Re:think

Submission to Tax Discussion Paper:

Small Business Proposed Tax Reforms

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A. Taxation of Families and Business Structures

Below are a number of options to improve the Australian tax systems inter-action with small businesses in terms of their structure.

Option 1: Spouse Tax Marginal Tax Rate System

Many small businesses are operated as sole traders, with business income assessed to the individual. While Australia largely taxes ‘individuals’ separately and not ‘families’ – for various transfer payments (such as family tax benefits) the income of the ‘family’ unit (especially spouse) is considered. Due to Australia’s individual marginal tax rates when one spouse is not working (or under-working) there can be greater tax impost on the family unit compared to if the same income was earned between both parties.

To provide greater alignment between the tax system and the transfer payments system, allow spouses to be assessed to tax together – and subject to a Spouse Tax Marginal Tax Rate System. The Spouse Tax Marginal Tax Rate System would essentially represent double the individual marginal tax rate system (ie the tax free threshold would be $36,400 instead of $18,200). This would also reduce various tax planning strategies that try to achieve this any way.

Option 2: Family Business Election

To provide improved taxation consistency for small business regardless of business structure, allow small businesses to make a ‘family business election’ – which nominates a ‘test individual’ (similar to the family trust elections in Schedule 2F of the ITAA 1936).
Making such an election (for a sole trader, general partnership, trust or company) allows the business income to be distributed among family members (as defined) for tax purposes. This allows for income splitting within the family unit each year. An “income allocation form” would need to be completed by 30 September after the relevant financial year – indicating who and what amount is being allocated.
This means even though legally that:

- A sole trader earned business income all (or part of it) could be allocated for tax purposes to her husband; or
- A partner in a general partnership earned business, income all (or part of it), could be allocated for tax purposes to his/her daughter; or
- A private company dividend income was earned by a husband shareholder; it could be allocated for tax purposes to his wife.

Consider whether it would also apply to losses. However, allocated losses would be subject to a ‘cost basis’ rule of the test individual (ie the person with actual equity in the business structure - reflecting the extent of equity at risk).

Option 3: Introduce Australia's own S Corporation to be known as the 'Small Business Company'

Option 3 and 4 outlines to possible alternative tax flow-through business structures. Option 3 is the 'Small Business Company' which allows non-related equity members to form a corporation to operate a business together. Option 4 is the 'Family Business Company' which has a more restrictive shareholding to family members.

A corporation can be considered the most appropriate business structure for commercial purposes. By allowing Australian private companies to make a 'small business company' election for tax purposes this would provide some flexibility of income distribution and the flow through of tax losses. Such an election would have to be made by a majority of shareholders and directors of the company. Making such an election would provide the following:

- Profits would be initially taxed at the company level at 30%. There is no requirement to distribute the business profits, so that it would be possible to retain income for future operations within the business structure. (This is preferential compared to the automatic flow-through of income to shareholders and being subject to potentially higher individual marginal tax rates). Note that retained income would need to be notionally allocated to respective shareholders to increase their 'cost basis' of their share (see loss restriction rules below).
- There would be some flexibility in distributing retained profits to any shareholders in the company (could have different classes of shares –such as non-voting shares). Distributions would be franked to the fullest extent possible, with a franking credit available. To the extent a dividend is unfranked then it would be exempt income (essentially allowing the pass-through of any tax preferences to shareholders). Note that distributions for tax purposes would include dividends, loans and use of assets by shareholders. Note a Small Business Company would not be allowed to do asset revaluation distributions.
- In a year that losses are generated these could be distributed to shareholders of the company. The ability to use the losses would be subject to a 'cost basis' rule – which is essentially how much equity contributed plus allocated income less distributions. An alternative could be that these losses could be converted to a 30% rebate in the hands of the family member – this would mean that essentially the losses are only sheltering income at the 30% rate and the individual marginal tax rate.
- To encourage adoption of the small business companies – only small business companies would be entitled to concessional treatment – such as the 50% CGT discount and the non-application of Div 7A and PSI rules.
- Allow trusts who have made a Family Trust Election to rollover to a small business company structure.
- Existing companies would convert to the small business company regime by paying tax on any retained profit not covered by franking credits.
- Small business companies could own other small business companies.
- Need to consider how shares held by employees (ESS) would be treated.

