CHAPTER6

CGT, PPS, PAYE, SG AND TSV'

Capital Gains Tax (CGT)

6.1 Net capital gain is included as assessable income under the ITAA. Although it is not a separate tax, it is distinguished from income tax in that tax is not levied until the capital gain is realised.

6.2 Capital gains tax applies in relation to the disposal of assets after 19 September 1985. Assets acquired before 20 September 1985 are exempt unless something occurs which triggers a deemed acquisition of an asset after that date or unless an asset is deemed to be disposed of for CGT purposes where no disposal has occurred under general law.

The Complexity of CGT

6.3 The complexity of CGT was the subject of much criticism in evidence to the Committee. Professor]an Walischutzky of the University of Newcastle commented that before 1985, there was a 'fairly simple' provision consisting of less than one page of the ITAA that taxed the profit from the sale of property acquired for the purpose of profitable resale:

> We now have ... over 200 pages of capital gains legislation basically doing the same job.

6.4 He suggested that the 200 pages could be replaced by simply taxing long-term profits (for example profits of assets held over five years), or reducing it to the two main assets which produce revenue, those being land and shares.

6.5 The Queensland Chamber of Commerce and Industry suggested that the increased complexity and coverage of the CGT 'impeded productivity '3 higher employment, better technology and flexibility of operations'.

6.6 The Taxation Institute of Australia (TIA) submitted that a problem associated with the complexity of the CGT was the issue of record keeping, viz: small businesses often do not tend to keep separate records for CGT purposes and nor do their accountants; and where a small business changes accountants, the latter often keep working notes which a new accountant needs to be able to calculate CGT.

6.7 The Small Business Development Corporation of Western Australia considered that the cost of calculating CGT liability was often prohibitive for small businesses and was not cost-effective for many smaller firms, the cost of assessment can be greater than the resultant liability.

6.8 The Committee believes that the complexity of the CGT has remained as issue for small businesses since the Beddall Committee reported on the matter in 1990, again because of the unavailability of economies of scale which enables larger, incorporated businesses to not only absorb the considerable compliance costs but to defer or circumvent capital gains tax by reorienting or expanding their business activity within a corporate structure. Consistent with this general theme, the Committee believes that a review of the CGT with a view to simplification, particularly those relating to record keeping requirements for small business, is inevitable in the long term.

Rollover Relief

6,9 Evidence was given to the Committee that CGT limits the scope of business to restructure or form new businesses. Recommendations included a call for small businesses to be granted an exemption from the CGT on proceeds they receive from the sale of their businesses provided the proceeds are reinvested in another business within 12 month S.7 This course of action was often referred to as CGT rollover relief.

6.10 The TIA suggested in evidence that while there were some provisions which allowed limited rollover relief, the CGT regime does not recognise the gains made in the course of business expansion, such as on the sale of a business in order to purchase a new business'.

> On an after tax basis, many business proprietors may find themselves commencing a new business with a depleted capital base, which is a distinct limitation and disincentive to business expansion,

6.11 The TIA advocated more generalised rollover relief for small business in certain situations, as exemplified in the previous paragraph, with safeguards built into such a provision specifying a value threshold, and limiting the period of time within which capital gains could be rolled into a new business. (For example, 12 months recommended by PATEFA9). The TIA also commented that

> even the goodwill exemption that currently exists… will not cover all the assets of a small business…. [for example] fixed assets… plant and equipment, land and buildings

6.12 The thrust of this argument was also forwarded, amongst others, by the Motor Traders Association of Australia which commented that the CGT has an adverse effect on capital mobility (where operators diversify and grow by moving from one business to another) due to lack of knowledge and understanding of the operation of the CGT and the desire of most businesses to minimise such tax obligations."

6.13 Rollover relief was considered in detail by the Beddall Committee. That Committee concluded that the impact of the CGT on small businesses was a major concern and recommended that rollover relief was an appropriate measure to assist small business. 12

6.14 The Government rejected the Beddall recommendation on the grounds that the introduction of the CGT rollover provisions raises questions about the consistency of the Government's approach to taxing different forms of income:

> Such a proposal may also result in extensive periods of tax deferral and would breach a fundamental principle of the capital gains tax system of applying tax on disposal.

