Date: 22 July 2018

Board of Taxation
The Treasury – Melbourne Office
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By email: taxboard@treasury.gov.au

Dear Sir/Madam

My name is Dung Lam and I wish to make a personal submission to this review.

This submission does not cover all the questions posed by the Board but rather focuses on particular questions.

Question 1 – What tax issues are of particular concern for small business?

A lack of timeliness in tax law making and retrospective law

In recent years there has been significant delay between the time that proposed tax law changes are announced and the time when the legislative bill is introduced into parliament. Examples of delayed legislation include:

(a) the proposed changes to Division 7A which were outlined in the 2017 Federal Budget (which included providing taxpayers with a self correction mechanism for Division 7A and a single compliant loan of 10 years) but which had not yet been legislated and so in the 2018 Federal Budget were announced to be deferred until 1 July 2019 so that they could be introduced with further Division 7A changes announced in the 2018 Federal Budget; and

(b) the proposed simplification of the TOFA rules which was meant to remove most taxpayers from its application, and which was slated to come into force from 1 January 2018 has now been delayed indefinitely.

This complaint is common for all taxpayers, whether big or small, but small business taxpayers are arguably more disproportionately affected by delayed legislation. This is because they have less resources to monitor tax changes than larger businesses. Small business is more concerned about running their business than undertaking such monitoring. The lack of timeliness produces uncertainty and prevents small business from planning properly for tax changes and cash flow impacts.

The fact that a lot of new tax law is retrospective is also disturbing. Small business plan their tax structure based on the tax law as it is. When tax law is changed there should some recognition of this and some grandfathering to ensure that taxpayers who have planned for their future are not disadvantaged by later changes in tax law. The recent changes to the corporate tax rate and franking rules are an example of retrospective law that adversely affects small business by generating excess franking credit issues for companies with significant retained earnings. Whilst the reduction in the company tax rate for small business was intended to assist it, the franking rules actually work against this and encourages small business to restructure or implement further actions (which should not be needed) to ensure that franking credits are not lost and retained profits are not subject to higher effective tax rates. A more appropriate introduction of the reduced company tax rate would have been provide grandfathering rules that allow a company to frank its retained profits (which have been taxed at the 30% tax rate) at the 30% tax rate.

The introduction of the integrity rules for the small business CGT concessions in the *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* is another example of inappropriate retrospective law. The Exposure Draft to this legislative bill was only released on 8 February 2018 and yet it purported to apply from 1 July 2017 and so would have affected CGT transactions that occurred prior to the release of the Exposure Draft. Taxpayers selling their businesses may have be basing their calculations on being able to claim the small business CGT concessions and now find out they cannot. It is noted that this bill was amended in the Senate to apply from 8 February 2018 but arguably the bill should apply prospectively i.e. from a time in the future after it is enacted.

Rushed law making and a lack of consultation

Very often the tax laws that apply to taxpayers in the SME sphere is rushed and minimal consultation is held with affected parties. The introduction of the small business restructure rollover provides an example of rushed legislation which has defects in it. There was minimal consultation on the practical use of this rollover with the result that the legislation which was enacted is technically defective with respect to discretionary trusts (which is a vehicle commonly used in the SME sphere) and the requirement of maintaining ultimate economic ownership in the business asset transferred. As a result anecdotally there seems little take up of the rollover in the SME sphere because to use the rollover one would also need to obtain a costly private ruling from the ATO to ensure that the rollover applies.

For reforms which affect the ‘big end of town’ (e.g. managed investment trusts) it appears that more opportunities are provided for consultation across the industry as compared to the SME sphere. There should be a more formalized consultation process.

Question 2 – What do you regard as the most useful or effective small business tax concessions? Why?

The small business CGT concessions are the most useful and effective small business tax concessions. This is because:

(a) they enable some small business owners to restructure their businesses into more appropriate structures. Many people start businesses without seeking proper advice concerning asset protection or the tax effects of cash flow that different business structures provide one. Or even if they do get such advice, there may not be enough funds to implement the right business structure from the initial beginning. The small business CGT concessions combined with the 50% CGT discount may provide a tax effective pathway to migrate to a better structure;

(b) the small business CGT concessions recognise that many business owners may not provide themselves with appropriate remuneration (including superannuation) over the years as they build up their business. The concessions provide SME owners with retirement savings on a sell out of their business. Given that the baby boomers are close to retirement these concessions are likely to be even more relevant.

Question 3 – What opportunities do you see for improving the existing small business concessions?

50% Active Asset Reduction

The 50% active asset reduction should be allowed to pass through a company and unit trust without triggering tax implications. It makes no sense that a discretionary trust or individual structure can pass the benefit of this concession without tax consequences, but companies and unit trusts cannot. The only tax effective way of paying out amounts sheltered by the 50% active asset reduction from a company is to liquidate the company. This can be costly process even if a members' voluntary liquidation is undertaken. It would be more cost effective to allow these amounts to be paid out of the company or unit trust without triggering further tax in the same manner as the 15 year exemption.

