1 June 205

Tax White Paper Task Force
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Sirs

Re:think tax white paper submission

On behalf of the national accounting and advisory firm, William Buck, I am pleased to be able to provide this submission to the *Re:think* tax discussion paper.

William Buck has been working with Australian small and medium enterprises ("SMEs") for over 120 years. We currently advise over 4,000 SMEs across Australia. In preparing this submission I have drawn on our firm's collective experience in this section of the Australian economy. Rather than address every discussion question, I have focused on those most relevant to SMEs.

There is no universal definition of an SME or a small business, and this is in itself an issue. For the purposes of this submission, I am using the terms broadly and interchangeably. Generally these businesses are closely held, Australian owned private businesses.

I trust that our submission will be a valuable contribution and encourage positive change in our taxation system.

Question 1: Can we address the challenges that our tax system faces by refining our current tax system? Alternatively, is more fundamental change required, and what might this look like?

The Australian tax system is based on solid principles that, by and large, continue to be relevant and applicable to today's economic environment. A wholesale change to the taxation system that attempts to reset the principles on which the system is currently based is not, in my opinion, warranted. Such a change has the potential to create more uncertainty and complexity as taxpayers, regulators, advisors and the judicial system attempt to understand and apply the new system.

However, the current taxation system is not perfect. The solid foundation principles have been modified and at times corrupted by ad-hoc amendments to the law, either through

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poorly designed amendments or simply the cumulative effect of multiple changes over many years. It is these issues that require attention to achieve a more efficient and equitable taxation system for the future.

Question 4: To what extent should reducing complexity be a priority for tax reform?

Two things really drive compliance costs – complexity in the tax laws and administrative process.

In November 2014 William Buck, in conjunction with The University of Western Sydney, St George and Western Sydney Business Connection undertook a survey of 200 business owners and senior management for businesses based in Western Sydney.

The results of this research where published in the *Making Western Sydney Greater* report and are available at:

http://www.williambuck.com/AboutUs/MakingWesternSydneyGreater

The finding in respect of tax matters were consistent with our experiences in working with businesses across Australia.

Micro businesses (defined for the purposes of the research as businesses with less than $2m turnover) identified calculating and reporting business taxes as the biggest impediment to their business.

The second biggest impediment for micro businesses and also for SME business (defined for the purposes of the research as businesses with between $2m and $100 million turnover) was payroll and employment related taxes.

Tax compliance was relatively less of an issue for large business (defined for the purposes of the research as businesses with greater than $100 million turnover).

All businesses, but in particular micro businesses and SME businesses, believe that they spend more money with their accountant and advisors on complying with tax laws than they spend on obtaining advice that would help improve their businesses.

Complexity in the tax system is a key driver of these high compliance costs.

Micro businesses and SME businesses make a significant contribution to the Australian economy. Whilst different people have differing views as to what is an acceptable level of compliance, it is clear that the costs associated with complying with the tax system fall disproportionately on smaller businesses and this comes at the added economic cost impeding the growth and improvement of these businesses.

For this reason alone, reducing the complexity of the tax system and through this reducing the costs of complying with the tax system, should be a priority issue for any future tax reform.

Question 13: What creates incentives for tax planning in the individuals income tax system? What can be done about these things?

There are multiple drivers of tax planning, but two factors warrant particular attention.

The first factor creating incentives for tax planning is tax rate disparities. The disparity in the tax rates applying to different types of taxable income (e.g. income gains v capital gains) and different types of taxpayers (e.g. individuals v companies v superannuation funds) creates a significant incentive for tax planning.

In theory, a single tax rate applying to all taxable income and all taxpayers would remove this incentive, but such a broad application of a single tax rate is unlikely to be appropriate, equitable or feasible. Rather, an objective should be to reduce the disparity between the tax rates payable by companies (the most commonly utilised tax paying entity) and that payable by the vast majority of individual taxpayers.

If the marginal tax rate applicable to incomes in the $80,001 - $180,000 bracket could be reduce to 30% (or closer to 30%), the marginal and effective rate for 97.7% of taxpayers would approximate the corporate tax rate (putting aside the proposed reduction in the corporate tax rate for small business, which further exasperates this issue).

