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Ref: TS/CMB/hg

21 September 2012

Business Tax Working Group Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

By email: BTWG@treasury.gov.au

Dear Sir/Ms,

DISCUSSION PAPER - 13 AUGUST 2012

Thank you for the opportunity of making a submission on the Discussion Paper ("the Paper") issued by the Business Tax Working Group ("BTWG") on 13 August 2012.

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

General comments

We note that the BTWG report does not make specific recommendations - it does however, say "that Australia should have an ambition to reduce its company tax rate over the medium term and that achieving a materially lower rate is a worthwhile reform objective."

Whilst we agree that a cut in the corporate tax rate is a laudable objective, if the same revenue is to be collected (i.e. despite any cut in the corporate tax rate) there will have to be winners and losers - some taxpayers will pay less tax and others will end up paying more.

We fear that taxpayers in the middle market, which comprises hundreds of thousands of non-corporate taxpayers, will be the losers and that the Australian economy will suffer as a result.

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We submit that merely altering the tax mix between corporate and non-corporate taxpayers without any reduction in the overall tax burden can, at best, only be of marginal benefit. In other words, we question whether the Australian economy actually needs a corporate tax rate reduction if any such reduction must be funded by tax base-broadening measures in order to make it 'revenue neutral'.

Due to the specific targeting of certain measures to fund the tax rate reduction, it is likely that such measures will have a direct impact on some industries more than others. In this regard, we note that the BTWG has specifically acknowledged that it "is vital that the net effects - especially on particular sectors and on investment decisions - of removing existing concessions are examined carefully."

We cannot emphasise enough the importance of the need to examine the effect of any tax changes on the middle market sector of the Australian economy.

Summary of the concerns / issues that we have for the middle market

Here is a bullet point summary of the concerns / issues that we have for the middle market. These points are expanded upon in the attached Appendix:

- If the same revenue will be collected there will have to be winners and losers - we fear that the middle market will be the losers given that, with the exception of the mining and exploration industries, virtually all of the tax base broadening measures are highly relevant to the middle market.

- Limiting deductions and changing the tax treatment of items will affect different industries in different ways. Proper consultation will be crucial to ensure that there are no 'collateral victims' of any changes.

- Limiting the R&D tax incentive to companies with less than $20 million turnover is far too low in the context of the middle market companies that can afford meaningful R&D and are most likely to be motivated to increase their R&D. The turnover threshold should be increased to at least $50 million.

- Limiting the R&D tax incentive for "larger" companies could reduce the amount spent in Australia by foreign parent companies - how does this encourage non-residents to invest more in Australia?

- Property owners - there will be "winners and losers" from any effective life change depending on how quickly buildings are renovated / updated etc. In addition, any move to bring buildings within the balancing adjustment rules will need to be carefully implemented so that existing arrangements are adequately 'grandfathered'.

- Division 7A - any reduction in the company tax rate will just encourage more people to use companies. In the context of the current Division 7A Board of Taxation Review there would seem to be a risk therefore, that the

Government will decide that Division 7A needs to be 'strengthened' rather than 'simplified'.

- Capping all interest deductions:
  - Will discriminate against certain industries that have long lead times for income generation (e.g. agriculture; property development and construction; and R&D).
  - There are existing commercial caps on what many middle market taxpayers can borrow, so why do we / they need a statutory cap?
  - Most middle market taxpayers are domestically based, are in trusts and use debt funding as a 'matter of course' so they are likely to be adversely effected by any general interest cap.
  - Property industry taxpayers / start-up taxpayers and the like are usually highly dependent on borrowing; accordingly, any general interest cap will just discriminate against them.
  - An interest cap could make things worse for companies in financial problems - i.e. they may have to comply with not only the current continuity of ownership ("COT") and same business test ("SBT") rules but also the new interest cap rules.
- Accelerated depreciation and capped effective lives are there for a reason - i.e. to encourage taxpayers to invest in the newest technology rather than continuing to use out-dated plant and equipment. The removal of these 'concessions' will have an adverse effect on a large number of non-corporate taxpayers in Primary Production and Capital-intensive industries.
- Debt and equity are not equal for middle market businesses - lenders have security over assets and will not inject equity in the first place.
- Whilst the corporate tax reduction will attract more non-resident investors, we note that middle market companies and trusts struggle to attract capital from such investors given the illiquid nature of private entities from an exit strategy perspective.
- Any thin capitalisation changes will discourage SMEs from investing overseas, which is not just a bad economic outcome but is also wrong from a tax policy perspective.
- Taxpayers conducting their activities / businesses through trusts will get no benefits from a corporate tax rate reduction unless they use a corporate beneficiary - which will only encourage the greater use of such beneficiaries and thus, potentially lead to more disputes with the ATO and/or adverse Division 7A compliance implications.
- Compliance costs may increase with transitional rules for arrangements / transactions that straddle the introduction of any changes.