Small business restructure rollover

The small business restructure rollover provisions should be amended as follows:

(a) the ultimate economic ownership tracing rule for discretionary trusts in section 328-440 of the *Income Tax Assessment Act 1997* (**ITAA 97**) should be amended because its current wording is defective. It presumes that one can trace through ultimate economic ownership through the trust before it can be applied. Additionally, its requirement that every individual who held ultimate economic interests in the relevant CGT asset before the asset transfer and every individual who holds ultimate economic interests in the CGT asset after the transfer, must be members of the same family group seems to require that one must review and amend one's trust deed to remove beneficiaries who do not fall within the family group. It is suggested that this requirement be removed, and the fact that a trust has made a family trust election and that all persons who had ultimate economic ownership in the asset before the asset transfer, are within in the family group should be enough;

(b) the tracing rule in section 328-440 does not allow for a multi-level rollover from an individual to a company owned by a discretionary trust. This is because the tracing rule requires that the discretionary trust either transfer or receive the relevant CGT asset. It makes no sense to prevent this multi layer rollover which would get an individual to a commonly used business structure. The company entity giving limited liability and also access to the lower company tax rate, and the discretionary trust as shareholder provides an extra level of asset protection. The fact that multi layer rollovers can be done through companies and unit trusts also shows how illogical this limit in the tracing rule is;

(c) the rollover should give recognition to pre-CGT asset status – for instance, any shares or units issued by the recipient company or unit trust (as the case may be) in return for receipt of the pre-CGT asset should be deemed pre-CGT as well.

(d) the 'genuine restructure' element of the rollover is a narrow concept and makes it difficult for a SME to use the rollover because many restructures have an eye to family succession planning or divestment. There is a three year safe harbor rule which may allow for long term succession planning but the ATO has flagged the application of Part IVA to restructures which are not genuine even if the safe harbor rule is met. The approach taken by the ATO is similar to its traditional refusal to allow private businesses to access the demerger rules. Due to the uncertainty as to how the ATO will treat a restructure, most taxpayers prefer to apply the small business CGT concessions if they are eligible because the result is more certain than this rollover.

Partnerships and small business CGT concessions

Tax law partnerships should not be treated as entities for the purposes of the small business CGT concessions. Rather the fractional interest approach should apply in this situation. Currently it appears that the ATO has a position that if a taxpayer is a > 40% co-owner of a rental property (which is a tax law partnership) then 100% of the rental property must be included in the taxpayer's $6 million maximum net asset value test – see PBR 1051259768078. This approach conflicts with the fact that the 'connected with' rules in section

328-125 of the ITAA 97 is based on the taxpayer carrying on a business, which suggests that a tax law partnership is not intended to be affected by the connected with rules.

New integrity provision in section 152-10(2) should be revised

The proposed revised section 152-10 as contained in *Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018* should be amended to be targeted at true abuse. As it stands the tests contained in the proposed revised section are complicated and require a significant amount of tracing through the years (particularly in relation to the modified active test). The tests practically mean that many small business owners may not be able to claim the small business CGT concessions on the sale of their shares or units, and if they can, the compliance costs of ensuring that they meet these tests (including obtaining tax advice) would be significantly more than in years gone by where such complicated tests were not required to be stepped through. The modified active asset test should be removed as it is difficult to apply without incurring significant compliance costs.

Lower company tax rate

The franking rules that accompany the lower company tax should be amended, so that there are rules (similar to older repealed franking rules) which enable retained profits which have been subject to the higher 30% company tax rate to be franked at 30%. Similarly, retained profits which have been franked at the lower company tax rate should be able to be franked at the lower company tax rate. This prevents franking credit wastage. There is no point providing a lower company tax rate if it penalises small business companies who have retained profits for working capital and then when the principals wish to pay themselves out a dividend, they are faced with a higher effective tax rate because of franking credit wastage. The lower company tax rate is not really a benefit because of this franking credit wastage and the fact that most businesses pay out their profits to principals to live and also as an asset protection practice.

Question 5 – What ideas do you have for new concessions that could help small business?

Trusts to be allowed to accumulate income for working capital

This is not a new idea, but trading trusts should be allowed to accumulate business income for working capital at the low company tax rate. If this was possible, then it may dispel the need to have a multi layer structure where a trading company is wholly owned by a trust. The Board of Taxation's Second Discussion Paper release on 25 March 2014 on the Post Implementation Review of Div 7A of Part III of the ITAA 1936 suggested a tick the box election for a trading trust in return for forgoing the CGT discount. This option should be legislated.

Question 6 – Do you agree with the reform principles outlined in this document? Are there any other principles that should be considered? Why?