The second factor creating incentives for tax planning are arbitrary distinctions created for tax purposes. The concept of a "personal services business" is one such situation. There is an underlying principle that personal income cannot be alienated. Historically the general anti-avoidance provision was the mechanism for enforcing this principle. When this principle was codified in the alienation of personal services income provisions, an artificial concept of a personal services business was created and given a different tax treatment. This created an incentive for tax planning. The incentive was magnified by the misconception created when these provisions were introduced that Pt IVA did not apply to the alienation of personal services income by a personal services business.

In terms of removing incentives for tax planning, a better approach to this issue would have been to codify the principle – personal services income cannot be alienated – in its totality and not create exemptions and exclusions. There are numerous other examples of similar issues across the tax system.

Question 16: To what extent does our fringe benefits tax system strike the right balance between simplicity and fairness? What could be done to improve this?

From the perspective of a SME business, the costs of complying with the FBT system are disproportionate with the amount of fringe benefits tax actually paid.

The FBT laws are proscriptive and detailed. Compliance with the FBT laws requires a relatively in-depth analysis of transactions that are often not otherwise economically significant to a business and wold not otherwise be considered in this detail (for example, in respect of meal entertainment). There is also a need to maintain FBT specific documentation (for example, the various declarations required from employees). These and other factors result in FBT being a difficult tax to manage in an efficient manner.

Australia is also one of the few countries in the world that impose a tax of this nature.

An alternative approach could be to deal with fringe benefits through a combination of non-deductibility to the employer, or the assessability of the value of benefits to the employee. These approaches would be more in line with that adopted in overseas jurisdictions.

A broader exemption from aspects of the FBT system for SME businesses may be an alternative, as in most instances SME businesses only provide a limited range of fringe benefits. However, a selective application of the FBT laws depending on the size of a business may actually create further complexity. In my view, repealing the existing FBT laws and replacing them with provisions in the income tax laws to tax or deny a deduction for the benefits would be the most appropriate approach.

Question 19: To what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?

A tax based rationale for the CGT discount is that a capital gain accumulates over multiple years but is taxable in a single year. This can mean that the tax rate on the capital gain is higher than what would normally be the individual's tax rate as the capital gain pushes the individual into a higher tax bracket. Discounting the taxable amount of the capital gain removes some (or all) of this impact. If a change in the extent of the discount is being contemplated, this impact on tax rates should be considered as part of that process.

There are other rationales for the CGT discount (such as encouraging capital investment) and I do not propose to comment on the ongoing merits of these.

An observation is that a single 50% rate of discount is a blunt way of addressing the tax rate impact. If the tax rate impact was the sole rationale for the CGT discount, a scaled discount rate matched to the period an asset has been held would seem a more appropriate approach. However is more complex than the current single rate discount.

Question 29: To what extent does the tax treatment of losses discourage risk-taking and innovation and hinder business restructuring? Would alternative approaches be preferable and, if so, why?

The current treatment of losses, particularly in an SME context, is problematic.

A key issue is that the tax laws relating to losses are applied, for various reasons, is an overly legalistic manner rather than with a focus on the economic and commercial substance of the situation.

The company loss rules have been hampered by poorly drafted (on one view) or narrowly interpreted (on another view) rules that made pass the continuity of ownership essentially impossible for companies that had multiple classes of shares on issue. The test was applied in an overly legalistic manner that placed greater emphasis on form than substance. A continuity of ownership test should be based on continuity of economic ownership in a commercial sense.

The same business test is applied so strictly that any material change in the business or business practice risks causing a failure of this test. Rather than encouraging businesses to adapt and change, the same business test has the opposite effect.

The trust loss tests (and other tax laws relating to trusts) have been hampered by the legalistic interpretation of fixed v non-fixed trusts. Again, rather than the law reflecting a position that is consistent with accepted commercial practice (i.e. that a unit trust is generally a fixed trust), we have a position where few trusts (other than widely held trusts) can ever be fixed trusts. This gives inappropriate outcomes when the trust losses tests are applied to such trusts.

However, putting aside other issues with the family trust elections, a benefit of the family trust election approach has been a dramatic simplification of the treatment of losses within family discretionary trusts. This is an example of how tax laws can be simplified, although the implementation of this particular measure could have been improved.

