at beneficiary's marginal rate	Taxed at the relevant corporate tax rate
Losses ¹⁰⁸	Can be applied against other income	Can be applied against other income	Quarantined in the trust and carried forward	Quarantined in the company and carried forward
50 per cent CGT discount	50 per cent discount for the individual	50 per cent discount for individual partners	50 per cent discount if distributed to resident individual beneficiary	No discount for capital gains
Distributions	All income attributed to the individual	Partnership profit attributed to partners	Distribution determined by trustee	Distribution of profit by way of dividends based on shareholding which are taxed at shareholder's marginal rate, with an allowance for franking credits
Retained profits	Taxed at individual's marginal rate	Taxed at partner's marginal rate	Taxed in the trustee's hands at the top marginal rate	Taxed at the relevant corporate tax rate
Liability (non-tax)	Personal liability	Joint and several liability	Trustee liable	Limited liability

- 9.5 There are legitimate commercial reasons as to why small business owners would choose a certain type of entity, or combination of entities, from which to conduct their business.

¹⁰⁸ Sole traders and partners in a partnership may be subject to the non-commercial loss provisions being satisfied prior to being able to utilise losses arising from business activities.

Alternatively, some stakeholders have indicated to the Board during consultations that certain industries, such as the mining support services sector, have no choice but to incorporate as, without such a structure, they would not be able to obtain the appropriate insurances or otherwise be excluded from engaging with clients who have a policy of not engaging with unincorporated businesses.

- 9.6 Increasingly, however, the influence of certain tax characteristics can lead small business owners (and their advisors) to favour certain entities or structures which can create commercial inefficiencies, increase unnecessary compliance costs and introduce complexity. These differences in tax treatment can force small businesses into making 'tough' decisions about their structure based on the tax benefits they may or may not have access to vis-a-vis commercial considerations. This may result in small businesses finding themselves in cumbersome structures so as to ensure that they do not lose out on beneficial tax characteristics that simpler structuring may not be able to provide. Whilst arbitrage opportunities are available for those businesses that are willing to enter into complex arrangements, on the other hand, small businesses which lack the resources (for example, start-ups) and do not have access to specialist advisors may find themselves at a competitive disadvantage.

OBSERVATION: BUCKET COMPANIES

A discretionary trust can provide various tax and commercial benefits to small business. It can facilitate succession planning, limited liability (where a corporate trustee is adopted) and access to the general CGT discount. But this comes at a disadvantage as any income retained within the trust is taxed at the highest marginal tax rate if not distributed to eligible beneficiaries.

To overcome this, businesses operating through a trust may have a corporate beneficiary (also known as a 'bucket' company). By making distributions to a corporate beneficiary, this arrangement enables small businesses to have their profits taxed at the corporate tax rate whilst retaining the various benefits associated with using a discretionary trust. However, this comes at a cost in the form of higher compliance costs. For example, this approach would require the business to navigate highly complex integrity rules, particularly in relation to Division 7A.

- 9.7 It is clear that key features currently existing in the tax system are influencing structuring choices made by small businesses. But the drivers behind these choices are deeply embedded in the tax system and extend beyond the small business sector. Based on the Board's review into the small business tax concessions, listening to stakeholder feedback, as well as drawing upon insights from the Board's previous reports, the Board can make the following observations on what those drivers are likely to be:
- (a) The differential between the highest marginal tax rate and the corporate tax rate
 - This creates a significant incentive for the use of structures designed to defer or

eliminate ‘top up’ tax. This is particularly relevant for small businesses that need to retain working capital to re-invest in their business;

- (b) The general 50 per cent CGT discount – Only available to capital gains derived by individuals including capital gains made by trusts and distributed to resident individual beneficiaries;
- (c) Use of different entity types – For example, small business owners and investors generally favour entities such as trusts, which enables them to access tax-preferred amounts such as the general 50 per cent CGT discount;
- (d) Small business CGT concessions – This can provide significant tax relief upon sale of the business. But fully utilising these concessions can be highly dependent on how a small business has organised their structure at the start-up stage of their business life cycle. Having the wrong structure in place can lead to the loss of concessions on disposal.

Other options considered

9.8 Through the course of consultation, stakeholders raised targeted solutions which sought to address the issue of tax driven complex structuring in the small business sector. The Board has overviewed some of these suggestions and makes the following observations.

A ‘Business Income Election’ model

9.9 It is not uncommon for small businesses to combine the use of both companies and trusts in their group structure as a means of overcoming the limitations of each type of entity. The bucket company structure is a common example. Utilising such arrangements can expose small business to significant compliance costs and potentially adverse tax consequences under Division 7A.

“[Trusts] have an advantage in accessing the company tax rate by way of corporate beneficiaries – by still also accessing the general 50% CGT discount...the Business Income Election recommended in the Report is a way ... to either give up that advantage ... or live with the ‘full’ complexity of Division 7A.”

Stakeholder submission

9.10 In the Board’s previous review of Division 7A,¹⁰⁹ the Board recognised the complexity that can be imposed on those small businesses that have chosen to use such arrangements. But the desire to assist active trading trusts seeking access to working

¹⁰⁹ Board of Taxation 2014, *Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936*.

capital needed to be balanced with Division 7A's function to act as a disincentive for the private use of corporate funds.

