The Board of Taxation
c/ The Treasury
Langton Crescent
CANBERRA ACT 2600
Fax to: 02 6263 2617

23 May 2014

Dear Sirs

Review of impediments facing Small business

We refer to your request for submissions in relation to the impediments small business face in achieving their commercial goals.

We consider that the overriding objective for any tax reforms involving the small business sector (including family and private company groups) should be that of simplification so that smaller taxpayers are provided with a better experience in meeting their income tax obligations.

This is currently difficult to achieve due to the volume of income tax legislation, the propensity of prior Governments to introduce changes via press release and the existence of overly complex specific anti-avoidance income tax legislation. Consistent messages coming from our clients are that the documentation requirements are too onerous; complex rules are beginning to inhibit growth and many simply do not have the resources to afford dedicated tax accountants to obtain proper advice.

PwC believes there is a clear need for comprehensive tax reform – done the right way. The 'right way' means increasing those taxes that have the least effect on investment and employment, and at the same time reducing reliance on taxes that distort incentives to work, invest and transaction business. It also means addressing those factors which increase the complexity of the tax system and the cost of compliance. We consider that any reform impacting the small business sector should encompass these principles.

We provide the following specific comments.

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PwC Private Clients Family Business Survey

During July and August 2012, PwC surveyed close to 2,000 family businesses from around the world, including 50 Australian family businesses. The PwC Private Clients Family Business Survey focuses on key areas including performance, internationalisation, and the unique qualities that set family businesses apart from listed or public companies, with the intention of increasing the availability and reliability of information and statistics about family business in Australia. Please note that the release of our next Family Business Survey is scheduled for November 2014.

The survey supports the positions being put forward in this submission by providing a valuable insight into the structures, strategies and views of family businesses both within Australia and globally.

Key findings:

- The key challenges to growth over the next five years cited are the general economic situation, competition (pricing and the number of competitors), the need to innovate, and attracting the right skills and talent.

- Family businesses believe they hold some key advantages over non-family businesses, including motivation and values within the company, agility and speed of decision making, freedom from bureaucracy, continuity, and the ability to take a longer term view.

- Some disadvantages over non-family businesses are also recognised, including reduced access to capital, family politics, difficulty in attracting non-family people into the business, and challenges around succession.

- Australian family businesses believe they play a vital role in our country's economy; including job creation and adding stability to a balanced economy.

- They generally believe that Government does not recognise the importance of family businesses, and feel more should be done to help, for example, improved access to finance and creating a level playing field for access to some of the advantages enjoyed by (public) corporations.

- Some believe that family businesses will need to float, merge, or adopt more corporate behaviour in order to survive and thrive in the years ahead.

- Almost 40 per cent intend to pass down the business and management to the next generation. The remainder are twice as likely to sell or float than to pass down but employ non-family management.

A copy of our PwC Private Clients Family Business Survey is attached.

Division 7A rewrite

Division 7A of the Income Tax Assessment Act 1936 operates to penalise families who, amongst other things, obtain loans from private businesses whose terms, whilst often commercial, do not comply with other strict requirements of the Division – including regular repayment of capital within seven years. In many cases families are forced to borrow from third parties as they usually offer less onerous servicing demands. This leads to additional costs being born by families and inefficient capital markets within Australia's economy.

We welcome the review which is currently being undertaken by the Board in relation to Division 7A and consider that this work should be fast-tracked as it is one of the key impediments to small business operating on the same playing field as larger corporates.

The rule against perpetuities

Abolishing the rule against perpetuity or introducing a rollover for trusts would prevent the succession issues we encounter with families holding assets in a trust reaching its 80 year limit.

Trusts are well established vehicles for families to hold assets - which may have been acquired or developed by earlier generations - for the benefit of the family as a whole rather than particular individuals. Trusts can support the financial needs of family members and protect assets should an individual family member face financial difficulties; assets which if lost may threaten the viability of a family's business. Trusts are also a safer, more predictable option for passing assets – including businesses such as farms - down through generations.

With the exception of South Australia, all states impose an 80 year limit on the period during which a trust can exist; legislation which we believe has outlived any current relevance. South Australia removed the automatic imposition of the 80 year limitation on the life of trusts in 2006, while making it possible for beneficiaries to apply for a trust to be terminated if that trust has existed for longer than 80 years.

The termination of a trust can have a serious impact on families and family businesses. When a trust is dissolved, assets must be transferred to a different owner. If the value of the asset is greater than their cost, it precipitates a capital gains tax event for the beneficiaries, who may be forced to find up to 47% per cent of the assets' value without a liquidity event. This forced taxing point can threaten the viability of the family business.

The 80 year limit on trusts can also impact business decisions and structures before the trust is terminated. If a family is to acquire a major asset and their trust is already 50 years old, it would be unwise of them to place that asset in the existing trust – a vehicle with just 30 years remaining. This will prompt the creation of a new structure to hold the asset, further complicating the family's financial structure and increasing the cost of managing their assets.

For many older existing trusts, abolition of the 80 year rule would remove the need to consider whether changes to a deed are a resettlement. We suggest a more appropriate alternative for family businesses would be to abolish the 80 year rule, and permit trusts that include a Family Trust Election to make any deed amendments necessary in order to accommodate the changing and evolving needs of their family.

We believe that to protect the future of Australia's family businesses, consideration should be given to abolishing the termination date of trusts, thus removing any artificial taxing points. We acknowledge that some changes will require state legislation and will require the co-operation of the states, but believe this should not preclude the rule against perpetuities from policy discussion.