A second issue relates to "grouping" of losses. Historically, companies had an ability to transfer losses subject principally to satisfying various ownership requirements. With the implementation of the tax consolidation regime, the ability to transfer losses was removed. Now, for companies to transfer losses they must form part of a tax consolidated group. For SME businesses, the tax consolidation regime is too complex, it is expensive to implement and is beyond the understanding of many of the tax agents working with SME businesses.

In an SME context, where there is sufficient commonality of ownership of entities, business losses should be able to be transferred. This ability should exist independently of the consolidation regime.

Loss carry-back provisions should be reconsidered. These rules, in principle, recognise that a business operates on a continuous basis and the division of these operations into period for tax purposes is artificial. Reflective of this, the impact on tax payable of tax losses should be spread over the years both before and after the year in which the loss arose.

Question 30: Could the current treatment of intangible assets be improved?

Without question, the current treatment of intangible assets could be improved. Intangible assets are assuming greater significance in economic activity however the tax treatment of such assets has not altered to any material extent in recent times. At a minimum, this is an area of the tax law that warrants review. An objective should be to develop a tax policy for intangibles that encourages innovation and entrepreneurship.

There are a limited group of intangible assets that are able to be depreciated – copyright, patents, designs and some software. All other intangible assets are treated as capital assets with the acquisition or development costs forming part of the cost base of those assets. The group of intangible assets eligible for depreciation should be reassessed with a viewed to expanding this list. The basis for depreciation of software should also be reassessed and extended to cover all software.

The comments regarding goodwill in the discussion paper are of some concern. The goodwill of a business is the product of everything that is done in the business. The implication that some costs (the example was

marketing expenses) are potentially capital in nature as they enhance the goodwill of the business demonstrates a misunderstanding of the nature of goodwill. Aside from this, any move to modify the tax system to require capitalisation of such costs would add significant compliance costs and would negatively impact on entrepreneurial behaviour.

The pricing of intangibles is a challenging area, both commercially and for tax purposes. On the international aspects, I would encourage the adoption of rules and processes that are consistent with the OCED guidance, in particular the guidance being developed as part of the BEPS program. Where there are higher risk transactions (international or otherwise) modification of the income tax return form to require disclosure of the transaction should be considered. This would facilitate review of the transactions by the ATO. If the existing law is found to be deficient, then modifications to the law should be considered. As action should be formulated to reduce complexity in the tax laws and target attention only at those taxpayers undertaking the higher risk transactions.

Question 32: To what extent does the tax treatment of foreign income distort investment decisions?

The current tax treatment of foreign income is an impediment to the international expansion of SME businesses.

At present, foreign business income is taxed in the foreign jurisdiction. When the business income is repatriated to the Australian owners the income is generally exempt (in the case of companies) or taxable (in the case of individuals). Where the foreign income is taxable in Australia, a credit is given for foreign tax paid by the Australian taxpayer (such as withholding taxes) but not tax paid on the foreign business income by a foreign entity (such as a foreign subsidiary company).

For SME businesses, income of the business is often distributed to the business owners to a greater extent than what would be the case for larger, and in particular listed, businesses. The distinction between the shareholders and the operating entity is less pronounced as the entities are closely held. This is problematic for foreign income as the overall effective tax rate on the income can exceed 60%. When faced with an effective tax rate well in excess of the top marginal tax rate, the commercial investment decisions of SME business owners are biased towards Australian activities (where franking credits can be generated for tax paid) as opposed to international activities (where the higher effective tax rate occurs). In this way tax is distorting commercial decisions.

Conceptually, it would be beneficial if the maximum effective tax rate ultimately payable by the taxpayer and their associates on foreign business income could be limited to the highest marginal tax rate for individuals.

Question 34: How can tax avoidance practices such as transfer pricing be addressed without imposing an excessive regulatory burden and discouraging investment?

From an SME perspective, the costs of complying with the transfer pricing provisions is disproportionately higher (relative to larger businesses) and the extent of the transfer pricing problem is disproportionately lower (again, relative to larger businesses).