6.15 However, this reasoning ignores the fact that an integral feature of the CGT system is that the realisation of capital gain upon disposal defers the CGT liability during the life of the business, thereby producing a substantial advantage over other taxes. Furthermore, the fundamental principle of applying tax on disposal would not be breached as the very nature of a rollover provision would ensure that net capital gain is not used for any other purpose for any significant period of time. A similar principle applies for rollovers of eligible termination payments within the superannuation regime whereby a payment is deemed to remain inside the concessionally taxed superannuation system as long as it is rolled into a suitable superannuation fund within 3 months.

6.16 The Committee therefore concludes that provision for rollover relief is an appropriate measure to apply to small businesses and consequently recommends that the proposal advocated by the Beddall Committee be reconsidered by the Government.

Recommendation 6.1:

The Committee recommends that CGT be deferred on the capital gain realised on the sale of a trading business which is rolled over by the vendor into another trading business

Goodwill

6.17 Fifty per cent of the capital gain that accrues to a taxpayer on the disposal of the goodwill of a business is exempted from tax, provided certain conditions are met. Prior to 27 February 1992, 20 per cent of the capital gain on goodwill that was disposed of was exempted where the net business interests of the taxpayer did not exceed the exemption threshold of $1 million. This threshold was raised to 50 per cent for disposals of goodwill after 26 February 1992 where the net business interests of the taxpayer do not exceed $2 million. 14

6.18 The ASCPA considered that the current exemption could be better structured by applying it at flat rates on progressive levels of goodwill.15 For example, the first $500,000 would be exempt, phasing in through several thresholds to a maximum rate of $150,000 plus a marginal rate of 50 per cent on the surplus over $2 million.

6.19 However, the Committee does not consider that any further adjustments to the exemptions on goodwill are called for at this stage. As noted in paragraph 1.17 above, there was a substantial improvement in the exemption allowed on goodwill in 1992 when it was raised from 20 per cent to 50 per cent. This improvement also addressed the argument that a general exemption should be allowed upon retirement in lieu of what was submitted to be foregone superannuation. The Committee agrees with the reasoning used by the Beddall Committee in relation to this issue that since the introduction of the CGT in 1985, business people should have been aware that the proceeds of the sale of their business would be subject to the CGT. They should also be making alternative arrangements to supplement their income on retirement through superannuation.

Long Term Assets

6.20 The ASCPA also suggested that CGT should be progressively phased out where fixed assets are held for more than 10 or 15 years. This would act as an incentive to hold assets for a long period rather than making speculative gains in the short term.

Section 47(1A) of the ITAA

6.21 The MTAA submitted that the operation of section 47(1A) of the ITAA produces an anomaly in that it results in small companies being subject to double taxation on the disposal of an asset and subsequent liquidation: the CGT is applied to the real gain, with the distribution of the indexed base cost to shareholders being deemed as being unfranked dividends taxable at marginal rates - the tax effect on an unincorporated entity is limited to the CGT. 17 While it seems that there are devices for dealing with this anomaly, the Committee suggests that section 47(1A) should be amended.

Recommended 6.2:

The Committee recommends that:

(i) the Government examine the proposal to phase out the CGT on fixed assets once they have been held for a certain period of time, say 25 years; and

(i)	section 47(1A) of the ITAA which ignores nominal capital losses and depreciation when calculation capital gain to be added to income, be reviewed and amended, if necessary

Prescribed Payments System

6.22 The prescribed payments system (PPS) is a form of withholding tax. It was introduced in the May 1983 mini-budget and brought into effect in September 1983 to be levied on contract workers and subcontractors. It was designed to prevent avoidance of payroll and personal income tax through the use of cash payments.

6.23 PPS is an income tax collected at source from certain prescribed payments for work or services in specified industries, and must be the day after the end of the month in remitted to the Tax office by the 14th day after the end of the month in which the payment from which the deductions were made. Tax will generally be withheld at the rate of 20 per cent unless the payee holds a current variation deduction certificate or a deduction exemption certificate.

6.24 The PPS appears to serve its function effectively and attracted little comment in evidence to the Committee, with the exception of one issue raised by Mr Brian Harmer of Bowman Manser and Associates concerning the timing of payments. The example used to illustrate the anomaly was of a subcontractor who completes some work and submits an account late in the 1994 financial year, perhaps June, but does not get paid for that work until the following financial year, perhaps July. The subcontractors income is assessable on those earnings in the 1994 year even though the PPS tax is not deducted until the 1995 year because it is withheld at the time of payment. The subcontractor cannot, therefore, gain a credit for that tax.

