Parliament of the Commonwealth of Australia

A QUESTION OF BALANCE

THE TAX TREATMENT OF SMALL BUSINESS

SENATE ECONOMICS REFERENCES COMMITTEE

JUNE 1995

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TERMS OF REFERENCE

The Australian Senate has referred to the Economics References Committee the following matters for inquiry and report by 30 March 1995 (extended to 29 June 1995):

(a) the impact of the timing of the payments of taxation, particularly provisional tax, PAYE tax, tax under the prescribed payments system and fringe benefits tax, company tax and wholesale sales tax, on the cashflows of small business;

(b) changes in the overall burden of tax on small business, in particular the impact of tax changes introduced by and since the 1993 budget, including increases in excise and wholesale sales tax;

(c) whether the tax system can be improved to prevent tax failing due prior to the taxable income actually being received by small business;

(d) the appropriateness of the quantum, and current form, of the provisional tax uplift factor;

(e) the appropriateness of the thresholds for early payment of company tax for small business;

(f) the potential for reducing tax compliance costs for small business through the improvement of tax payment arrangements; and

(g) such other matters as the committee considers to be reasonably relevant to the above terms of reference on improving the tax treatment of small business.

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CONDUCT OF THE INQUIRY

On 20 October 1994, the Senate referred this matter to the Senate Economics References Committee. The terms of reference were advertised in national newspapers in December 1994 and submissions called for by 31 January 1994. The Committee received 69 submissions from a range of individuals, organisations and government instrumentalities. A list of submissions is given in Appendix 1.

The Committee held six public hearings as follows:

24 March 1995	Canberra
19 April 1995	Brisbane
20 April 1995	Adelaide
26 April 1995	Sydney
12 May 1995	Melbourne
29 May 1995	Canberra

A list of witnesses is given in Appendix II

ABBREVIATIONS

ABS	Australian Bureau of Statistics
ACCI	Australian Chamber of Commerce and Industry
ASCPA	Australian Society of Certified Practising Accountants
ATO	Australian Tax Office
COSBOACGT	Council of Small Business Organisations of Aust. Capital Gains Tax
EPACFBT	Economic Planning Advisory Commission Fringe Benefits Tax
ITAA	Income Tax Assessment Act 1936
MTAANTAA	Motor Trades Association of Australia National Tax and Accountants Association Ltd
PATEFA	Printing and Allied Trades Employers' Federation of Australia
PAYE	Pay As You Earn
PAYG	Pay As You Go
PPS	Prescribed Payments System
PTUF	Provisional Tax Uplift Factor
QCCISAECCI	Queensland Chamber of Commerce and Industry South Australian Employers' Chamber of Commerce and Industry
SAEDASAP	South Australian Economic Development Authority Substituted Accounting Periods
SBCANSWSG	Small Business Combined Association of NSW Superannuation Guarantee
SME	Small to Medium Enterprises
TIA	Taxation Institute of Australia
TFN	Tax File Number
TSV	Trading Stock Valuations
WGCA	Winegrape Growers Council of Australia
WFA	Winemakers' Federation of Australia
WST	Wholesale Sales Tax (sales tax)

RECOMMENDATIONS

Provisional Tax

Recommendation 1.1:

The Committee recommends that where provisional tax is payable in quarterly instalments, the earliest due dates be 30 October, 30 January, 30 April of the year of income, and 30 July immediately following the year of income.

Recommendation 1.2:

The committee endorses the concept of PAYG as an option and recommends that:

(i) the proposed PAYG system be refined to enable maximum flexibility of voluntary payment arrangements to recognise the reality of the volatility of small business incomes and the difficulties encountered by small business in containing compliance and accounting costs: and to this end

(ii) the proposed PAYG system allow flexibility to small businesses in estimating their estimating their end of year instalment; and

(iii) small businesses be ensured of retaining any provisional tax credits upon electing to enter the PAYG system

Recommendation 1;3:

The Committee recommends that the winegrape growers industry look at taking advantage of the new PAYG system of payments if it is implemented. The Committee also recommends that in the event that PAYG turns out to be unsatisfactory to the industry, the Government consider granting use of a substituted accounting period appropriate to the industry's financial and seasonal circumstances.

Provisional Tax Uplift Factor

Recommendation 2.1:

The Committee recommends that the provisional tax uplift factor be set at a level no higher than the current or projected annual movement in the Consumer Price Index.

Penalties

Recommendation 2.2:

The Committee recommends that the only penalty for understating taxable income when lodging an application when lodging and application to a vary provisional tax be a levy calculated by applying the highest commercial rate of interest to the unpaid tax resulting from understated income.

Wholesale Sales Tax

Recommendation 3.1:

The Committee recommends that, in addition to the current threshold which enables quarterly remittances, businesses defined as 'small' by the Australian Bureau of Statistics in ABS Catalogue No. 1321.0 (Small Business in Australia 1993) be permitted to remit sales tax either:

(i) on a quarterly basis; or

(i) 45 days after the end of the month in which the transaction occurs

Recommendation 3.2:

The Committee recommends that the Government conduct a comprehensive review of the sales tax exemptions and classifications system with a view to:

(i) removing the ambiguities and complexities within and between the sales tax classification schedules: and

(ii) establishing a simple effective process whereby the classification of new products can be quickly and simply achieved, thereby lessening reliance on the general rate of sales tax as a default rate.

Recommendation 3.3:

The Committee recommends that the $10,000 sales tax threshold for the small business exemption be indexed annually.

Fringe Benefits Tax

Recommendation 4.1:

The Committee recommends that small businesses be exempt from annual FBT liabilities
Of $200 or less.

Recommendation 4.2:

The Committee recommends that statutory and compulsory award obligations from which an employer is prohibited from cashing out into salary or wages be exempt from FBT

Recommendation 4.3:

The Committee recommends that car parking be exempt from the FBT.

Recommendations 4.4:

The Committee recommends a that child care be exempt from the FBT where a number of small business combined to provide child care exclusively for the children of the personnel employed by those businesses.

Company Tax

Recommendation 5.1:

The Committee recommends:

(i) that the Government investigate the adequacy of the notification of the new company tax arrangement, in particular to those companies with company tax liabilities of between $8,000 and $20,000; and

(ii) that the Government ensure that taxpayers which are affected by changes in the legislation are properly notified well in advance.

Recommendation 5.2:

The Committee recommends that 'small' and 'medium' company tax payers be permitted the option of paying their tax instalments on a quarterly basis applicable to either 'medium' or 'large' taxpayers.

Capital Gains Tax

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.

Recommendation 6.2:

The Committee recommends that:

(i) the Government examine the proposal to phase out the CGT on fixed assets once they have held for a certain period of time say 25 years;
(ii) section 47(1A) of the ITAA which ignores nominal capital losses and depreciation when calculating capital gain to be added to income, be review and amended, if necessary.

Trading Stock Valuations

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
(ii) 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.

Carryback of Losses:

Recommendation 7.1:

The Committee recommends that the Government investigate the efficacy of implementing carry-back of losses for a limited period.

Provision for Statutory Liabilities

Recommendation 7.2:

The Committee recommends that the Government investigate the possibility allowing the provision for money for statutory liabilities (such as long service leave) to be placed in approved deposit schemes, Or equivalents. Money deposited in such a scheme should not be treated as assessable income until such time as it is withdrawn from the scheme.

Income Averaging and Income Equalisation Deposit Scheme

Recommendation 7.3:

The Committee recommends that the Government implement the Beddall Committee's recommendation to introduce an income average facility and an income equalisation deposit scheme of the type currently enjoyed by primary producers, to assist (on an individual basis) other small businesses which experience large income fluctuations across income years.

Small Business Establishment Costs

Recommendation 7.4:

The Committee recommends that the Government implement Recommendation 41 of the report by the Beddall Committee that small establishment costs be allowable as deductions from income subsequently derived from a small business.

Small Business Statistics

Recommendation 8.1:

The Committee recommends that:

(i) the ATO compile and publish aggregated tax data, arrayed by business size; and
(ii) changes to tax law be preceded by the preparation of small business impact statements prepared after consultation with small business and its representatives through existing for a.