Trust law rewrite

In a sophisticated economy it is difficult to avoid complexity in tax law. The laws around the calculation of taxable income of trusts (mainly Division 6 of the Income Tax Assessment Act 1936 and related tax cases, including the High Court decision in Bamford) are particularly complex and we understand that the Government is considering rewriting these laws.

We agree that this is necessary, but are concerned that the rewrite may be viewed by Treasury as an opportunity to introduce laws that increase the already extensive obligations of trustees.

One area of trust administration which is particularly onerous for trustees is the requirement to prepare trust distribution minutes by 30 June, which is often before they are certain of the actual composition of the trust's net income (especially where they need to receive advices from all the managed funds they hold).

We would recommend that where a Family Trust Elections in place, this 30 June requirement is dispensed with and instead trustees are simply required to have put the necessary document in place prior to the lodgment of the trust's relevant tax return.

Rollover of assets to discretionary trusts

Currently the tax laws levy income or capital gains tax where an individual transfers an asset to their family trust, as no rollover is available.

We recommend introducing a specific roll-over to disregard any capital gains arising from such transfers provided a valid Family Trust election is in place. The Family Trust election is an integrity measure that penalises those trusts that provide benefits to non family members.

Succession issues

It is generally recognised that, with the retirement of the baby boomer generation, succession planning has become, and will continue to be, a key issue for small businesses including family groups.

(a) Implications for private company shareholding structures

One hurdle to the implementation of an orderly succession plan for family companies is the capital gains tax and other transfer taxes that may arise upon the transfer, redemption and / or issue of shares held in the family company.

Tax concessions are available upon the death of an individual which might reduce these costs, but for most private groups it is too late to wait until the death of a key individual to implement an effective succession plan (especially in the current economic environment).

We consider that in order to enable the private sector to take a more active and competitive approach to the management of their family business, family companies should be given a degree of flexibility to issue, redeem and transfer shares within their family group. Only if non-family group members become involved should any tax implications arise. A 'Family Company Election' (similar in concept to the Family Trust Election) could be put in place in order to record who falls within the family group.

(b) Management incentives and Employee Share incentives

Small businesses generally have little depth of management and the retention/ attraction of key managers is critical for the successful transition of the business from the current owner / manager to a new ownership / management structure.

Providing equity to managers can be an effective measure to attract and / or retain managers who are key to the smooth transition of the business. However, it is often difficult for small businesses to attract quality managers in competition with public companies who are able to offer attractive employee share plans as part of their remuneration packages.

Providing shares to an employee of a small business is usually seen more as aligning the long term goals of the business with those of the employee rather than being a component of a remuneration package. This is because shares in a private company are not liquid.

Because of this lack of liquidity, paying full value for equity in a small business is not attractive to employees who have no certainty as to when, or if, they will be able to realise that value. It is therefore often both desired and deemed necessary for small business owners to gift or discount equity to key managers. However the taxation impediments to this often mean that equity is not provided or is provided through complex, cumbersome arrangements in order to not fall foul of the current taxation provisions.

We consider that reform of the employee share plan legislation is needed to facilitate the attraction of management talent to small businesses and succession planning.

The Government's current review of these rules should not be limited to 'start-ups' but instead be extended to all private companies. Not only would this involve amendments to the current Division 83A of the ITAA 1997 but also consequential amendments to the capital gains tax value shifting rules (to provide an exemption) and to the Fringe Benefits Tax Act (to extent the existing exemptions).

Small business concessions

A number of changes were made to the operation of the small business capital allowance rules with effect from the 2012-13 income year. However, it is disappointing to see that these changes are to be reversed as part of the repeal of the Minerals Resources Rent Tax. The additional complexity caused by such short lived measures should be avoided in any future tax reform targeted at the small business sector.

The small business CGT concessions were originally introduced in 1999. Despite the fact that many of the problems identified with rules have been rectified (most notably following the Board's 2005 post-implementation review) we are still faced with a series of complex and cumbersome rules spread over two Divisions. The use of complex terminology and definitions has meant that many taxpayers and tax practitioners have struggled to navigate their way through these provisions. Although we consider that no changes should be made to the actual concessions available, the drafting of these provisions should be revisited with a view to providing taxpayers with a simple streamlined set of rules to follow.

The thresholds which apply to small businesses throughout the income 0tax legislation should also be revisited in order to provide a consistent approach. For example, under the small business CGT provisions, taxpayers are required to satisfy either the $6 million asset value test or the $2 million aggregated turnover test in order to qualify for these concessions. In contrast a $20 million aggregated turnover test applies for the R&D refundable tax offset rules. We note that the newly announced Paid Parental Leave Levy will introduce yet another threshold – a $5 million taxable income test. The existence of all these different thresholds can often lead to confusion and adds to the complexity of the rules applicable to the small business sector.

Streaming of private business profits

As a result of a number of integrity rules introduced over the last decade (principally Subdivision 115-C and Subdivision 207-B of the ITAA 1997), the tax rules currently allow trusts to stream income whilst companies are prevented from doing so.

We believe private company shareholders should be afforded the ability to stream franked and unfranked dividends to selected shareholders, provided the streaming of private companies is limited to members of the shareholder's family.

Tax consolidation

The mandatory resetting of a company's cost base in its assets (Division 705) - which occurs when undertaking most corporate restructure - can penalise family groups.

We recommend that the rules be amended to allow family groups to retain their existing cost base. Further, family groups should have the ability to retrospectively choose to tax consolidate provided this decision is made within the ordinary amendment period of four years currently afforded to such taxpayers.

If you have any questions in relation to the above or would like to discuss this issues further please do not hesitate to contact me.

Yours sincerely

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