- Any corporate tax reduction should initially be focused on the middle market (less than $250 million turnover) and there should be no trade-offs. On the contrary, tax incentives should be increased - middle market taxpayers are major employers in this country and many are finding it ‘tough’ at the moment.

  In this regard, we also note that a staggered introduction of the corporate rate reduction that is initially focused on the middle market will ease the pressure on the Government’s fiscal position.

Further information

We believe that the issues raised in this submission are of critical importance to the middle market should a decision be taken to proceed with the measures proposed in the Paper and we would appreciate a meeting with the BTWG to discuss these issues further.

Please contact the writer on 03 8610 5503 if you would like more information on, or clarification of, any of the issues raised in this submission or to organise a meeting to discuss this further.

Yours faithfully
PITCHER PARTNERS ADVISORS PROPRIETARY LIMITED

THEO SAKELL
Executive Director

Encl: Appendix

Appendix - Specific Comments

The Importance of the Middle Market to the Australian Economy

Due to the specific targeting of certain measures to fund the tax rate reduction, it is likely that such measures will have a direct impact on some industries more than others. In this regard, we note that the BTWG has specifically acknowledged that it "is vital that the net effects - especially on particular sectors and on investment decisions - of removing existing concessions are examined carefully."

We cannot emphasise enough the importance of the need to examine the effect of any tax changes on the middle market sector of the Australian economy.

Economic statistics

As the Reserve Bank of Australia pointed out in a publication it released earlier this year for a Small Business Finance Roundtable entitled "Small Business: An Economic Overview"[1]:

> *… [small] businesses play a significant role in the Australian economy, accounting for almost half of employment in the private non-financial sector and over a third of production. …*
>
> *Around 95 per cent of the 2 million actively trading businesses in Australia in 2011 were small businesses. …*
>
> *Their contribution to employment is highest in agriculture, where small businesses accounted for 86 per cent of employment …*

Taxation statistics

In terms of taxation statistics on the middle market, we note that the ATO stated in its Compliance Program 2012/13 earlier this year that there:

> *… are around 183,000 businesses in Australia with an annual turnover of between $2 million and $250 million, which we classify as small-to-medium enterprises (SMEs). Of these, around 80% have a turnover of between $2 million and $10 million. …*
>
> *The SME taxpayer segment includes over 2,000 public company groups, over 11,000 self-managed superannuation funds and around 400 larger superannuation funds regulated by the Australian Prudential Regulation Authority (APRA).*

More recently the ATO has published a specific guide entitled "Tax compliance for small-to-medium enterprises and wealthy individuals"[2] which provides a more detailed breakdown of the middle market (references to 'our' and 'we' below are to the ATO and not to Pitcher Partners):

[1] http://www.abs.gov.au/websitedbs/d3310114.nsf/4a256353001af3ed4b2562bb00121564/d291d673c4c5aab4ca257a330014dda2/$FILE/RBA%20Small%20Business%20An%20economic%20Overview%202012.pdf
[2] http://www.ato.gov.au/businesses/PrintFriendly.aspx?ms=businesses&doc=/content/00129961.htm

A diverse range of taxpayers fall within the SME market. For the purpose of our compliance activities we break the SME market into three sub-segments. We base this division on the net wealth of Australian resident individuals and the annual turnover of entities.