6.25 The result is that when the return is lodged, the taxpayer is taxed as if that PPS tax had not been deducted, notwithstanding that s/he will gain a tax credit in the following year.

6.26 The suggested solution is to allow the credit in the year in which the income is assessable, 1994 in the example given, despite the fact that the tax will not be remitted until the following financial year. This course of action is consistent with the method with which PAYE remittances are treated in the identical situation. Mr Harmer commented that PPS appeared to be an attempt to get subcontractors treated as if they were on wages and evidence from the ATO and the Treasury confirmed that PPS is analogous to PAYE.

6.27 The ATO response to a question about this anomaly was that the different years was not problem of income and credits occurring in income stream because generally an issue where a person has a regular income stream the payments and credits even out and do not cause any difficulties for the taxpayer. The ATO conceded that it could be an issue if the person receives an irregular flow of income from year to year. In this circumstance, the taxpayer can apply to the Commissioner of Taxation to have the amount of the credit refunded or applied to other tax debts prior to assessment of tax liability.

PAYE Tax

6.28 Introduced in Australia in 1942, pay-as-you-earn (PAYE) tax is deducted in instalments at source by the employer from the employee's wages or salary on a quarterly, monthly, or bimonthly basis

depending upon the amount involved. Remittances must be made by the 7th day after the end of the quarter, the month, or the half month, as the case may be.

6.29 Currently, small businesses with an annual PAYE liability of more than $10,000 must remit taxes by the 7th of each month. COSBOA suggested that the access thresholds of quarterly PAYE tax collection be . raised from the current $10,000 liability to $100,000 on the basis that, from the employees point of view, it would reduce paperwork and exposure to tax penalties by a factor of four.

6.30 In contrast, ASCPA recommended resisting any suggestions that the 7 day time fag be extended as the temptation can be too great for businesses that are experiencing cash flow difficulties:

> Indeed, it is a common warning signal that a business faces insolvency when group deductions are not paid in time.

16.31 The QCCI recommended that the payment of PAYE tax become the responsibility of the employee, maintaining that an employees responsibility should end with advising the ATO that income has been distributed. The QCCI also recommended that where PAYE deductions are required by Government, then a fee for service should be paid by the ATO to the business concerned.

6.32 When questioned about these proposals, the QCCI responded that banks may be an appropriate institution to carry this function. The QCCI's argument was that:

> ... it comes back to the philosophy that, if you are going to organise a payment system, you should deregulate the system ... by allowing anybody to deduct those needed PAYE taxes ... If you are going to do something, everybody should be in there offering those services, and that means you get a fairly competitive environment ... It does not matter what industry you are in, whether it is electricity, water, forestry or even taxation, it is a competitive environment and, if services are going to be utilised, anybody should be able to provide those services.

6.33 The Committee does not accept this line of argument because the PAYE remittances system appears to be functioning smoothly with few complaints from industry, and because of the possibility that, rather than ing collection costs, the creation of other centres of tax collection ally increase costs.

Superannuation Guarantee (SG)

6.34 Superannuation guarantee (SG) is a levy imposed on employers in relation to each individual employee earning a wage or a salary above a certain threshold (currently $450 per month). Contributions are required to be paid into a complying superannuation funds The level of contribution, paid is calculated as a percentage of an employee's gross income a there are two percentage rates applicable to employers depending on 1 size of their payroll. There is to be a gradual phasing in of compulsory superannuation contributions such that, by the year 2002, all employ, will be required to contribute a minimum of 9% of an employee's wage or salary to a superannuation fund.

6.35 PATEFA recommended that as SG diverts funds from investment, employees should be required to make contributions to their own superannuation to help the Government reach its target of 9% of earnings being invested in superannuation. The Committee notes that in its recent Budget, the Government announced an intention to phase in compulsory employee contributions amounting to 3 per cent by 1999/2000.

6.36 J.B. Murray & Associates contended that the inclusion of subcontractors and non-residents into the definition of 'employee' under *the Superannuation Guarantee (Administration) Act* 19,92 was unfair' and recommended that these two groups should not be levied. The ATO has put considerable effort into refining the definition of 'employee' as it applies to subcontractors. The issue concerning non-residents

was dealt with in some detail by the Senate Select Committee on Superannuation in its 15th report, *Superannuation Guarantee: Its Track Record,* in which it recommended that the Government extend exemptions from SG requirements to all non-resident workers where there is sufficient evidence that superannuation is being paid in the country of residence.