INTRODUCTION

THE IMPORTANCE OF SMALL BUSINESS

Definitions

1.1 The Australian Bureau of Statistics defines a small business in the non-agricultural sector as one which employs less than 20 employees in the non-manufacturing industries, and less than 100 employees in the manufacturing industries. In the agricultural sector, a small business is defined as one having an Estimated Value of Agricultural Operations of between $20,000 and $399,000. Smaller operations are considered to make a negligible contribution to commodity aggregates.

1.2 Using this definition, small businesses account for about 860,000, (96%) of all businesses in Australia, and employ about 3 million out of 5.5 million people employed in the private sector. Of these enterprises, 635,000 (74%) employ fewer than five people.

1.3 The Australian Tax Office defines a small business as an entity (including self-employed individuals) that returns business income of less than $10 million. The latest data on returns lodged revels that there were a total of 1,662,188 such entities in the 1992-93 year of income, of which 1,230,830 (74%) were individuals or partnerships.

The Importance of Small Business

1.4 Whichever definition is used, it is clear that small businesses form a significant part of the Australian economy, providing employment for millions of Australian. Indeed, the significance of small business in Australia is underscored in a recent report by the Industry Task Force on Leadership and Management Skills which reveals that Australia is notable for the small number of world scale enterprises which it supports. Only 600 enterprises in Australia employ more than 1,000 people, which 'is a tiny number by the standards of the major trading nation.

1.5 According to research prepared for the Industry Task Force, small firms in Australia have been the source of almost all private sector employment growth since 1 991. The Task Force predicted that most new jobs created in Australia up to the year 2000 will be generated by small to medium enterprises (SMEs).

1.6 With unemployment still a major problem facing the Australian community, support for the important SME Sector takes on added meaning, especially because the potential for SMEs to become increasingly important contributors to Australia's expanding export base.

The Beddall Committee Report

1.7 In January 1990, the House of Representatives Standing Committee on Industry, Science and Technology tabled its report, *Small Business in Australia: Challenges, Problems*

and Opportunities (the Beddall Report). That Committee expressed the belief that although there were concerns raised about almost every aspect of Commonwealth taxation, the most pervasive and most important complaints had been about the rapid growth in the size and complexity of taxation law, the complex and uncoordinated administrative systems which support it, and the associated compliance and reporting costs which are particularly onerous for small business.'

1.8 The recommendations made by the Beddall Committee reflected some fundamental small business perceptions as presented to it, one of which was that tax law and administration do not consider the operating environment of small (vis a vis large) business and, in particular, the working capital restrictions experienced by small business. The Beddall Committee noted that increases in taxation reporting and awareness costs had a disproportionate impact on smaller businesses because of:

- economies of scale, which apply to larger businesses in establishing a specific purpose accounting/reporting function to comply with taxation requirements, do not apply to small businesses; and
- the inability of many owner operated businesses to bring the costs of taxation compliance to account as a tax deduction against income. For example, the cost to a larger business of employing an accountant is offset by the fact that that cost is a fully allowable deduction against taxable income. A smaller business may not be able to afford an accountant without sacrificing other management/advisory services for which the business depends upon for its viability and will need to absorb the costs of compliance by requiring the owner/manager or his/her spouse to perform these tasks.

1.8 The Senate Economics Committee found during the course of its inquiry into the tax treatment of small business that although the implementation of some of the recommendations of the Beddall Committee report had been of considerable benefit to the small business community, some of the taxation problems encountered by small business remained essentially unchanged. This report attempts to address these concerns.

This Report

1.9 The Committee believes that the relative advantage enjoyed by larger businesses in using economies of scale and associated tax deductions to cope with compliance costs and tax imposts should be balanced to some extent by certain concessions to small business.

1.10 Therefore, the fundamental approach used in this report, and expressed through its recommendations, is to attempt to counter the disadvantage of the size of a small business operation. Unless otherwise stated, the definition of small business employed by the ABS will be used.

1.11 The Committee considers that small businesses should not be considered to be on the same footing as larger businesses in relation to much of the current tax legislation, and that affirmative action needs to be taken to redress some of these deficiencies. Some of measures recommended in this report will be revenue neutral. Others, however, will not be revenue neutral in the short term, as they are targeted to assist small businesses to enhance their operations and increase business outputs, profits and employment. In the long-term, these measures should increase taxation revenue.

Legislation

The terms of reference for this inquiry are primarily concerned with various provisions contained in the *Income Tax Assessment Act* **1936** (the **ITAA),** the *Fringe Benefits Tax Assessment Act* **1986** (the **FBT)** and the *Sales Tax Assessment Act* **1993.** Tax changes introduced **by** and since the 1993 Budget until the end of 1994 include:

* *Taxation (Deficit Reduction) Act (No 1) 1993*
* *Taxation (Deficit Reduction) Act (No 2) 1993*
* *Taxation (Deficit Reduction) Act (No 3) 1993*
* *Taxation Laws Amendment Act (No 3) 1993*
* *Income Tax (Franking Deficit) Amendment Act 1993*
* *Taxation Laws Amendment Act 1994*
* *Taxation Laws Amendment Act (No 2) 1994*
* *Taxation Laws Amendment Act (No 3) 1994*
* *Taxation Laws Amendment Act (No 4) 1994*
* *Income Tax (Deficit Deferral) Act 1994*
* *Training Guarantee (Administration) Amendment Bill 1993*
* *Sales Tax Assessment Amendment (Deficit Reduction) Act 1993*
* *Sales Tax (Customs) (Deficit Reduction) Act 1993*
* *Sales Tax (Customs) (Wine - Deficit Reduction) Act 1993*
* *Sales Tax (Excise) (Deficit Reduction) Act 1993 Sales Tax (Excise) (Wine - Deficit Reduction) Act 1993*
* *Sales Tax (General) (Deficit Reduction) Act 1993*
* *Sales Tax (General) (Wine - Deficit Reduction) Act 1993 Sales Tax (In Situ Pools) (Deficit Reduction) Act 1993.*

* *Sales Tax (In Situ Pools) (Deficit Reduction) Act 1993*

The Tax Treatment of Small Business

1.12 There are a number of taxes affecting small (and large) businesses, including provisional tax, wholesale sales tax (WST), pay-as-you-earn (PAYE) tax, fringe benefits tax (FBT), prescribed payments system (PPS), capital gains tax (CGT), company tax and superannuation guarantee (SG).

1.13 All small businesses in Australia must comply with at least one and frequently several of these taxes. As the following chapters illustrate, none of these taxes in themselves are simple, and when three or four different taxes apply to the one business, compliance may become a considerable burden on the operation of that business.

1.14 Part 1 of this report discusses each Commonwealth tax that may affect a small business and Part 2 assesses the cumulative impact of multiple taxes on small business, which results in a considerable burden of compliance.

PART 1

THE TAXES AFFECTING SMALL BUSINESS

CHAPTER I

PROVISIONAL TAX

Definition

1 Provisional tax is anticipatory in come tax payable before the end of the current year on the non-salary (or wages) income of that year. It is -ought forward and credited against ordinary tax assessed on the year's come after deductions. Excess provisional tax is credited or offset against any provisional tax already notified for the following year or any provisional tax instalment already due and payable for the following year. However, under new arrangements announced by the Tax Office, excess tax paid by taxpayers who are not subject to the quarterly instalment system (that is: with tax liabilities of less than $8,000) will now receive full refund rather than have a credit offset against their provisional tax liability.

1.2 Provisional tax may be imposed on salary or wages income from which insufficient tax instalments have been deducted.

1.3 This tax is payable by every taxpayer and trustee on all assessable income except salary and wages, except by'.

(a) a company;

(b) a trustee of a superannuation fund or an Approved Deposit Fund;

(c) a trustee of a Pooled Superannuation Trust;

(d) a trustee of a corporate unit trust or public trading trust; and

(e) a trustee on trust income to which a beneficiary who was a non-resident at the end of the relevant year of income was presently entitled.

1.4 Provisional tax is payable in lump sums or instalments if the previous year's provisional tax was $8000 or less, or taxable income includes primary production income, or where there is an entitlement to be taxed at concessional rates under the averaging rules for authors, artists, sports-persons, performing artists etc, provisional tax is payable as a lump sum in the last quarter of the income year. It is otherwise payable by quarterly instalments which commence on 1 September of the year of income.