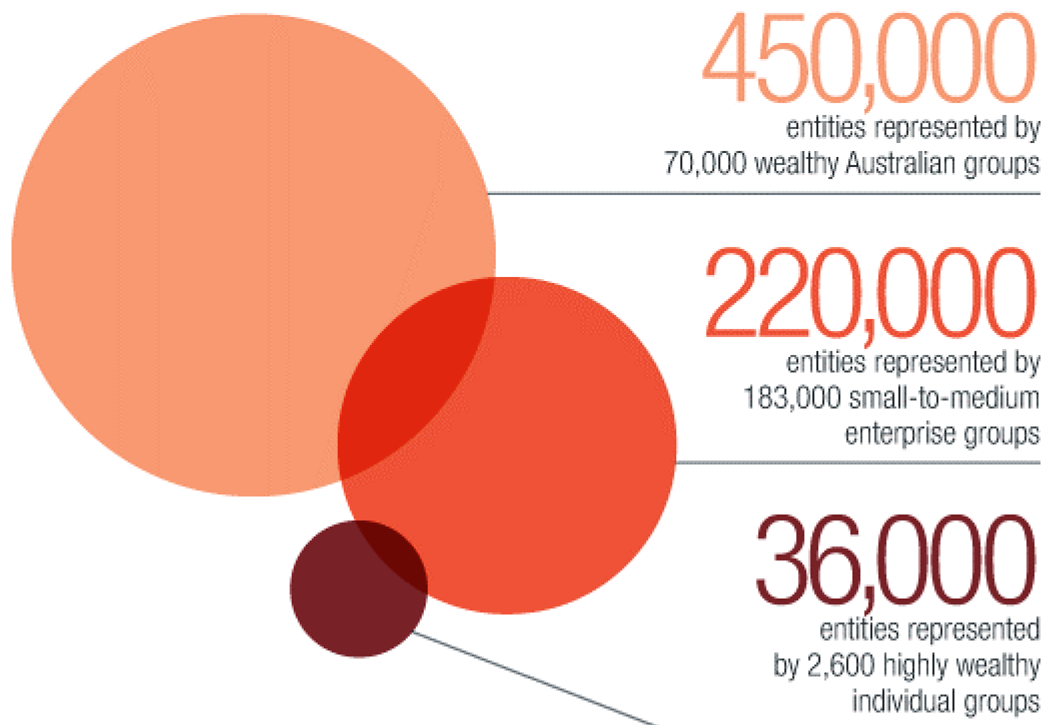
The segments are:

- *Highly wealthy individuals - defined as Australian resident individuals who, together with their associates, effectively control an estimated net wealth of $30 million or more.*
- *Wealthy Australians - defined as Australian resident individuals who, together with their associates (often including micro-enterprises), effectively control an estimated net wealth of between $5 million and $30 million.*
- *Small-to-medium enterprises - defined as economic groups with turnover of $2 million to $250 million.*

We classify an economic group with a combined turnover of $250 million or more as a large business. However, where a wealthy individual owns or controls a large business, we monitor the individual's tax affairs using the information collection methods developed for wealthy individuals. ...

Overall, the SME market represents three main populations with close to 250,000 groups and over 600,000 taxpayers.

Figure 3: The three main populations the SME market represents



We collected $272.97 billion in net cash in 2010-11. Approximately $74.7 billion of it (27.4%) came from the SME market. The revenue from the SME market includes:

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Tax	Amount ($)
Net income tax payable (companies)	15.6 billion
Goods and services tax	21.07 billion
Net income tax payable (individuals)	35.2 billion
Super	1.08 billion
Fringe benefits tax	932 million
Excise	383 million
Other	446 million

Most of the 700,000 trusts in Australia are used by the middle market

In the taxation statistics that it released earlier this year[3] the ATO provided a detailed breakdown in Chapter 6 of the income derived by, and types of, trusts in Australia. As you can see from the following Table produced by the ATO, the vast majority of the roughly 700,000 trusts in Australia are not either large or very large trusts:

Table 6.5 Trust total business income, by trust size, 2008–09 and 2009–10 income years