Applying the same transfer pricing rules to SMEs and to larger businesses creates an excessive regulatory burden for the SME businesses and is a further impediment to their international expansion.

This is an area of the tax law that needs to focus on the problem, rather than attempt a “one size fits all” approach.

High thresholds, such as those applied in the amended thin capitalisation provisions, are an effective approach. This targets the measure on the taxpayers where the issue is most economically significant.

Where the transfer pricing provisions do apply to an SME business, an increased use of published safe harbour style data for common transactions is effective. This removes a major cost for SME businesses, being the benchmarking process required to substantiate pricing methodologies.

Template documentation that sets out the specific information required for acceptable transfer pricing documentation, tailored to SME businesses, would be beneficial.

Question 41: What effect is the tax system having on choice of business structure for small businesses?

Tax outcomes is a major driver behind the business structures chosen for the operation of small business. When working with a small business on determining the optimum structure, the following would generally be the key factors being considered:

Tax factors

— Tax on business profits, in particular the ability to limit the tax on retained profits to the corporate tax rate;

— Tax on distribution of profits. Hand in hand with this is flexibility in the distribution of profits in terms of timing and recipients. It would be redundant to state the objective is to minimise, legally, the level of taxation on the distributed profits;

— Accessing capital gains tax concessions on sale.

Other factors

— Asset protection considerations;

— Family law considerations;

— Succession planning.

For micro businesses, a partnership, sole trader or trust structure may be appropriate. For most SMEs, a company with a discretionary trust as the shareholder is the preferred structure.

The eligibility criteria for the small business CGT concessions are a major influencer of the legal structure chosen for SMEs. These concessions favour direct ownership of operating entities rather than the use of subsidiaries. This can mean that associated businesses are held in “sister company” structures rather than wholly owned groups, or a single trading entity is used rather than undertaking the businesses in separate

entities. These structures are often not as effective for the non-tax factors that influence the choice of legal structure and can be more cumbersome to administer. These costs are a trade-off to achieve access to the CGT concessions.

As finance is often limited for SMEs, many do not obtain advice on the appropriate legal structure until their business is operational and profitable. At this time, the costs (tax, duty, legal, etc) of transitioning from the existing structure to the preferred structure can be prohibitive as the value of the business is material (in an SME context). With the exception of the small business CGT concessions, the current CGT rollovers are narrow and do not facilitate making substantial changes to the legal structure of SMEs. Duty costs are also an issue.

In my experience, the vast majority of SME businesses do not contemplate, let alone implement, the more "exotic" structures. Reasons for this include the costs of the advice, the costs and complexity of operating these structures and the reaction of others (customers, supplies, banks, etc). This is relevant when drafting the tax laws for legal structures for SME businesses, as it can mean that the avoidance aspect of the laws can be limited, or more targeted, thereby reducing complexity for the vast majority.

Question 42: What other options, such as a flow-through entity (like an S-Corporation), would decrease the overall complexity and costs for small business involved with choosing a business structure? How would such an entity provide a net benefit to small business?

I am strongly of the view that the concept of a special purpose entity for small businesses should be considered as part of the next stage of this consultation process.

If a new form of legal entity could be created that provided the key attributes the SME business owners seek from their legal structure, this would mean that business owners could implement an efficient and effective structure from the commencement of their business and would greatly reduce costs (advisors costs, tax costs of changes, commercial costs of operating through sub-optimum legal structures) associated with the current situation.

In principle, the attributes that this structure should embody would include:

— Taxation of business profits, retained in the business, at the corporate tax rate;

— Flexibility on the timing and recipients of distributions. This could be limited to the family group, as is currently the case with family trusts;

— Access to CGT concessions;

— Asset protection equivalent to the current company/discretionary trust structure. That is, limited liability for owners in respect of the liabilities of the business, and effectively limited liability for the business for the liabilities of the owners.

— An ability to transition ownership, whether to family or otherwise.

If the structure does not embody these factors, SME business owners will continue to look for alternative structures that do. This would undermine the reason for introducing a SME specific entity in the first place.

If a new SME specific entity is introduced, a flexible basis for transitioning from the existing legal structures to the new entity type would need to be introduced. Both tax and duty costs should be considered.