1.5 in many circumstances, a likely start for a small business would be for it not to show a profit for the first year or more, and for a low level of profit and hence taxable income to manifest in the early years of operation. Under the current system, this would keep it in the lump sum tax payment regime until it reached the $8,000 tax liability threshold which would propel it into the quarterly instalment regime. The same double impost in year 2 that is discussed below will occur in the second year of a business's liability for provisional tax, unless the business lodges an early return under subsection 221YC(4) of the ITAA.

1.6 Depending on the fluctuations in a business's income, and in particular its tax liability, the business could alternate between lump sum tax payments and quarterly payments regimes as its tax liability fluctuates around the $8,000 threshold. This adds to the complications facing such small businesses.

The Provisional Tax System

1.7 The application of provisional tax can be quite complicated as the level of tax payable has an impact on the level of tax payable in the following year. The following exercise has been chosen to illustrate the complexities of provisional tax, and to demonstrate the types of issues commonly confronting small businesses at various stages of their development.

1.8 The scenario consists of a five year time line starting from 1 July 1994 and charts the course of the business's income and tax liabilities for a period of five financial years ending on 30 June 1999 (Figure 1). For the purposes of this exercise the following assumptions have been made:

- the new business operator starts out on 1 July 1994 without a provisional tax carryover from any previous employment or enterprise, expands in his/her first three years of operation before suffering a moderately severe reduction in income in year four;

- the tax rates for each year are assumed to remain at 1994/95 rates throughout,

- the provisional tax uplift factor is 8% throughout; and

- the Medicare levy, rebates, other taxes and imposts, for example: PPS, RPS, PAYE, WST, SG, and so on are not included in the calculations.

1.9 The new business will probably not pay provisional tax within its first year of operation. This is in spite of subsection 221YC(4) of the ITAA, which requires a new business (or more precisely, a taxpayer who did not earn more than $1,040 other than from salary or wages in the previous year of income), which has earned assessable income in excess of $1,040 up to 31 March in the year of income, to furnish a return estimating its income for the first year of income. The *Australian Federal Tax Reporter* comments in this regard that as a matter of practice, the Commissioner does not require such returns to be furnished.'

1.10 If the new business pays no provisional tax in its first year of operation, the tax assessment for that year arrives sometime in late 1995 or early 1996, depending upon when the tax return was lodged and how long it has taken the Tax Office to process. It is accompanied by a notice informing the new business operator of an impending liability for provisional tax which will become payable no earlier than 31 March 1996.

1.11 The income tax assessment for 1994/95 turns out to be $9,802, payable no earlier than 31 March 1996, and the actual provisional tax assessment for 1995196, based on an 8% uplift of the previous year of income, amounts to $11,178. Because there was no provisional tax paid in 1994/95 in relation to 1993194, provisional tax for 1995196 becomes payable as a lump sum, regardless of the amount payable. The provisional tax owing is also payable no earlier than 31 March 1996.

1.12 In year two, 1995/96, income rises slightly to $41,500. The tax liability payable within that year of income is $9,802 + $11,178 = $20,980, just over 50% of the taxable income for that year. The tax liability of $20,980 which becomes payable in year two is entirely a result of the $40,000 of taxable income in year one, which would be payable regardless of the level of taxable income in year two. Had the business's taxable income for year two been $20,980, then the tax liability would have been 100% of the taxable income for that year, unless the taxpayer had lodged a request for a variation for that year.

1.13 When the tax liability exceeds $8,000 for a financial year, the provisional tax for the following year becomes payable by quarterly statements, commencing no earlier than 1 September of that (the flowing) year. Liability to pay an instalment does not arise unless the 3x Commissioner serves an instalment notice on the taxpayer.

1.14 Year three will be the first year in which the new business is drawn into quarterly instalments because the amount of provisional tax paid in year two was greater than $8,000. Each of the first three instalments in this case amounts to 25 per cent of $11,178, which is $2795.

1.15 Because taxable income for year two, 1995/96, did not increase by the 8% predicated by the provisional tax uplift factor, the income tax assessment for that year will result in a refund in year three (1996/97) of $731. Nevertheless, the tax uplift factor applied to the taxable income in year two results in the final instalment for year three rising to $3,490 in order to discharge the actual provisional tax liability for year three.

1.16 Year three is successful and taxable income for that year is assumed to be $65,000.

1.17 The business suffers a moderately severe decline in income in year four (1997/98) to $45,000. from the previous year's high of $65,000. The income tax assessment for year three, based on a taxable income of $65,000 is $21,152 less provisional tax already paid ($11,875) , leaving $9,277 owing by no earlier than 1 February 1998. The taxpayer also receives a notice of a forthcoming provisional tax liability for 1997/98 of $23,596. Assuming that the first three instalments of $2969 each (one quarter of $11,875) have been paid, the final instalment for year four, due on 1 June 1998, will be $14,689. The total amount of tax payable within year four, based on taxable income for year three, is $9,277+$23,596=$32,873, and will be payable out of the taxable income of $45,000.

1. 18 The first three instalments for year five (1 998199) will be no more e actual provisional tax for 1997/98 than $5,899, or 25 per cent of the actual provisional tax for 1997/98 Income tax for year four is assessed at $11,95. Because of the large amount of tax paid in the previous year, the business will now receive a refund of $11,644 ($23,596 - $11,952). Assuming that the tax assessment for the previous year and the notice for the third instalment are received shortly after the second instalment has been paid, the instalment notice for the third quarterly payment will be calculated on the basis of actual provisional tax for yearfive, $13,500.

1.19 The third instalment must be calculated on the basis of actual provisional tax rather than estimated provisional tax, unless the former results in an instalment that is greater than $5,899. In this

case, the amount to be paid in the third instalment must be 75 per cent of the actual provisional tax liability for year five, less any amount already paid, hence:

($13,500 x 75%) - ($5,899 x 2) = $10,125 - $11798

= - $1,673

1.20 Accordingly a refund of $1,673 will eventuate from the third instalment. The final instalment on 1 June 1999 will be the amount outstanding for that financial year, ie**:** $13,500 - $10,125 = $3,375. Taxable income for the year is assumed to be $50,000**.**

1.21 A summary of the business's taxable income for each year vis a vis the tax liabilities that became payable within those years of income is shown in Table 1.1.

Table 1.1 - Summary of taxable income for each year and provisional tax liabilities due within each of those years.

Year of Income	Taxable income	Tax payments due within the Year of income
Year one (1994/95)	$40,000	Nil
Year two (1995/96)	$41,500	$20,980
Year three (1996/970	$65,000	$11,144
Year four (1997/98)	$45,000	$32,873
Year five (1998/99)	$50,000	$1,856

1.22 Other factors affecting the operation of provisional tax include:

- Late payments may be subject to late payment penalty tax plus interest.
- Quarterly payments of provisional tax are calculated on the basis of estimated provisional tax, ie: provisional tax liability of the previous year, unless actual tax is known. Any revised quarterly instalment amounts will not exceed the instalments due on the basis of the previous year's provisional tax. If actual provisional tax is less than estimated provisional tax, quarterly instalments can be reduced. The final instalment for a year of income will be the balance of the total provisional tax payable for the year.
- A taxpayer can request one variation at any time during the year of income, based on estimated income for the year. Should the taxpayer underestimate taxable income by more than 15 per cent, additional tax may apply. The taxpayer may request a remission of that additional tax. Non-payment of additional tax may result in penalty tax plus interest.

C*onclusion*

1.23 A number of important issues emerge from this exercise. Unless a new business takes advantage of an unenforced requirement in the ninth month of the first year to furnish a return estimating its income for he first year of income, and to pay the liability resulting from the Subsequent assessment, a lump sum tax liability arising from the combined taxable income for both the first and second year of operation mill be incurred. This was cited in numerous submissions to the Committee as a major factor for the failure of new businesses.