Trading Stock Valuation

6.37 Trading stock is defined under the ITAA as anything produced, manufactured, acquired or purchased for the purposes of manufacture, sale or exchange. Where a taxpayer carries on business, all trading stock on hand at the beginning of the year of income and all trading stock on hand at the end of that year is taken into account in determining whether the taxpayer has a taxable income. Trading stock is considered to be "on hand" if the taxpayer has the power to dispose of the stock.

6.38 Where the value of closing stock exceeds the value of opening stock, the amount of the excess must be included in the assessable income. Where the value of opening stock exceeds the value of closing stock, the amount of the excess is an allowable deduction.

6.39 Trading stock is valued according to any one of three bases for valuing trading stock:

- cost price;
- market selling value; or
- replacement value.

6.40 Cost price refers to full absorption cost, which is not just the invoice or purchase price, but includes costs associated with bringing the stock into its existing condition and location. Taxpayers are permitted to value stock at either cost, market value or replacement cost.

Effect on Working Capital

6.41 SAECCI submitted that the obligation to hold stock is one reason for lack **of** working capital available to small businesses. Businesses that are expanding frequently require an increase in stock holding-which locks up more working capital. SAECCI contends that:

> Stock holdings, particularly for manufacturers who are required to value stock using full absorption costing, causes them to bare a significant tax consequence, ie the capitalising of overhead onto the value of stock... the impact of [which] is that, as a business expands and stock holdings increase, the profit is invested into stock and is subject to tax thereby further eroding the working capital.

6.42 SAECCI suggest that deductions be allowed for industries where their stock turnover is slower than averages or where there is an excessive build up of stockholdings, claiming that this will assist business growth through the provision of additional working capital.

The Wine industry

The wine industry echoed these concerns in relation to the valuation of wine stocks, contending that the industry has:

> Atypically strong demands for working capital due to its long lead sale of the final product…. the absorption costing of expenses under the wine industry situation of low stock turnover leads to understated expenses for the current year, and subsequent overstated profits. Taxation, therefore is paid in advance of sale, thereby calling upon additional working capital.

6.43 In its draft report, the Commission of Inquiry into the Winegrape and Wine Industry assessed the arguments put by the wine industry and reported that the net effect of the differences in the treatment of business investment on the wine industry vis-a-vis other industries was unclear:

> If the net effect is considered to disadvantage the wine industry, then a change in the tax treatment of wine stocks into an expenditure incurred basis (ie. taxing stocks at the time they are sold) might improve the efficiency of resource allocation between the wine industry and other industries, and between the different options for investment facing the wine industry.

6.44 The Committee of Inquiry went on to comment that changing the tax treatment of stocks only for the wine industry would distort stock holding decisions for wine in comparison to other products:

> **As** a consequence, a change could only be justified of it were assessed that the relationship between stock holding and other forms of investment in the wine industry is more important than the relationship between stock holdings in the wine industry and stock holdings in other industries.

6.45 The response by the WGCA and the WFA rejected the notion that a change would confer a tax advantage on the wine industry, arguing to the contrary for an equivalent outcome to other industries whereby all expenses are deductible in the year in which they are incurred."

6.46 The Committee of Inquiry had been unable to identify a net economic benefit from changing the current arrangements, commenting that the Treasury would be better placed to determine whether a change to the taxation treatment of stocks for the wine industry vis-a-vis other industries is warranted."

6.47 Perhaps more to the point is not whether there is a net economic benefit to be gained from any changes, but whether any changes to the current arrangements would produce fairer outcomes. The Committee acknowledges the complexity of balancing considerations of fairness and equity against net economic benefits. Nevertheless, it considers that it would be unacceptable to refrain from reviewing an arrangement which may no longer be appropriate to circumstances which have either not been fully assessed or which have changed since its inception.

6.48 in reviewing the TSV treatment of wine stocks, the Government could canvass the option that was floated by the Committee of Inquiry into the Winegrage and Wine Industry that the tax treatment of wine stocks be changed into an expenditure incurred basis, or alternatively that they be treated as an investment.

Recommendation 6.3:

The Committee recommends that:

(i) the Government review the method of valuing trading stock for small businesses to ascertain its continued relevance to trading stock where stock turnover is slower than average, or where there is a greater than normal build up of stock necessitated by the nature of the business; and

(i) the method for valuing trading stock for the wine industry be reviewed to recognise the specific characteristics applying to the industry, particularly in relation to the maturation of wine stocks which are geared to producing premium wines.