Structure of Australian SME taxation

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Topics

- Policy
- Current structure and why it arose
- Future directions
- Broader relevance
  - Particularly large closely held businesses/investments (HWIs)
- What is generally not covered
  - Concessions
  - Simplification of income measurement
  - Compliance costs
  - Tax gap
  - Other elements of tax system, eg CGT discount, superannuation etc
  - The mess that the legislation affecting SMEs is in as everywhere

Policy for taxing individual labour and capital income

- Framework of Apps and Rees
  - emphasises household and incentives for home production created by current system
  - saving problem is essentially one of taxing labour income not capital income
  - problems of tax on capital income
    - impossible to tell who is doing saving and should be taxed on capital income
    - no existing (decent) economic model for deriving the optimal tax rate for capital income
- Policy difficulties driven by information problems
  - cannot observe full income (including household production)
  - cannot observe who is really contributing to saving/consumption

Implications for individual SME income

- Similar information problems in many cases
- Difficult to observe who is providing labour that produces the income
  - Family partnerships seem to be accepted by ATO without investigating contributions and control, notwithstanding s 94
  - Personal service income rules Divs 84-87 seek to identify the real service provider
    - or really preventing income being diverted to legal entity (and consequently to other individuals or legal entities subject to lower tax rates)?
- Cannot observe division between income from labour and income from capital
- Cannot observe who is contributing capital
  - Apps & Rees on individual income above

Taxation of business entities

- Two methods of taxing income of legal entities
  - Distributions and gains on owners' interests in entity (our corporate system)
  - Attribution of entity income to owners (our trust/partnership system)
- Realisation introduces complications
  - One main reason for corporate tax is to tax undistributed realised gains of companies but does not solve issue of tax rate
    - Another is taxing foreign shareholders
    - For imputation also withholding tax on distributions
    - Tax rate setting by foreigners for companies, by residents for trusts
  - For entities taxed on attribution basis issue of recognition of dual cost base if wish to ensure that unrealised gains at entity level are captured on realisation of owners' interests
    - Main structural issue for discretionary trusts is no tax (CGT) on interest of beneficiaries

Taxation of SME entities

- Attribution is generally appropriate for closely held entities
  - Family business trusts, partnerships and companies
  - But also underlies consolidation, CFC regimes as they involve closely held entities below any widely held top entity
- Taxes income similarly to owners deriving income directly
  - Assumed to be policy objective of taxing SMEs but can be achieved indirectly as well as directly
  - Also commonly applied to collective investment
- Other assumptions about policy design/objectives
  - Reasonable for SME owners to want limited liability without significantly affecting tax outcome, compare ANTS/Ralph Review
    - Need limitation of loss rules if losses passed through entity
      - Now in system for limited partnerships
  - Recognition of capital market failures in financing of small business

Australian SME/family business entity structure

Business trust
(corporate trustee)

Surplus income

Attribution tax regime

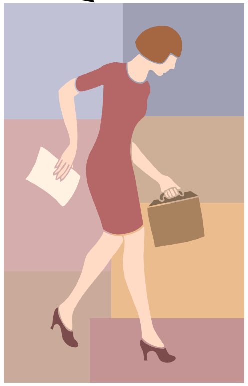
Consumption
+ (some) tax concessions

Company
30%

(reinvested in
business)

15%

SMSF
(separate investment)



Individual rates

Development of small business structure to 1970s

- Prior to 1970s most small business seems to have been in either corporate or partnership form
- For corporate form businesses the main issue was the penal tax rates on undistributed profits potentially applicable under Div 7
  - Hence significant successful tax planning activity directed to avoiding Div 7 tax
  - By 1970s Div 7 was almost impossible to avoid after amendments
- Tax advantages of trusts
  - Avoided then double layer of taxation of distributed corporate profits
  - Permitted income splitting among whole family (including initially children)
  - Ability to access funds of trust without Div 7 deemed dividend issues
- Large scale swapping of SMEs from companies to trusts from 1970s
  - Self help was initially ignored > accepted?

Current advantages of trusts for SMEs and others

- Non-tax
  - limitation of liability in both directions
    - asset protection being wound back in various ways
  - flexibility through lack of regulation
  - relatively low cost
- Tax
  - income splitting and diversion to company
  - ability to stream capital gains to individuals, other income to companies
  - ability to make cash distributions of untaxed income and capital
    - failure to effectively apply CGT to interests in discretionary trusts
  - ability to stream tax liability to low tax entities without cash payments
    - now controlled since 2011 Bamford amendments

Past suggested reforms

- Government has only itself to blame for problems in SME taxation?
  - Asprey 1975 and Campbell 1981 reports recommended partnership tax election for companies
    - would permit limited liability with flow through taxation
    - model was subchapter S in US which is not without complications
    - no suggestion that limited liability relevant
  - Apart from one issue now have experience with building blocks necessary
    - Exception is CGT treatment of interest in discretionary trusts
- But what would happen to taxation of trusts
  - If no changes then probably alternatives would be ignored or only slowly be taken up
  - Trusts are essential part of much of our lives
    - Superannuation, collective investment, custodians, death/incapacity

Possible future reforms to Australian SME taxation

- Application of distribution model
  - contrary to history and current development of entity and trust tax regime especially for small business
  - fails to recognise the importance of the transparency policy for income in controlled entities
  - could be modified, eg passthrough of certain preferences
- Refinement of transparency regime
  - Replacement of current regimes would be very expensive transition
  - Modification of current transparency regimes to overcome technical issues

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Issues that need to be considered in SME taxation

- Applying CGT Event E4 to discretionary trusts (ie taxing distributions)
  - Tax preferences pass-through
- Income splitting
  - How much of a concern
- Tax rate
  - Access to capital > Board of Taxation review of Div 7A
- Access to superannuation
  - Relation to access to capital > Div 152 partly refocused