1.24 Another issue which emerges is that the current system accrues tax liabilities at a rate which is unrelated to current cash flows. Notwithstanding a final assessment and the option to lodge an

application to vary provisional tax, cash flow problems generated by a decline in income will be compounded by provisional tax which is related to previously higher incomes. Conversely, cash flow in a year in which income rises will be assisted for the main part of the year, before the fin assessment is received, by lower levels of provisional tax resulting from lower taxable income in the previous year.

1.25 The establishment of parity between wage and salary taxpayers and other taxpayers through the provisional tax system is, as the Beddall Committee points out, a legitimate objective which aims to limit the tax deferral advantages derived by non-salary income. It is questionable, however, whether this objective is fulfilled when cash flows and income are not aligned with tax liabilities. Incomes from wages and salaries are rarely subject to the volatile fluctuations which characterise much of the provisional taxpaying sector. In the PAYE sector tax is deducted very much in alignment with receipts whereas provisional tax is remitted in accordance with levels of income from two years prior.

Timing of Provisional Tax Payments Under The Existing System

1.26 In evidence to the Committee, SBP State Council Inc. and the Australian Earthmovers & Road Contractors Federation asserted that the timing of quarterly payments of tax instalments one month before the end of the quarter to which they relate means that in theory tax is payable on income earned in the quarter one month before the end of that quarter.

1.27 Since provisional tax is based upon the previous year's actual provisional tax, which in turn is based upon the income received in the preceding year, and since there is no guarantee that a small business will be able to maintain its income, let alone fund its liabilities, the Committee considers that some more leeway should be introduced into the current quarterly instalment regime.

1.28 As already noted, the provisional tax system was implemented as an equity measure to ensure parity with the PAYE system applying to salary and wage earners, and was intended to reduce the advantage perceived to accrue to earners of unincorporated business income by reason of the deferral of tax liabilities arising from earnings.

1.29 A number of submission advocated that the provisional tax system revert to payment of tax in arrears. Arguments used in support of this suggestion included the following points:

(a) For wage and salary earners, the earning and the receipt of income happens at the same time - this is not so for many small businesses who are taxed on income earned or derived, before money is actually received.

(b) Provisional tax takes effect in the second year of a new business when the business is expanding, thereby withdrawing large amounts of working capital when it is most needed, frequently forcing small business operators into debt financing or asset sales.

(c) Provisional tax, which is based on the previous year's taxable income, can place a severe strain on the cash flow of a small business which is experiencing a decline in income. The option of lodging a variation is fraught with danger in the early part of the year because of the penalties which apply if the revised self-assessment understates income by more than 15 per cent. The subsequent tax credits available to businesses which do not apply for a variation may come too late to be a useful remedy.

1.30 Despite these arguments, the Committee considers that it would :)t be appropriate to revert to a system of paying all tax in arrears because of the deferral of a large amount of revenue to the ATO and because such a system is inequitable vis a vis PAYE taxpayers.

1.31 However, the Committee does believe that a significant problem as in the fact that the existing deadlines for quarterly remittances, which commence one month before the end of the quarter in which they are aid, place undue strain on small businesses because the tax liabilities become due and payable not only before income is received but, for the ninth of September, before it is earned/derived.

1.32 When asked about the reason for the 1 September deadline, treasury gave evidence that it may have been designed to ensure that over a 12 month period there were four instalments that roughly fitted into a financial year. In addition, Treasury commented that since the instalment was based on income two years prior, and if income were generally rising, the instalment represented a quarter of the income for two years prior, which may compensate the taxpayer for not having received some of the income for the current quarter.

1.33 Neither argument appears sustainable. The Committee believes that the fact that a quarterly regime commencing on 1 September fits into a financial year is not a relevant consideration. Quarterly company tax payments have been brought forward to straddle years of income, now commencing toward the end of the year of income to which they relate, conforming with the Government's policy to improve the equity of the tax payments system vis a vis provisional taxpayers, amongst others.

1.34 The assumption that incomes will generally rise seems unjustified. During a recession the entire economy contracts and this is reflected generally in reductions in business income. Information supplied by Treasury (summarised in Tables 2.1 and 2.2, pages 26 & 27), demonstrates that the entire provisional tax paying sector has experienced a number of downturns in the last 6 years. This tendency is even more pronounced within the provisional tax sector, particularly within primary production which is subject to the vagaries of climate.

1.35 Accruals based accounting is now an integral part of the tax accounting system. Whatever deadlines for the quarterly provisional tax instalments are chosen will therefore result in the payment of tax before all relevant income is actually received, notwithstanding a minor tax deferral advantage which is gained vis a vis salary and wage earners who pay as they receive their income. The Committee considers that this deferral advantage should not be overstated, as it is more than offset in many instances by the uncertainty in the source, quantum and regularity of business income. A more appropriate deadline would allow for income to be derived, and for a standard term of credit to elapse, before tax becomes payable.

Recommendation 1.1:

The Committee recommends that where provisional tax is payable in quarterly instalments, the earliest due dates be 30 October, 30 January, 30 April of the year of income, and 30 July immediately following the year of income.

Tax office Proposal - PAYG

1.36 in response to many requests made by small business representatives for alternative payment arrangements to provisional tax, the Tax Office issued a discussion paper proposing a pay-as-you-go (PAYG) system (Appendix 111). PAYG would apply to all unincorporated non-salary/wage earners. Under the Government proposal a taxpayer could choose to come under the PAYG arrangements, enabling self assessed payments to be made, the pattern (monthly, quarterly, biannual) for which would be chosen by the taxpayer as long as it was also suitable to the ATO. Payment patterns would be tailored to suit the taxpayer's income stream, and payments would be calculated on actual tax payable in the period. There will also be an option to switch payment patterns and between systems of payment. Most, if not all of tax payable within a year of income must be paid. within the year of income, although the ATO has indicated that 90 per cent may be sufficient payment within the year of income with the shortfall being paid by 30 November.

1.37 Reactions to this proposal have been generally favourable. The South Australian Economic Development Authority supported the PAYG proposal, principally because the proposal would enable a small business to deal with cashflow problems more effectively (Table 1.2). As illustrated, the advantage of the PAYG system is that tax liabilities fluctuate in line with cash flow. This is in contrast to the unsynchronised accrual of liabilities evident in the current provisional system.

Table 1.2 - Comparison of timing of tax payments under the provisional tax system and under the proposed PAYG system.

Year of Income	**Taxable Income**	**Tax Payments Current System**	**Tax Payments PAYG System**
Year One	$40,000	Nil	$8,822
Year Two	$41,500	$20,980	$10,383
Year Three	$65,000	$11,144	$20,082
Year Four	$45,000	$32,873	$12,872
Year Five	$50,000	$1,856	$13,887

1.38 PAYG has been endorsed by the Australian Society of Certified Practising Accountant, and the Taxation Institute of Australia (TIA), both of whom were appreciative of the response by the ATO to submissions put to it by various professional bodies.

1.39 However, Mr Paul Greenwood, recently of COSBOA, told the Committee that he was disappointed with the proposal:

... because it is trying to collect the tax within the year of income and allow flexibility within the year of income when the problem is that the payment should be after the year of income ... It has not recognised the fag between earning and receiving ... The problem is that it is relying all the time on estimated income ... You cannot know your true income until after the end of the year, lots of things change. You are having to pre-estimate all the time. If you cannot pre-estimate then last year plus an uplift factor automatically applies. If your income is fluctuating, as it has been in the small business sector - it is a volatile area - how do you get to that 90 per cent figure?"

1.40 The Committee is concerned that the narrow margin of error in estimating taxable income within the year of income could impose additional compliance costs upon small business. This may happen because a small business may have to establish two or more sets of comparative accounts as a precaution against underestimating its PAYG liabilities. At the very least, record keeping would need to be meticulous and ongoing, and therefore probably more time-consuming than is currently required. Although this may increase compliance costs, it may also encourage 'small businesses to get a better handle of their finances. In order to be able to pay tax as they go, they are going to need to understand their income as they go, so ... that is an important side benefit of this sort of proposal'.

1.41 However, while endorsing the concept of PAYG in principle, the Committee considers that a greater margin of error needs to be allowed in estimating projected income for the final quarter to allow for unfamiliarity which will occur with the transition to new tax payment arrangements and for the volatile cash flow situations which are endemic much of the provisional taxpaying small business sector.