In later years, if the business wanted to expand it could be possible to revoke the 'Small Business Company' election and be taxed as normal company.

There are a number of attributes desired by small businesses in Australia. These attributes with the current possible business structures are represented in the table below.

Desired Attribute	Sole Trader	General Partnership	Limited Partnership	Discretionary Trust	Unit Trust	Company	Small Business Company - Option 3	Family Business Company – Option 4
Separate legal entity to members	ý	ý	ý	ý	ý	þ	þ	þ
Liability protection for members from business operations	ý	ý	þ [1]	þ	þ	þ	þ	þ
Liability protection of business operations from members bankruptcy	ý	ý	ý	þ	ý	ý	ý	ý
Perpetuity	ý	ý	ý	ý	ý	þ	þ	þ
Ability for member to participate in management	þ	þ	þ [2]	þ	þ	þ	þ	þ
Ability to issue equity membership	ý	þ [3]	þ [3]	ý	ý	þ	þ	þ
Flexibility with profit distributions to family members	ý [4]	ý [5]	ý [5]	þ	ý [5]	ý [5]	ý [5]	þ
Flow-through of tax losses to member	þ	þ	þ	ý	ý	ý	þ	þ
Retaining tax preferences as flow from business structure to members	þ	þ	þ	þ	ý [6]	ý [6]	þ	þ
Ability to retain profits within business structure	ý	ý	ý	ý	ý	þ	þ	þ
Access to corporate tax rate of 30%	ý	ý	ý	ý	ý	þ	þ	þ
Access to CGT 50% discount	þ	þ	þ	þ	þ	ý	þ	þ
Access to Small Business CGT concessions	þ	þ	þ	þ	þ	þ	þ	þ
Ability to later to do public equity listing	ý [7]	ý [7]	ý [7]	ý [7]	þ	þ	þ	þ

[1] Some liability protection for limited members, compared to general members.
[2] There can be adverse consequences to liability protection by a member being actively involved in the business
[3] There are limits on the number of equity members allowed
[4] But could employ or lease business assets from spouse
[5] But could issues equity, employ or lease business assets from spouse
[6] Generally tax preferences are claw back on distribution to equity members.
[7] Generally would need to convert to another business form (with potential stamp duty and CGT consequences)

Option 4: Introduce Australia's own S Corporation to be known as the 'Family Business Company'

A corporation can be considered the most appropriate business structure for commercial purposes. By allowing Australian private companies to make a 'family business company' election for tax purposes this would provide for flexibility of income distribution and the flow through of tax losses. Such an election would nominate an Australian tax resident as the 'test individual' (similar to the family trust elections in Schedule 2F of the ITAA 1936) – who must have equity (membership) interest in the Family Business Company. Making such an election would provide the following:

- Profits would be initially taxed at the company level at 30%. There is no requirement to distribute the business profits, so that it would be possible to retain income for future operations within the business structure. (This is preferential compared to the automatic flow-through of income to shareholders and being subject to potentially higher individual marginal tax rates). Note that retained income would need to be notionally allocated to respective family member shareholders to increase their 'cost basis' of their share (see loss restriction rules below).
- There would be flexibility in distributing retained profits to any 'family members' (as defined) holding shares in the company (could have different classes of shares –such as non-voting shares). Distributions would be franked to the fullest extent possible, with a franking credit available. To the extent a dividend is unfranked then it would be exempt income (essentially allowing the pass-through of any untaxed profits). Note that distributions for tax purposes would include dividends, loans and use of assets by family members. Note a Family Business Company would not be allowed to do asset revaluation distributions.
- In a year that losses are generated these could be distributed to any 'family member' holding shares in the company. The ability to use the losses would be subject to a 'cost basis' rule – which is essentially how much equity contributed plus allocated income less distributions. An alternative could be that these losses could be converted to a 30% rebate in the hands of the family member – this would mean that essentially the losses are only sheltering income at the 30% rate and the individual marginal tax rate.
- To encourage adoption of the family business companies – only family business companies would be entitled to concessional treatment – such as the 50% CGT discount and the non-application of Div 7A and PSI rules.
- Allow trusts who have made a Family Trust Election to rollover to a family business company structure.
- Existing companies would convert to the family business company regime by paying tax on any retained profit not covered by franking credits.
- Family business companies could own other family business companies provide same test individual.
- Family business companies could form partnerships with other family business companies (or even non-family business companies) to run a business. This would allow non-family members to run a business together with a family business company.
- Need to consider how shares held by employees (ESS) would be treated.

In later years, if the business wanted to expand it could be possible to revoke the 'Family Business Company' election and be taxed as normal company.

Option 5: Aligning the taxation of trusts and companies

Amend section 99A of the ITAA 1936 to provide that trustees of trusts that have made a 'family trust election' are taxed at 30% for trust income to which there is no present entitlement. This would allow for family trusts to retain income to fund business operations. Distributions from such taxed retained income could be 'franked'.

Remove the eligibility of trusts to be entitled to the 50% discount (Division 115).
(Alternatively deem all trusts for tax purposes to be taxed as companies – then with distributions either franked or unfranked).

B. Cash Flow and Small Businesses

Managing cash flow is a critical issue for small business. Outlined below are a number of tax reforms to encourage small businesses to get advice and education to manage their cash flow, as well as changes to penalties.

Option 6: Improve professional advice and education for small businesses

Introduce a 'Professional advice and Education rebate' – capped at $5,000 pa for first five years of operation. This rebate would cover advice from members of certain registered professional bodies and would assist small businesses to get essential advice about business structures; tax compliance, membership agreements; accounting practices, software; cash flow management practices and superannuation (also eligible for software purchases – to encourage e-commerce).

Eligibility for the rebate requires the small business owner to do a series of online small business models each year that the rebate is claimed. These online models could utilise materials developed already by various government agencies (including the ATO and ASIC) (similar to professional development hours of 10 hours per year).This would encourage small business owners to aid their own technical knowledge about business and legal obligations.

Option 7: Asset write-off

To assist with cash flow, allow small businesses to immediately write-off asset purchases of $10,000 pa. Assets above $10,000 would be depreciated (or may be pooled depreciated).

Option 8: Other Cash flow reforms

Cash flow is a critical issue for small businesses; some of the following suggestions could assist with this:

- To assist small businesses to manage their income increase the threshold of eligibility to use the Cash Method to account for GST to $5 M (currently $2M). This means that businesses would not need to account for GST until they have received it from suppliers.
- Access to equity – consider whether it is possible to have provisions to encourage people to invest in small businesses. Potentially the immediate deduction for equity investments (but cost base of such equity reduced to nil).
- Self-disclosure of mistakes – automatic decrease in penalties (and interest) for small businesses who self-disclose tax mistakes.
- Have a small business early payment discount for the first five years of operation – if they pay their PAYG instalments on-time they receive a 10% discount (to encourage on time payment of income tax).