It is not clear what the reform principle 6 'Concessions should not incentivise complex structuring' is aimed at. As outlined in the discussion on principle 6 in the Consultation Paper there may be other reasons besides tax for having multiple structures such as asset protection. Asset protection provides a reason why there may be holding company structure or having the trading company owned by a discretionary trust. A family trust may also be suited to a family succession planning as it allows for split control where the retiring parents may stay as appointors whilst the next generation can take over as trustees. A company structure does not have this feature.

The final comment that 'Tax concessions should be designed with the aim of reducing incentives for complex structuring' should not be used as guide to limit concessions to only 'simple' one layer business structures. This is because to do this, would ignore the reality that many SMEs use multi layer structures and mean that many SMEs would not be able to claim the concessions which are intended to benefit them. There is no point providing a tax concession if the conditions to claim it are so onerous that few entities can practically use the concession. To insist on a flat structure would be retrograde and take small business tax concession law back to the old days where the controlling individual test prevented multi layer structures from accessing the small business CGT concessions.

Larger businesses may have complex structures but this is not seen as a factor that should affect the tax laws for those businesses. It is difficult to see why SMEs should be adversely affected because they have complex structures for non-tax reasons.

Question 8 – What are the objectives of small businesses using a particular legal structure (companies, trusts, partnership, sole trader)?

8.1 **What are the main objectives businesses have when they seek structuring advice (e.g. reducing tax liabilities, succession planning, asset protection etc)?**

8.2 **Relative to other factors, how important is reducing tax liabilities?**

The main aims of a small business using a particular legal structure would be asset protection and cost efficiency (particularly in the start up phase). Whilst tax is important it is not often the determinative factor when people structure their businesses. People are more concerned with having a structure that is easy to use and provides them with limited liability.

Question 9 – Are the small business tax concessions skewed to specific parts of the business life cycle? If so, should they be refocused and in what way?

The small business CGT concessions receive a lot of publicity because the tax savings may be large. However, this needs to be put into perspective, the small business CGT concessions recognize small business owners see their business as their nest egg for retirement and may put all their finances into their business to build and maintain it. The fact that the concessions may lead to a large tax saving should not be seen as something that is untoward, rather it reflects the Government policy not to tax capital gains on the sale of a small business where it is intended that the sale proceeds be used to fund the business principals' retirement. The small business CGT concessions should be maintained but other new small business tax concessions should be developed to assist a small business owner during the life of their business.

Question 10 – Generally, tax concessions are broadly based and apply across different sectors of the economy. Should there be small business concessions for specific sectors? If so, why?

There should not be preferential concessions for specific sectors. This is because it would suggest that one form of business is more important than another form of business, such that it should receive a particular concession. Sectors that have better paid lobbyists may benefit more than other sectors which do not have the wherewithal to lobby effectively.

Question 11 – Does the small business eligibility criteria (e.g. $2 m turnover threshold for small business CGT concessions) influence you to not grow your business?

Anecdotally I have never known a small business owner try to stop growing to ensure eligibility for these concessions. However, where a taxpayer nears these thresholds it may make them consider whether they need to restructure their business to a more appropriate structure. This is because at that point there may be only be one chance to use the small business CGT concessions to get the structure right. A curious result is that if a taxpayer has structured themselves properly from the outset (as a result of paying for proper advice) then they run the risk of undertaking a Part IVA 'wash sale' if they restructure just before exceeding these thresholds. In contrast a small business taxpayer who did not get advice and structured inappropriately does not have this Part IVA risk.

Question 12 – Are there alternative mechanisms to phase-out the small business tax concessions as opposed to a hard cut-off?

To reward people who take risk and grow a business to a significant size, the law should allow principals who have done this to be able to claim the benefit of the small business CGT concessions up to say a set limit (e.g. $6 m net asset value) and this should be so regardless of whether the business has since exceeded the small business CGT thresholds. It is strange that the concessions provide benefit to people who sell out before the thresholds are met but are denied to persons who continue to grow their business.

Alternatively, the ability to claim the small business CGT concessions should be progressively reduced as one exceeds the relevant thresholds. It is particularly harsh that a taxpayer is denied the ability to claim these concessions by being just $1 over say the $6 million net asset value. If a taxpayer is hovering just above the threshold then the argument that they should not get the concessions because they are too big a size (and hence wealthy enough) holds less weight. Rather it seems unfair that their sacrifice in growing their business is not recognized by the tax law.

The current thresholds for the small business CGT concessions have not changed in many years. The $6 million maximum net asset threshold was increased from $5 million in 2007 and at the same the $2 million small business entity test was introduced. The $500,000 retirement exemption level has not changed since 1999 when its current incarnation was enacted. It is suggested that the thresholds all be increased to reflect bracket creep and that the retirement exemption be increased to the $1.6 million transfer balance cap amount. These thresholds should also be indexed going forwards.

Yours faithfully

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