Recommendation 1.2:

The Committee endorses the concept of PAYG as an option and recommends that:

(i) the proposed PAYG system be refined to enable maximum flexibility of voluntary payment arrangements to recognise the reality of the volatility of small business incomes and the difficulties encountered by small businesses in containing compliance and accounting costs; and to this end

(ii) the proposed PAYG system allow flexibility to small businesses in estimating their end of year instalment; and

(iii) small businesses be ensured of retaining any provisional tax credits upon electing to enter the PAYG system.

The Winegrape Growing Industry

1.42 As an example of the complexities of provisional tax, and its impact on a particular industry which is largely comprised of small businesses, the evidence received from the Winegrape Growers' Council of Australia (WGCA) is considered in detail as follows. 11

1.43 In the past, most of the grapes grown by small enterprises were purchased by major co-operatives and growers had few problems with the provisional tax system. For tax purposes, growers had accounted for their income on the basis of cash accounting (that is, when they were paid by the wineries). Two things then happened, there was a demise in co-operative wine purchasing and the ATO ruled that accrual accounting was more appropriate for income from grape sales.

1.44 While certain concessions w ere made by the ATO to facilitate this changeover, problems associated with the seasonal nature of grape and South growing were exposed. In New South Wales, Victoria Australia, wineries pay grapegrowers on 30 April, 30 June and 30 September following the purchase of grapes**.** As lump sum provisional tax is payable on 31 March, the problem occurs that none of the payments have been made for the income which has accrued to the grower. The tax liability for payments outstanding must therefore be paid before receipt of that income, often through debt financing.

1.45 Although the ATO was willing to grant extensions of time for the growers to pay their tax liabilities, their request that their income be assessed on the basis of cash accounting was rejected by the Parliamentary Secretary to the Treasurer.

1.46 During evidence given to the Committee, the Council commented that:

> it is not just the normal situation of provisional tax being paid in advance of earning the income to which it applies. It is actually provisional tax being paid without the cash flow of the year befores income being available.

1.47 The main problem, therefore, is that the industry payment structure straddles the end of the year of income.

1.48 While there seems to be no problem in requesting dispensation for an extension of time in which to make tax payments, the Committee agrees that the unique seasonal nature of the industry combined with its move into accruals based accounting makes this an inappropriate remedy, particularly as virtually each grower would have to request an extension every year. The Committee considers that either the proposed PAYG system or a substituted accounting period would be more appropriate for the circumstances.

CHAPTER 2

PROVISIONAL TAX UPLIFT FACTOR

2.1 The provisional tax uplift factor (PTUF) is the amount by which the previous year's taxable income of an unincorporated business is increased for the purposes of calculating provisional tax in that business's rent year of income.

2.2 It is necessary to bear in mind that the provisional tax uplift factor (PTUF) is essentially a method of bringing forward anticipated tax receipts. It is therefore a timing device and not an impost. The amount of for which provisional tax payers are liable at the end of the day will not affected in dollar terms by the PTUF, regardless of its quantum or form. What will be affected is <u>when</u> that money will be paid.

2.3 The PTUF was introduced in 1980-81 at 7.5 per cent, rose to 12 cent, before being installed in section 221YA(1) of the ITAA at a default rate of 10 percent, subject to Parliamentary discretion. Parliament set the PTUF at 8 per cent for the two previous financial years. The Government is proposing that for 1995196, it will again be 8 per cent.

2.4 Should a provisional taxpayer consider that his/her taxable income not increase by the amount predicated in the PTUF, or that his/her taxable income will decline during the remainder of the forthcoming year, taxpayer has the option of lodging an application to vary provisional If that variation understates actual income by more than 15 per cent, then the onus is on the taxpayer to make a case for a claim as to why that underestimation occurred, otherwise they are subject to penalties.

Rationale

2.5 The rationale for the PTUF is based on the expected average annual growth in income subject to provisional tax over the following !rat years. The joint submission by the Australian Tax Office and the Treasury states in relation to the PTUF that:

> The level of aggregate income that should be subject to provisional tax is difficult to predict with accuracy. For this reason, it is preferable not to place undue emphasis on a specific forecast or estimate in setting the provisional tax uplift factor. Rather the [PTUFI should, on average, over time and across taxpayers, represent a reasonable reflection of the growth in income of provisional taxpayers. The 8 per cent uplift factor for 1994-95 has regard to the expected average annual rate of growth in income subject to provisional tax over the next several years ...

2.6 The Treasury advised the Committee of the factors that were taken into account in formulating the PTUF for 1995-96, as follows:

> It is done on the estimates of income growth for the major items fitting into that category. Affecting that are a range of issues. Inflation is an important one but it is by no means the sole influence. If 1 can look at the three major categories that we have already spoken of [property income (including interest), other business, primary production] 1 can give you some general indications of the factors influencing those.

As it currently stands, income from property and from other business are the two major elements, with primary production accounting for about 10 per cent; **so** the first two categories account for about **45** per cent [each] of total provisional income at the moment.

Within property income, the major element there would be interest and non-dwelling rent income, followed by dividends and rental income. If you think of the components which are influencing that, interest rates and growth in the stock of assets would be the prime determinants of interest receipts there.

For the normal situation, you would have growth in assets which would be more in line with nominal growth in the economy than simply inflation. Interest receipts represent an element of real return relative to inflation so normally interest levels are significantly in excess of inflation as well. If you look at current experience, interest receipts are growing at something like 17 per cent in the year to December - the latest information we have - well in excess of inflation rates.

If we think in terms of the other major category, other business income - this is primarily the receipts that businesses obtain - in general one would think of that again as growing in line with nominal GDP growth adjusted for any movements in real earnings relative to productivity growth. In the year to December, which again is the latest information we have, that sector grew at around a little under eight per cent.

When you think in terms of projected real rates of growth in the economy of around **33/4** per cent and an inflation rate of four per cent, and with real earnings projected to move in line with productivity - so there is no significant shift in wage or profit shares - then the earnings of the other business sector would be expected to approximate nominal income growth significantly in excess of the inflation rate.

In the area you have already mentioned as being a particularly volatile one, the primary production sector, we have had very marked declines in income in the year just coming to an end as a result of the drought. With projections of the drought easing successively over the next couple of years, volume growth should be exceptionally strong. With prices projected to rise somewhat in excess of the general inflation rate, the projected income growth there is particularly large,

So taking these three sectors together, certainly the growth in each of them should be in excess of inflation and the aggregate growth is in line with the uplift factor as suggested.'

Efficacy of the PTUF

2.7 By Treasury's own admission, outcomes have not matched predictions:

> If you looked at the actual data, you would find that in a lot of cases their provisional tax uplift factor, compared to what actually happened, varied quite a lot. On that basis, the record is not good .

2.8 Looking at the actual data supplied by the Treasury, it reveals little if any correlation between the PTUF and the actual annual changes in taxable income for all provisional income earners. 3 Table 2.1 displays estimates by the Treasury, based on National Accounts data, about the annual change in income subject to provisional tax compared to the PTUF used for each year. Table 2.2 **SHOWS** the picture when ATO figures, based on taxpayer return data for taxable individuals, are used. When these figures were tested to see how the outcomes (all income subject to provisional tax) fitted the predictions (the PTUFS), it was found that the predictive value of the model used to calculate the **PTUFs** was poor and
was worse than if a constant PTUF had been used for every year.

Table 2.1: Treasury estimates based on National Accounts data.

Year	PTUF	All Income	Property (including interest)	Other Business	Primary Production
	Types of Income Subject to Provisional Tax (percent annual change)				
1988-89	12%	15.9%	21.8%	12.9%	2.0%
1989-90	10% (a)	10.2%	18.2%	1.4%	2.1%
1990-91	10%	-4.3%	1.6%	-1.25	-45.1%
1991-92	10%	-2.9%	-14.5%	12.4%	23.5%
1992-93	8%	0.9%	-10.8%	14.3%	11.0%
1993-94	8%	5.5%	-0.3%	7.8%	25.5%

Table 2.2: ATO data based on taxpayer return data for taxable individuals.