C. Employee/Contractor

Option 9: Employee/Contractor

The Australian tax system needs to facilitate and not inhibit the new world economy, including the rise of the importance of the service sector to the economy. . If someone holds themselves out as a 'business' (and they conduct themselves accordingly) then the tax law should respect that. Part of this relates to the need for greater certainty about the distinction of employee/contractor for small business. To provide for this:

- A safe harbour rule that a small business can rely on the presence of an 'ABN' signifying that a person is a contractor not an employee (together with a copy of the ATO Employee/Contractor Decision Tool signed by both parties). Any later determination which is different would not apply retrospectively for PAYG and superannuation. Encourage State Revenue Authorities and WorkCover Authorities to recognise and use the ATO Employee/Contractor Decision Tool signed by both parties.
- Legislate for a universal 'employee' definition based on an extended 'results test' in section (section 87-18 ITAA 1997). That is an 'individual will be regarded as an employee when:
    - They are paid to achieve a specified result or outcome;
    - They have to supply the plant and equipment or the tools of trade needed to produce the result? (except motor vehicles and tools of trade)
    - They are liable for the cost of rectifying any defective work?
    - Plus they are able to delegate (pay another person) to do the work?
- Repeal provisions that 'deem' a contractor to be an employee for tax purposes (even though at law they are a contractor). This just confuses the sector and is not consistent with encouraging a new world economy. The following should be repealed:
    - Repeal PSI rules (Division 84 to 87 ITAA 1997). Why should someone be penalised who uses their intellect as their core business asset.
    - Repeal section 12(3) and (8) of the Superannuation Guarantee (Administration) Act 1992 that deems certain contractors to be an employee for Super Guarantee purposes.

Other reforms that should be considered relating to the issue of employees are:

- Increase the superannuation guarantee threshold from $450 to $1350
- Deductibility of superannuation guarantee charge (SGC) provided voluntary disclosure by employer
- FBT increase minor and infrequent benefits to $500

D Other ideas

Option 10: Small business definition

There is a need for consistency of the definition of 'small business' with the Federal tax acts, as well as other Federal Agencies and State governments. A new definition could be:

- Closely held definition (ie not public per section 103A)
- Family Business (with a 'Family Tax Election')
- Two out of three test (looking at employee numbers, turnover and asset holdings).

Note that current turnover test of $2 M is really a 'micro' business and should be increased to $5 M turnover. The preference should be that the one definition is used and exceptions only provided for good policy reasons.

Option 11: Reform of Small Business CGT concessions

Reform Division 152 by repealing the 15 year exemption and the further 50% reduction. For the remaining two concessions – make them available to all private businesses (s103A definition), so that there is a

- A lifetime contributions of up to $500,000 into superannuation tax free in relation to disposal of active assets (this should be available to all taxpayers, whether employee or self-employed & no need for the 10% rule).
- Allow for active asset rollover relief when one active asset is sold to purchase another one.

Option 12: Greater alignment of tax rates

The difference in tax rates between individuals and companies drives a lot of tax planning work. If the individual tax rate could be reduce to 36% this would remove much the incentive for planning. Such a move could be paid for by the removal of:

- deductions for individuals (including rental properties)
- 50% CGT discount
- Franking rebate system (including refunding excess franking credits)
- Remove pre-CGT assets (deem acquire at market value)
- And taxation of withdrawals from superannuation at 15%

Option 13: Dual Income System

Regardless of business structure, introduce a dual income system that separates income into two types :

- Active Business Income (including business income generated from personal services income) and Capital Gains- taxed at 30%
- Non-Active income: taxed at 36% (or marginal tax rate)

Option 14: Reduce headline company tax rate

Reduce the headline company tax rate for small businesses to 10% but remove all deductions. This tax rate could apply to the company's income reported on the BAS, and be paid each quarter. There would be no need to lodge tax returns each year. Remove the recognition of losses.

Option 15: Transaction costs and State taxes

It is important that State taxes are reformed that are seen as inhibiting business operations/transactions – especially stamp duty (and to a lesser extent payroll tax). To compensate the States for loss of revenue due to removing stamp duty, changes to increase the base (and/or rate) of GST need to be seriously considered.

A universal Payroll Tax Act at the Federal level could be enacted and then with each state and territory to set their own threshold and payroll tax rate.