Alternatively to a new type of legal entity, it may be appropriate to provide a "check the box" style option where, regardless of legal structure, SME businesses can elect to be taxed as SME businesses. This may be the avenue for accessing CGT concessions on sale or a lower tax rate for business profits. It could also facilitate the targeting of other concessions, such a modified Division 7A or simplified transfer pricing.

Further rationale for consideration of the small business entity concept is included in my responses to question 44.

Question 44: What are the most significant drivers of tax law compliance activities and costs for small businesses?

There are numerous drivers of compliance activities and costs for small business. I have provided below some examples that I believe highlight the underlying causes of the high compliance costs imposed on small business.

Definition of small business

There is no consistent definition of small business, and the most common definition (Div. 328) includes relatively complex grouping provisions. That a business can be a "small business" for one tax measure but not for another increases compliance costs as eligibility needs to be assessed multiple times. There should be a single "base level" definition of a small business that applies across all taxes (and broader if possible). The threshold should be set high enough to capture as much of the SME business grouping as possible. A low threshold is counter to the encouragement of economic growth. If a small amount of growth means the loss of numerous tax concessions/simplifications, then businesses will assess if the cost of that growth is actually worth it. I would suggest that the current $2M turnover threshold is too low. A threshold set at $5M or $10M turnover would be a significant improvement.

A higher threshold would capture a relatively small number of businesses, but businesses which are a growing and dynamic part of the economy. A greater economic benefit can be obtained by supporting a slightly larger growing business as compared to a smaller business without capacity and/or intent to grow. This is where tax policy should be focused.

A higher threshold would remove the need for most businesses to be concerned with exceeding the threshold, thereby reducing the compliance costs they face, as the need to monitor the threshold on a regular basis is reduced or removed.

Assessment of the optimum threshold should form part of the next stage of this consultation.

Inconsistent definitions

Unnecessary complexity is created where similar terms are used in different parts of the tax laws but each is defined in a materially different way.

For example, someone could be an associate under s. 318 for Division 7A purposes, but not be a connected entity under Div. 328 for CGT purposes. Someone could be a connected entity under Div. 328 but not part of the family group for the trust loss measures. The definition of Part 8 Associates for superannuation purposes is different again.

These types of situations require similar issues to be considered multiple times, adding to compliance costs. They also create areas of inadvertent errors for taxpayers who assume that the similar concepts are in fact the same.

Wherever possible, consistent definitions should be used across the tax law. If a special purpose SME entity or election was available, the grouping rule used to determine eligibility for this entity/election could then be the sole grouping rule used for that SME business across other parts of the tax system.

Inconsistent treatment

The taxation treatment of a situation should align with the commercial substance of the situation and should be consistent across the tax laws.

An example of where this does not occur is the employee/contractor situation. Different treatment can arise for the same arrangement under PAYG Withholding, FBT, Superannuation Guarantee and Payroll Tax regimes. Other non-tax workplace laws add further complexity. This is on the employer side. On the employee side, the personal services business/personal service income/employment divide is equally as problematic.

There should be a single set of parameters that distinguish an employee and a contractor for tax purposes. Ideally, this should align with the tax treatment of the income in the hands of the employee/contractor.

In our *Making Western Sydney Greater* research (refer response to Question 4) the second biggest impediment for micro businesses and SME business was payroll and employment related taxes. The use of contractors is increasing across the economy. By needing to individually assess each different tax obligation for each contractor, significant and unwarranted compliance costs are being imposed on businesses. A single set of parameters would address this.

Prescriptive law

Where law is drafted in a prescriptive manner so that a commercially justifiable transaction produces an adverse tax treatment, or a small departure from the tax laws produces a large adverse tax outcome, significant compliance costs arise.

The Division 7A laws, both in their current form and historically, are a good example of this. A loan from a private company to a shareholder on terms equivalent to those that a bank may offer, may not satisfy the requirements to be a complying loan for the purposes of these provisions. Likewise, a loan that is applied for income producing purposes such that the interest is tax deductible can still breach Division 7A. The same loan to an employee would not be subject to FBT due to an otherwise deductible rule.

Prescriptive tax laws risk creating situations where the tax treatment of a transaction is inconsistent with the commercial substance of the transaction. This adds to compliance costs.