Year	PTUF	All Income	Property (including interest)	Other Business	Primary Production
	Types of Income Subject to Provisional Tax (percent annual charge)				
1988-89	12%	25.2%	32.2%	17.7%	16.5%
1989-90	10% (a)	-1.1%	-2.2%	1.1%	-3.7%
1990-91	10%	-11.0%	-6.3%	-6.0%	-59.2%
1991-92	10%	-7.8%	-18.1%	6.8%	-0.1%
1992-93	8%	1.5%	-8.5%	8.6%	44.7%

(a) Uplift factor not used in 1989-90 because the amending legislation lapsed.

2.9 Whichever figures are used, it is apparent that the annual fluctuations in the income of the provisional income tax paying population of over 1.5 million taxpayers are substantial, even when averaged across the entire sector. When the figures are broadly broken down into the income types, these fluctuations are even more pronounced. They would also be reflected at the level of individual small businesses.

2.10 The Committee acknowledges the thoroughness employed by Treasury in attempting to take into account the widest range of relevant considerations when formulating a PTUF, but points out the subjectiveness of the process as evidenced by the need to utilise indicators such as long range weather forecasting:

> With projections of the drought easing successively over the next couple of years, volume growth in the primary production sector should be exceptionally strong .

2.11 The figures in Tables 2.1 and 2.2 demonstrate the underlying premise of continued annual growth in provisional incomes to be simplistic, even on the broadest average. Clearly, even during the limited lumber of years represented in the Tables, there have been one or more bears of growth and one or more years of contraction, both on an aggregate and sectoral basis. *Furthermore, the volatility manifest across and within the provisional income sector casts considerable doubt upon the appropriateness of the averaging process implicit in the PTUF, as currently applied.*

2.12 These doubts are reinforced by the Treasury's exposition of the factors which are taken into account in calculating the PTUF (paragraph 2.6). The provisional taxpaying sector is by no means a uniform group of taxpayers. The only commonality within the sector is that they are unincorporated recipients of business income.

2.13 Treasury pointed out that an 8 per cent PTUF was below the growth in income of a number of provisional taxpayers who:

are not required to vary upwards when their incomes are rising significant

2.14 The recommended remedy for provisional taxpayers whose growth

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in income was expected to be less than 8 per cent was to lodge a request to vary their provisional tax instalments. The Committee received a considerable amount of evidence concerning the usefulness of this facility and has found it to be deficient in its current form.

2.15 Firstly, many provisional taxpayers had fluctuating incomes which were very difficult to predict more than a few weeks ahead, let alone most of a year, if a taxpayer wishes to lodge a variation early in their accounting period. Consequently, as pointed out in a number of submissions and in evidence, many provisional taxpayers would not be in a position to lodge a request to vary until the final quarter of their accounting period because the 15 per cent margin of understatement allowed under the legislation was far too narrow for these taxpayers. As demonstrated in the case study of provisional tax (Chapter 1), this would very likely create considerable hardship for taxpayers who suffer reductions in income, as their provisional tax assessment may be based on what may well be much higher levels of income from a previous year.

2.16 About 12 per cent of provisional taxpayers lodge variations although doing so may necessitate additional accountancy fees. This places an extra burden on a taxpayer who is already likely to be in tighter financial circumstances.

2.17 The ATO, in evidence, stated that a provisional taxpayer who was expecting a growth in income greater than 8 per cent was not required to lodge a variation, although they were technically eligible to do so. It was extremely rare' for a variation to be lodged in these circumstances. There is no obvious logic behind this apparent *laissez fare* attitude, as a provisional taxpayer who did not lodge a request for a variation when they anticipated an upturn in their income, was implicitly understating their income. These taxpayers therefore gained a twofold advantage - firstly, by not incurring accounting costs associated with lodging a variation, and secondly, by deferring tax on the extra income until much later. In contrast, the provisional taxpayer who had lodged a variation because of an expectation of reduced income, may well be placed at a twofold disadvantage: accounting costs associated with lodging a variation, and a penalty if their actual income is understated by more than 15 per cent.

2.18 This is clearly unfair to businesses experiencing declining incomes. However, the Committee does not believe that this should be addressed by requiring variations to be lodged by provisional taxpayers expecting higher than PTUF-average increases in their taxable income. This would simply compound the unfairness as it would extend the narrow requirements involved in lodging variations to all provisional taxpayers.

Consequences of a High PTUF

2.19 As noted by the ATO:

> Provisional tax is generally paid either in a single instalment in the last quarter of the income year, or in quarterly instalments. This compares with PAYE taxpayers who are subject to deductions from their income as it is earned through the year. If the (PTUF) is set too low, this will provide a timing advantage to recipients of income subject to provisional tax compared to PAYE taxpayers and other recipients of income which has tax deducted at the time of receipt. Of course, an uplift factor in any given year will be too high for the individual circumstances of some taxpayers….This is accommodated through the arrangements that allow taxpayers to approach the (ATO) to vary the provisional tax for the year.

2.20 Thus the implications of setting the PTUF too low and consequent loss of revenue is of major concern to the ATO just as the problems associated with it being too high are of major concern to provisional taxpayers.

2.21 However, as the ATO acknowledges:

> The reality is that, at an individual taxpayer level, there will probably be a great number who will be below that average and far fewer who will be in excess of it, as the table points out

2.22 In other words, the rates at which the PTUF have been set since 1991 have resulted in the ATO never having lost any net provisional tax revenue, and in fact considerably exceeding what was required to be remitted in advance by provisional taxpayers in some years (Tables 2.3 and 2.4). Thus the ATO has had a considerable benefit from the PTUF being, on average, too high.

Table 2.3 Cases with provisional credit only that exceeds primary tax.

YEAR	NUMBER OF TAXPAYERS	PRIMARY TAX ASSESSED ($m)	PROVISIONAL TAX ($m)	EXCESS PROVISIONAL CREDIT ($m)
1991	238	1,806	1,165	641
1992	206	1,432	905	530
1993	236	1,670	1061	609

Table 2.4 Cases with provisional credit only that is less than primary tax.

YEAR	NUMBER OF TAXPAYERS	PRIMARY TAX ASSESSED ($m)	PROVISIONAL TAX ($m)	EXCESS PROVISIONAL CRED ($m)
1991	238	1,806	1,165	641
1992	206	1,432	902	530
1993	236	1,670	1061	609

Alternatives to the Current PTUF

2.23 While the Committee accepts the premise that provisional income will vary from year to year, -generally (that is: over multiple, not single years) in the direction of growth, the main problem in adopting this as the standard for calculating the PTUF is in the averaging process. Whatever figure is chosen as an uplift factor, there will always be a large number of businesses with higher income growth, and a large number of businesses with lower income, simply because it is an average. In other words, the aggregated nature of the PTUF coupled with the volatility in the rate of means that only very few provisional taxpayers will ever record a growth in taxable income at the level of the PTUF within the year of income in question. Those recording a growth higher in taxable income than the PTUF forecast will enjoy the advantages conferred on them by a low PTUF, while those taxpayers with a lower than PTUF-anticipated growth in taxable income will incur the disadvantages described above.

2.24 The imposition of a factor which attempts to express an average rise in projected income upon this numerically very large, disparate and volatile section of the business is clearly inappropriate.

2.25 There are a number of alternatives. The first is to abolish the PTUF. While such a measure would undoubtedly be popular with provisional taxpayers, the deferral of over half a billion dollars of revenue would probably rule this out as a likely possibility in the short to medium term

2.26 Another possibility would be to use historical data to extrapolate a growth rate. For example a five or ten year (or even longer) historical rolling average moments in the taxable income of provisional taxpayers is one possibility. While this has the advantage on relying only on actual data, its shortcomings are essentially the same as the current PTUF in that an average is being applied to groups which are characterised by large fluctuations in annual incomes

2.27 The Committee does not support the notion of applying a different PTUF to each part of the provisional taxpaying sector, and endorses Treasury's view that such an approachmight subject many provisional taxpayers to the complications involving the use of two or more PTUF's.