- 9.11 With these competing interests in mind, the Board (in that review) proposed a model under which such businesses operating out of trust structures would be able to make a 'business income election', the effect of which would be to exclude loans from companies from the operation of Division 7A. The consequence of making this choice would be for the trust to forego its ability to access the CGT discount which would otherwise have been available (except on the disposal of goodwill and other intangible assets inherently connected with the business). The business income election was designed to relieve privately-held businesses carried on in a trust of the compliance burden associated with Division 7A where working capital is retained to genuinely fund their business operations and growth.
- 9.12 The business income election continues to have some appeal, particularly in light of this review's guiding principles. Specifically, the business income election allows for a small business that operates through a trust, with the aid of a corporate beneficiary, to share similar tax features of a company. The loss of the general CGT discount on many CGT assets also ensures that the benefits of making the election will largely be limited to trading trusts which are actively carrying on a business. In addition, as noted by stakeholders during consultations, the business income election would remove complexity for small businesses that operate using a typical trust and company structure.
- 9.13 However, the business income election represents an incremental approach. When dealing with embedded features of the tax system, such as the tax rate at which trusts can accumulate income or the availability of the general CGT discount, the Board considers that a holistic approach should be taken as part of a broader review of the complex structuring issue.

A new entity type for small business

- 9.14 The introduction of a new 'small business entity' was also suggested by stakeholders as a way to address complex structuring. It was argued that this would remove the distinction between the business owner and the entity. By integrating the two, the need to choose between business structures becomes irrelevant as the tax outcomes are ultimately assumed by the business owner. Some countries have managed to apply this through the use of 'tax transparent entities'.¹¹⁰ Broadly, such entities largely operate by 'looking through' the legal form for tax purposes and treating the activities of the relevant entity as those of the business owner.

¹¹⁰ Look Through Companies (LTCs) in New Zealand, SubChapter S Corporations (S-Corporations) and Limited Liability Companies (LLCs) in the United States, Limited Liability Partnerships (LLPs) in the United Kingdom and a *Sociétés à Responsabilité Limitée de famille* (SARLs de famille) in France.

- 9.15 The Board received mixed feedback from stakeholders in relation to the introduction of a new tax transparent entity for small business.
- 9.16 Of the stakeholders that were supportive, many noted the benefits by treating the entity on the same footing as sole traders and partnerships for tax purposes. It was argued that this would drive significant simplification benefits by making tax affairs simpler for small business.
- 9.17 Whilst there are positive benefits associated with a new tax transparent small business entity, they may be outweighed by the financial and administrative costs. Specifically, it would increase the compliance costs on small businesses through the need for complex entry and aggregation rules,¹¹¹ and introducing integrity measures to guard against the accessing of accumulated funds by shareholders or associates for private use.¹¹²
- 9.18 Introducing a new entity type for small businesses would also increase complexity by requiring consideration of yet another choice of entity which would be required to be made in the structuring decision making process. In particular for small business owners, this has financial implications as the increased choice of entity types will require specialist advice to ensure they choose the most appropriate structure. The Board considers that unless there are strong incentives for using the new entity type (for example by making access to the small business tax concessions conditional on its use), then the new entity will present a further tax arbitrage opportunity.
- 9.19 The Board discourages any increase to complexity in the tax system as it is counter to the messages the Board has heard from stakeholders which have clearly indicated that small businesses favour a tax system that is simpler and easier to understand.
- 9.20 Importantly, small businesses are largely able to replicate the features of a new tax transparent small business entity by combining different entity types. As mentioned earlier in the Board's observations, by entering into different arrangements small businesses are able to preserve tax preferred amounts, have flexibility in distributions, retain income at the corporate rate and have access to limited liability. As a result, a new small business entity would likely have limited utility in the current tax environment.
- 9.21 Having regard to the increased level of cost and complexity to small business owners in introducing a new entity type, the potential tax arbitrage opportunities, and the ability to already enter into arrangements to achieve the same or better tax outcomes, the Board does not support the introduction of a new entity for small business. The introduction of a new entity should only be considered as part of a wider tax reform process.

¹¹¹Freudenberg, B 2009, 'Fact or Fiction? A sustainable tax transparent form for closely held businesses in Australia', *Australian Tax Forum*, vol. 24, no. 3, pp. 375-422.

¹¹²This would suggest a need to have integrity measures akin to Division 7A.

Worker's co-operative

- 9.22 A further proposal centred around the promotion of a “Workers Co-operative” as an alternative model for business succession or a start-up, two critical stages in the life cycle of a business. This proposal was accompanied by several recommendations; including the establishment of a ‘co-operative business development fund’, a pilot program, CGT roll-over relief, stamp duty relief, payroll tax relief and legislation to support a form of discretionary trust – a ‘employee ownership trust’ as a business succession vehicle.
- 9.23 Similar to the Board’s conclusion on the new entity type, the introduction of a worker’s co-operative could be considered as part of a wider tax reform process.

Conclusion

- 9.24 Considering the breadth of the issues impacting on complex structuring in the small business sector, the Board believes that addressing the existing differences in the tax system should be part of a wider tax reform process. Addressing these tax drivers through such a process would allow for a more comprehensive discussion of complex structuring issues, not only for the small business sector, but also in relation to the broader business population.