Division 7A is an area where a simplified set of rules could be applied to taxpayers meet an small business definition or adopt a special purpose small business entity/election.

Antiquated concepts

Tax law is complex and compliance costs are high where the laws are based on antiquated concepts. The best example of this is the taxation of trusts. It is now well recognised that the tax law does not interact well with trust law.

In the absence of other legal structures that can achieve their commercial objectives (such as a special purpose small business entity) many SME business owners will use a trust to own and conduct their business, or to own the entity that conducts the business. By adopting this legal structure, SME business owners are forced to deal with a complex set of tax and trust law issues and a steady stream of amendments or changes in interpretation.

The taxation of trusts is an area that requires reform and should be part of the ongoing consultation process. I would suggest that this is one area of the tax law where continuing to try and modify the existing laws to deal with the various issues is not the right approach. A re-think of the way trusts are tax is warranted. The idea of taxing the trustee should be revisited, however the complexity of the entity tax model should not.

A special purpose small business entity could remove the need for SME businesses to deal with the complexity of the taxation of trusts.

Question 46: What other mechanisms (such as a single lower tax rate, improved technology deployment or other non-tax mechanisms) could assist small businesses to engage with the tax system while decreasing compliance and complexity costs?

There are two main drivers of compliance costs for small business – complex laws are one and have been the focus of much of this submission. Administrative processes are the second. The more streamlined and efficient the interactions of businesses and the regulatory authorities can be, the lower the compliance costs.

In our *Making Western Sydney Greater* research (refer Question 4) businesses agreed that electronic reporting to and interaction with the ATO has helped reduce compliance costs. Ongoing enhancements to the electronic reporting systems should continue to deliver compliance costs benefits and should be encourage.

Question 52: What are the relative priorities for state and local tax reform and why? In considering reform opportunities for particular state taxes, what are the broader considerations that need to be taken into account to balance equity, efficiency and transitional costs?

Two things stand out with state and local taxes. Firstly, there are taxes that are an impediment to economic activity. Secondly, there are taxes that apply in multiple states, but are administered differently by each state.

On the first point, I would advocate the removal of as many low value, narrow base taxes as is possible. For the businesses affected by these taxes, they add a compliance cost that is out of proportion with the revenue raised. If there is a strong public policy reason for the tax (and taxes on cigarettes may be an example), then that may outweigh the compliance impost. If not, the tax should be repealed.

It is not just small, narrow taxes that are problematic. Stamp duty on business assets and shares is a tax that impedes economic activity as it adds additional costs to restructuring inefficient businesses, to obtaining investment in existing businesses and encouraging growth through mergers and acquisitions. It is also a tax that can be narrow and prescriptive in its application, so commercially equivalent transactions may result in materially different duty outcomes. This encourages tax planning. Abolition of stamp duty on business assets and shares should be considered.

Payroll tax is a tax that discourages employment growth and economic activity, but it also plays a key role in the revenue of state governments. A consistent set of laws across the various states and the ability to deal with a single authority for all payroll tax obligations would be beneficial in reducing compliance costs. If a taxpayer could deal just with their home state in respect of their Australia wide payroll tax obligations, this could act to reduce the compliance costs imposed on businesses. This and other ways to improve the existing payroll tax arrangements should be considered.

Question 62: Would there be benefits in integrating the administration of taxes across the Federation? If so, what would be required to realise these benefits?

There is little question that dealing with a single tax regulatory would be an improvement over the existing situation. This should result in more consistent law, more consistent administration of the law and a reduced volume of reporting. These will also assist in reducing compliance costs.

The opposite approach, devolving taxation rights to the states, should be avoid, Dealing with multiple levels of government (on tax and non-tax matters) is a big issue for businesses due to the additional compliance costs it brings. If this approach was taken, the differences between the tax laws in each state that would inevitability arise will increase complexity and encourage tax planning. Neither of these are desirable.

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I thank for you for the opportunity to provide this submission and would welcome the opportunity to contribute further on the issue raised.

Yours faithfully
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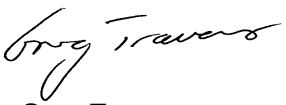

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