2.28 A constant PTUF could be used every year. As noted above, this would have the advantage of having a better predictive value. Its drawback is that it has all the problems of the current PTUF, and represents no more than an in-principle projection of annual income growth

2.29 One option examined at length by the Committee is to recognise the volatility in the provisional taxpaying sector of the business community and to tailor the uplift fact to this feature. In other words, each provisional taxpayer could have a personalised uplift factor derived directly from information in that taxpayers previous returns. This measure would be more effective in ensuring that parity is established with wage and salary earners as fashioning individually tailored PTUFs would be more consistent with the circumstances of each individual provisional taxpayer.

2.30 An uplift factor derived solely from previous annual changes in taxable income represents an extrapolation which, like the current PTUF, may not correlate with actual movements in taxable income for provisional taxpayers for the year in question. It does, however, have the advantage of expressing some of the circumstances of each and every provisional taxpayer, and is based solely upon easily derived facts and information. Coupled with a reform of the rules governing the lodgement of applications to vary provisional tax, it may represent an alternative structure which could more accurately, and flexibly, bring provisional taxpayers into an equitable regime vis-a vis wage and salary earners.

2.31 This option also addresses the situation with respect to retirees receiving incomes from fixed interest investments and who are subject to provisional tax. As their incomes will generally be more

predictable, individually tailored PTUFs will be more likely to reflect the eventual actual rise in their taxable incomes.

Conclusion

2.32 Almost all the submissions and evidence received from the private sector, as well as one of the three submissions received from the public sector, opposed the current level of the PTUF, the most frequently stated reason being that the PTUF was far in excess of inflation. Those that did not advocate its abolition, generally recommended that the PTUF be fixed at either the current or projected inflation rate.

2.33 The Committee supports the inflation-linked approach at this stage. Its main advantage compared to the current approach is that it anticipates a growth rate in incomes subject to provisional tax which is less likely to be higher than the actual growth in incomes of the majority of provisional taxpayers.

Recommendation 2.1: The Committee recommends that the provisional tax uplift factor be set at a level no higher than the current or projected annual movement in the Consumer Price Index.

2.34 The above recommendation is favoured by the majority of the Committee, that is: by the Coalition and Democrat members. In considering its position in relation to the provisional tax uplift factor, the Committee also considered the possible framework of the alternative discussed in paragraphs 2.29 to 2.31 above. That framework is set out below. The majority members of the Committee believe that the Government should examine this option.

An Alternative - The Individual Uplift Factor

(i) The provisional tax uplift factor be abolished in its current form and replaced by individual provisional tax uplift factors which are calculated by using a five year average based on the movements in the taxable income of each provisional taxpayer for the previous five years, or less if the taxpayer has not been paying provisional tax for that length of time;

(ii) such an uplift factor should be capped at a level to be determined by Parliament;

(iii) either:

(a) two applications to vary provisional tax be allowed annually; or
(b) applications to vary provisional tax should allow a margin of error greater than the current 5 per cent (perhaps 25 per cent) to reflect the volatility of annual changes in the movements in the taxable incomes of the provisional taxpayers; and

(iv) if, and only if, suggestions (i), (ii), and (iii) above are accepted, that provisional taxpayers be required to lodge variations if they
1 reasonably expect that their taxable income will *increase* by an amount greater than the margin allowed as a result of recommendation (iii) above.

2.35 The Government members of the Committee do not support recommendation 2.1 nor the suggested option described above. The views of Government members about the provisional tax uplift factor are set out in the attached minority report.

Penalties

2.36 The Committee does not consider it reasonable for a culpability factor to be added to the penalties which are applied to most small businesses who understate their taxable income when lodging an application to vary provisional tax. Instead, the amount of tax owing as a result of such an understatement should be subject to maximum commercial rates of interest.

Recommendation 2.2:

The Committee recommends that the only penalty for understating taxable income when lodging an application to vary provisional tax be a levy calculated by applying the highest commercial rate of interest to the unpaid tax resulting from understated income.

CHAPTER 3

WHOLESALE SALES TAX

Introduction

3.1 Wholesale Sales Tax (WST or simply 'sales tax') is an indirect tax levied since 1930 on the wholesale value of a commodity. It is imposed as an *ad valorem* tax; that is, it is expressed as a percentage of the value of the goods taxed. it is paid by the wholesale customer at the time of purchase and is passed on as part of the retail price. There are many exemptions, including foodstuffs.

3.2 The basic principle of sales tax is to impose tax on the last wholesale sale of goods going into use for the first time in Australia, that is, goods imported into Australia and goods which are manufactured and go into consumption in Australia. If the goods are not subject to a wholesale sale, then tax is imposed on a retail sale, if any, or on the use of goods. Tax is imposed on the wholesale selling price of the goods or an equivalent notional wholesale alternative. The general rate is 21%, which will increase to 92% on 1 July 1995, unless goods are exempted or taxable at another rate.

Streamlined Sales Tax

3.3 Following recommendations by the Beddall Committee inquiry into small business in Australia,' the Treasurer announced in the 1990 Budget that the Government would. undertake a review of the wholesale sales tax with the aim of improving the efficiency of the system by reducing compliance costs. The streamlined sales tax legislation which eventuated from this review and constitutes the current legislation governing sales tax, came into effect on 1 January 1993 and replaced a multitude of sales tax legislation that had accumulated over half a century.

3.4 Streamlining the sales tax legislation did not alter the basic rationale for sales tax which is to impose tax on the last wholesale sale of goods going into use for the first time in Australia. The legislation was redrafted in to be more readable and reduced the number of anomalies which had accrued under the old regime, although many of the complexities still remain. According to CCH's *Australian Sales Tax Guide,* streamlining measures included:

(a) removing certain inconsistencies in terms of classification;

(b) standardising the language used,

(c) clarifying the treatment of exemption certificates;

(d) broadening small business exemptions so that people who have a sales tax liability of less than $10,000 per annum pay tax on inputs but do not pay tax on outputs;

(e) removing some of the Tax Commissioner's discretions, although new discretions appear to have been added; and

(f) removing difficulties associated with liabilities arising from leases.'

3.5 The recommendations of the Beddall Committee, also resulted in the introduction of quarterly payment arrangements for businesses whose sales tax liability was $50,000 or less. Evidence before the Committee, however, indicated that some further refinements to the sales tax system were appropriate.

Sales Tax Rates

3.6 The Committee's second term of reference concerns 'changes in the overall burden of tax on small business, in particular the impact of changes introduced by and since the 1993 Budget, including increases in excise and wholesale sales tax'. A total of seven Acts to amend sales tax were passed in 1993 which increased the rates of sales tax, both generally, and specifically in relation to wine.

3.7 The tax rates depend upon the classification of the goods that are sold. They are classified under Schedules 1 to **7** of the *Sales Tax 'Exemptions and Classification) Act 1992.*

(a) Schedule 1 exempts the goods listed, and hence a 0% rate applies.

(b) Schedule 2 - 11% until 1 July 1995 when it increases to 12%

(c) Schedule 3 - 16% until 1 July 1995 when it increases to 17%

(d) Schedule 4 - 21% (the general rate) until 1 July 1995 when it increases to 22%

(e) Schedule 5 - 31 % until 1 July 1995 when it increases to 32%.

(f) Schedule 6 - 45%

(g) Schedule 7 - 24% until 1 July 1995 when it increases to 26%.

Sales Tax Payments

3.8 Sales tax is payable within 21 days after the end of the month in which a transaction occurs, unless a taxpayer is eligible to be a quarterly remitter, defined under subsection 62(2) of the *Sales Tax Assessment Act 1992* as a person:

(a) whose tax liability for the previous financial Year did not exceed a threshold for the current year (which for 1994195 is $52,643); and

(b) who has no outstanding liability to lodge returns (or pay tax) for assessable dealings that happened before the current quarter or the person was a quarterly remitter for the quarter before the current quarter.

3.9 About 83% of businesses in Australia are eligible to be quarterly remitters. About 95% of businesses in Australia are classified loosely as small businesses. Evidence suggests that a significant number of small businesses are not eligible to be quarterly remitters, and are consequently experiencing cash flow problems. This is discussed below.

3.10 Late payment penalties apply at 16% p.a. Non lodgement of forms and for false statements resulting in underpayment of sales tax can result in penalties amounting to 200% of the tax payable.