	2008–09[1]		2009–10[1]	
Trust size	No.	$m	No.	$m
Loss	852	–2,309	727	–121
Nil	382,790	0	405,871	0
Micro	253,162	84,426	271,285	90,180
Small	19,20	77,412	20,281	81,602
Medium	3,573	82,831	3,754	87,611
Large	130	18,580	122	17,886
Very large	33	18,028	38	18,016
Total[2]	659,744	278,968	702,078	295,175

1 Data for the 2008–09 and 2009–10 income years includes data processed up to 31 October 2010 and 31 October 2011 respectively. Data for 2008–09 has been revised.

2 Totals may differ from the sum of the components due to rounding.

For the purposes of the above Table, the ATO points out that:

[3] http://www.ato.gov.au/corporate/content.aspx?doc=/content/00305922.htm&pc=001/001/049/001&mnu=0&mfp=&st=&cy=

Total business income is the amount a trust declared at item 5 on page 3 of the 2010 trust tax return.
***Loss trusts** have a total business income less than $0.*
***Nil trusts** have a total business income equal to $0.*
***Micro trusts** have a total business income equal to or more than $1 but less than $2 million.*
***Small trusts** have a total business income equal to or more than $2 million but less than $10 million.*
***Medium trusts** have a total business income equal to or more than $10 million but less than $100 million.*
***Large trusts** have a total business income equal to or more than $100 million but less than $250 million.*
***Very large trusts** have a total business income equal to or more than $250 million.*

It is important to note that micro trusts are defined as trusts with less than $2 million of business income turnover. Thus, such trusts are either micro small business trusts or only hold passive assets. The above Table highlights that more than 95% of all trusts for these income years are micro trusts or smaller.[4]

In addition, the ATO pointed out that for the 2009/10 income year micro sized trusts:

- accounted for 30.6% of all trust total business income; and
- had the largest increase in total business income (a 6.8% increase on the previous year).

In summary, what the above information shows is that the trusts are predominantly used by middle market taxpayers. Accordingly, (and to paraphrase the BTWG) it is not just vital that the net effects of removing existing concessions for trusts are examined carefully - *it is critically important for the Australian economy to ensure that the effect of the removal of any tax concession that is available to a trust is subject to a very rigorous and extremely thorough cost / benefit analysis.*

Who will be the winners and losers?

Corporate taxpayers will benefit from any reduction in the tax rate if the proposals to offset the cost to the Federal Budget of a tax reduction (i.e. by broadening the business tax base) do not effectively ‘pull back’ deductions that affect them.

For example, at the current time, if a taxpayer with assessable income of $1500 has allowable deductions of $500, they will have a taxable income of $1000 and will pay tax of $300. Prima facie such a taxpayer will be a net ‘winner’ from any reduction in the corporate tax rate to 25%, as the taxpayer will pay $50 less in tax (i.e. $250 instead of $300).

[4] That is, with either no income or losses

However, this will only be the case provided that the "tax effect" of the allowable deductions it can claim is not reduced by more than $50. In particular, the taxpayer will only be a net 'winner' if its allowable deductions are not reduced by more than $200 (i.e. $50 / 25%). That is, $1500 less allowable deductions of $300 gives a taxable income of $1200 and tax of $300 at a 25% rate.

The deductions being targeted are depreciation, capital allowances and interest deductions together with the R&D tax incentive. For same middle market taxpayers that operate through a company, these options may not result in a significant decrease to the deductions being claimed or any significant increase in tax payable due to a reduction in the R&D tax offset - accordingly, a reduction in the corporate tax rate may result in a real benefit to such taxpayers.

However, as only one third of small businesses use a company[5] this means that *the vast majority of middle market taxpayers operate their businesses through unincorporated vehicles - i.e. as sole traders, partnerships or trusts. If such businesses do not shift their operations to a company structure (or in the case of trusts use a corporate beneficiary), they will not be able to access any reduction in the corporate tax rate and there will not be any immediate tax savings for them.*

Instead, these businesses will just face a possible reduction in the deductions available to them at the sole trader / partnership / trust level. This will have a detrimental effect on the middle market.

Whilst the corporate tax reduction will attract more non-resident investors, we note that middle market companies and trusts struggle to attract capital from such investors given the illiquid nature of private entities from an exit strategy perspective.

Which deductions used by middle market taxpayers may be reduced?

The BTWG has identified a number of possible options that can be used to broaden the tax base.

<u>Interest deductions for all taxpayers</u>

The BTWG has outlined an option of removing the thin capitalisation rules from the domestic law and replacing them with a cap on the deductibility of interest generally.

This option would involve limiting the net interest expense (i.e. the excess of interest paid over that received) that can be claimed as a tax deduction to a set percentage of 'earnings before interest, taxes, depreciation and amortisation' ("EBITDA") for all taxpayers.

This limit would apply regardless of whether the taxpayer operates only domestically or has offshore operations. *This measure would have a significant impact on the middle market, as any taxpayer that has used debt to fund their operations will be affected.*

[5] Per "Small Business: An Economic Overview", supra, page 4.

In particular, we have a number of issues / questions regarding this option:

- It will discriminate against certain industries that have long lead times for income generation (e.g. agriculture, property development and construction & R&D).
- There are existing commercial caps on what many middle market taxpayers can borrow, so why do we / they need a statutory cap?
- Most middle market taxpayers are domestically based, are in trusts and use debt funding as a 'matter of course' so they are likely to be adversely effected by any general interest cap.
- Property industry taxpayers / start-up taxpayers and the like are usually highly dependent on borrowing; accordingly, any general interest cap will just discriminate against them.
- An interest cap could make things worse for companies in financial problems - i.e. they may have to comply with not only the current continuity of ownership ("COT") and same business test ("SBT") rules but also the new interest cap rules.

In this regard, we have had the advantage of reading in draft form the submission that will be made by Alandal Consulting and can only concur with the observations and points raised therein. To paraphrase Alandal Consulting, *it is crucial that any tax guidelines which are imposed are consistent with the equivalent commercial guidelines - if they are not, then the tax system will be operating counter to commercial reality and will produce inappropriate outcomes.*

We also note that for the majority of taxpayers in the middle market debt and equity are not readily substitutable. This is because a party may only be prepared to loan funds to a middle market taxpayer (i.e. as it will have security over assets) and will simply not inject equity in the first place.

Interest deductions for taxpayers with international operations/owners

Alternatively, the BTWG has outlined possible changes to the thin capitalisation rules (and thus the ability to claim interest deductions) for those taxpayers with international operations/owners. Three separate options were put forward in the BTWG report.

The first option considers removing the arm's length debt test and reducing the safe harbour maximum debt limit for general entities from 75 per cent to 60 per cent on a debt-to-total assets basis (or from 3:1 to a 1.5:1 debt-to-equity basis). There would also be a reduction in the worldwide gearing ratio for general entities from 120 per cent to 100 per cent.

The second option is effectively the same as the first option; however, the arm's length test would be retained.

Finally, the third option would target specific thin capitalisation amendments for banks and non-bank financial entities.

Either option one or two are likely to have a significant impact for middle market taxpayers that have international operations / owners - especially where the Australian operations are required to be heavily geared in order to support the foreign activities.

We note that any thin capitalisation changes that may discourage SMEs from investing overseas will not just result in a bad economic outcome but will also be wrong from a tax policy perspective.

Depreciation on plant and equipment

The BTWG report considers reducing the diminishing value rate for depreciation to 150% (from 200%). Such an option would have the greatest impact on those middle market taxpayers that are highly capital intensive.

Building depreciation

The report outlines a number of options in relation to reducing capital allowance deductions on buildings.

These options include: (i) removing the capital allowance deduction completely; (ii) reducing the capital allowance deduction to a standard 2.5%; and (iii) moving buildings within the normal depreciation rules (which would result in buildings being subject to the balancing adjustment provisions).

If any of these options are considered, they are likely to have a direct impact on middle market taxpayers in the property sector - once again there will be "winners and losers" from any effective life change depending on how quickly buildings are renovated / updated etc.

Moving buildings within the normal depreciation rules could, in particular, have an adverse effect on the middle market. *For middle market taxpayers, buildings are generally held in a trust and the ultimate disposal is subject to CGT concessions - any move to bring buildings within the balancing adjustment rules will therefore, need to be carefully implemented so that existing arrangements are adequately 'grandfathered'.*

The R&D tax incentive

Another option considered in the BTWG report is a reduction in the new R&D tax incentive. Essentially, the options are targeted at reducing the incentive for larger taxpayers. The options include:

- denying the non-refundable R&D tax offset to companies with an annual turnover greater than $20 million;
- denying the non-refundable R&D tax offset where companies have a turnover greater than a "limit". An upper turnover threshold of either $10 billion or $20 billion is contemplated in the BTWG report;
- imposing a dollar "cap" amount on expenditure that qualifies for the non-refundable tax offset;

- reducing the rate of the non-refundable tax offset from 40 per cent to 37.5 per cent - i.e. effectively reducing the benefit to what was available under the previous 125% tax deduction.

The abovementioned $20 million annual turnover threshold is for too low and should be lifted to at least $50 million so that those middle-market companies that can afford meaningful R&D and are most likely to be motivated to increase their R&D can continue to access the R&D tax incentive.

We also note that limiting the R&D tax incentive for “larger” companies could reduce the amount spent in Australia by the foreign parent companies of Australian subsidiaries and question how such a move will encourage non-residents to invest more in Australia?

<u>Statutory effective life caps on some assets</u>

Under the current depreciation rules, a number of depreciating assets can be amortised over a period set by the legislation (i.e. they have a statutory effective life cap). The BTWG report indicates that those statutory caps are shorter than the real effective lives of such assets. Accordingly, the BTWG has proposed the removal of these statutory effective life caps.

Amongst the assets that will be affected if this proposal goes ahead are a number that used by middle market taxpayers such as buses, light commercial vehicles, trailers and trucks.

<u>Statutory effective life caps in certain industries</u>

Any middle market taxpayers operating in the gas supply, oil and gas extraction, petroleum refining and/or primary production sectors will be affected by the BTWG proposal to remove the capped lives of some of the assets used in those industries.

In this regard, *given that the majority of irrigators and primary producers:*

1. *are part of the middle market; and*
2. *operate via trusts,*

the removal of these statutory caps is likely to have a direct impact on this sector of the middle market.

Accelerated depreciation and capped effective lives are there for a reason - i.e. to encourage taxpayers to invest in the newest technology rather than continuing to use out-dated plant and equipment. The removal of these ‘concessions’ will thus, have an adverse effect on a large number of non-corporate taxpayers in the Primary Production and capital-intensive industries.

Other observations

We observe that any reduction in the company tax rate without an equivalent (or even greater) reduction in the individual tax rate will just encourage more people to use companies. There would seem to be a risk therefore, that the Government will decide that Division 7A of Part III of the 1936 Tax Act needs to be ‘strengthened’ rather than ‘simplified’ notwithstanding the current Division 7A review being conducted by the Board of Taxation – which will be

an extremely unfortunate outcome given that Division 7A is already posing a large number of compliance problems for middle market taxpayers.

As pointed out previously, taxpayers conducting their activities / businesses through trusts will get no benefits from any corporate tax rate reduction unless they use a corporate beneficiary - which will only encourage the greater use of such beneficiaries and thus, potentially lead to more disputes with the ATO and/or adverse Division 7A compliance implications.

Compliance costs may increase with transitional rules for arrangements / transactions that straddle the introduction of any changes.

Concluding comments

In our view, any corporate tax reduction should initially be focused on the middle market and there should be no trade-offs - middle market taxpayers are major employers in this country and many are finding it 'tough' at the moment. Any relief that can be provided to the middle market will accordingly, not only be welcome news but will provide the (proverbial) 'maximum bang for the buck' for the Australian economy. Such a staggered reduction in corporate tax rates will also reduce pressure on the Government's fiscal position.

Further to the above point we also submit therefore, that tax incentives should not be removed for middle market taxpayers but increased.