Sales Tax Issues

Taxpayers as Tax Collectors

3.11 Apart from the requirement to pay some of the tax owing before income has been received, a number of witnesses were unhappy with the requirement that sales tax payers act as unpaid tax collectors. In the words of Mr Robert Glynn, of Tucker, Glynn and Co:

> Sales tax is paid 21 days from the end of the month in which the sale was made. in many cases the taxpayer is required by market pressures to provide 90 to 120 days credit.
>
> It is obvious that in these cases tax is required to be paid well before it is collected. When we consider the taxpayer is in essence collecting the tax (without any form of commission from the ATO for doing so) it is a strange situation to have an agent account for the cash before it has been collected .

3.12 The Beddall Committee had considered this to be a legitimate complaint by small business, commenting that:

> A system of compensation for small businesses which recognises the service they provide to the ATO in collecting and remitting sales tax, is strongly recommended on the grounds of equity. It would be seen as a significant step by the Government and ATO in improving its standing with the small business community.4

3.13 The Beddall Committee had accordingly recommended that-.

> ... compensation in some form be provided to qualifying small businesses (ie small sales tax remitters) for the cost of sales tax collection and remittance to the Australian Tax Office, possibly by providing a tax credit based on an agreed reasonable 'compliance time' spent dealing with sales tax paperwork

3.14 This measure was not implemented by the Government on the grounds that changes in sales tax remittance arrangements and streamlining should lead to a reduction in the burden of sales tax collection on small businesses .

3.15 While these measures undoubtedly relieved some of the burden of sales tax compliance and collection, evidence indicated that there are still a considerable number of small businesses which do not come under the threshold needed for quarterly remittances. In addition, although streamlining simplified the legislation, a number of complexities remain, particularly within the exemptions and classifications rules. Furthermore, the costs of collecting sales tax was cited as still being a significant compliance burden with many small businesses.

3.16 The Beddall Committee had recommended that compensation be provided to small businesses for the cost of sales tax collection and remittance to the ATO, possibly by providing a tax credit based on an agreed reasonable 'compliance time' spent dealing with sales tax paperwork. The Committee does not at this stage endorse the Beddall Committee recommendation because of the broader implications involved in compensating businesses of all sizes for acting as tax collectors. Nevertheless, it recognises

the disparity between the relative burden of compliance costs for small business vis-a-vis large business and considers that it would be appropriate for the Government to address this issue at some future stage.

Timing of Sales Tax Payments

3.17 Many small businesses which are above the quarterly remittance threshold objected to the requirement that remittances of sales tax be made monthly. These enterprises expressed concern that the 21 day rule adversely affected their operations because of the need to fund tax liabilities before the income from which these liabilities are derived is actually received. Businesses affected generally recommended extending the payment period to 60 or more days after the end of the month of invoicing.

3.18 The Furnishing Industry Association of Australia (FLAA) and the Council of Small Business Organisations of Australia (COSBOA) expressed particular concern that sales tax frequently fell due well before income had ' been received.8 The opening comment by Mr Matthew Hughes-Gage of the FIAA was succinct:

> Our fundamental argument is that we should not have to forward on taxes which we have not received from our debtors."

3.19 The FLAA's dissatisfaction was further explained in the following comment:

> a sale is not a sale until the goods are both delivered and paid for. The government is actually seeking payment on an intention to buy rather than on the sale itself. This is the fundamental part of our argument: that we are being asked to pay taxes on a sale that is yet to be completed. In some cases, it drags off into a bad debt that may never be completed, but it is only at the end of the legal process that we are able to make adjustment to that sales tax question.1c)

3.20 The FLAA advocated paying sales tax on the seventh day following the month of collection rather than on the 21st day following the month of invoice. While the Committee is sympathetic to this proposal, it raises two major issues which are probably unresolvable:

- the question of shifting to cash based accounting; and
- the scope for tax avoidance through deferring receipts.

3.21 FLAA's proposal essentially advocates a move to cash based accounting. It is difficult to see how such a move could be limited to sales tax, especially since tax law is now firmly entrenched in accrual accounting. In any event, a movement to cash based accounting invites tax avoidance either through -an arrangement whereby cash receipts are deferred until the original value of the transaction has been devalued through the passage of time, or through bartering arrangements which do not readily lend themselves to cash accounting.

3.22 The ASCPA commented that businesses involved in manufacturing, wholesaling or some service providers will derive the majority of their sales on credit, with the average collection time being probably around 50 days from the end of the month of sale'."

3.23 The ASCPA also submitted that the requirement that sales tax be paid about a month before collection of sales proceeds requires large funding costs to small business. More specifically, the volume of sales tax being paid before receipt of income withdraws significant amounts of working capital.

3.24 The Printing and Allied Trades Employers' Federation of Australia (PATEFA) explained that their research had shown that in the printing industry, 89 per cent of printers surveyed in a trade debtor survey have a trading term of 30 days. Most of their customers (98 per cent) took over 21 days to pay

their debts, with over three quarters (76.3 per cent) taking longer than 35 days, and slightly over two in five (41.6 per cent) taking over 50 days.'

3.25 When asked about PATEFA's survey results, Treasury responded that the way the sales tax system worked for small businesses that are quarterly remitters is that they get, on average, 66 days credit from the Government on their sales tax liabilities. This was calculated by taking the midpoint of a quarter, that is day 45, and adding the 21 days by which the liability must be discharged.

3.26 Of the total sales taxpaying population, 80 per cent are quarterly remitters. However, these sales taxpayers contributed only 4.5 per cent ($461 million) of total sales tax collections ($10,170 million).

3.27 The other 9.5.5 per cent of sales tax remittances were therefore paid by 20 per cent of sales tax remitters. Although, as Treasury put it: 'They are less likely to be small businesses.'

3.28 The Committee does not doubt that a business chosen at random from the top 20 per cent of sales tax remitters is less likely to be a small business. Nevertheless, a substantial number of the monthly remitters are likely to be small businesses. Statistics reveal that at the bottom end of that 20 per cent of sales tax remitters, there were 4,597 businesses that remitted between $50,000 and $99,000 in sales tax, contributing a further 3.2 per cent ($786 million) of total sales tax remittances. 14 In contrast, and at the other end of the 20 per cent group, 1,348 (or just over 2 per cent of all sales tax remitters) contributed $7,538 million (or nearly 75 per cent) of net annual remittances during 1993-94.

3.29 Monthly remitters receive an average sales tax credit of about 36 days (1 5 + 21).15 However, many businesses dispatch their sales invoices at the end of the month of transaction. This effectively reduces their credit time to 21 days, if they are monthly remitters, on tax on earnings that they have not yet received. Evidence suggests that very few invoices are paid within that 21 days, particularly as terms of credit are usually at least 30 days, frequently being much longer, depending on the state of the market.

3.30 The evidence indicates that by their very nature, small businesses that are caught up within the sales tax system would more frequently than not be 'trading term takers' 16 in the market and that their terms of credit would frequently be 60 or 90 days, sometimes longer. While most small businesses within the sales tax system are quarterly remitters, there seems little doubt that a considerable number do not come within the requisite $50,000 plus threshold

3.31 Pointing to the incidence of bad debts, extended terms of credit, and payments delayed for extended periods of time, a number of submissions stated a preference that sales tax become payable following receipt of income so that payment of tax be aligned as closely as possible to the actual receipt of income.

3.32 COSBOA and the FIAA submitted that the requirement to finance tax liabilities in advance of the receipt of income had particular impact on small to medium enterprises that were too large to qualify as quarterly remitters, but who were relied upon to enhance Australia's export base.
The diversion of finances from working capital to finance tax bills retarded their opportunities to apply that capital to improve their export opportunities. COSBOA suggested the access thresholds of quarterly sales tax collections be raised from $50,000 to $100,000.

3.33 The issue of sales tax thresholds is a difficult one because of the difficulty in establishing correlation between sales tax liabilities and business size. While it seems likely that most businesses with sales tax thresholds of less that $50,000 are small businesses, evidence given by PATEFA indicates that sales tax liabilities also depend upon the nature of the business:

Some people in our industry are very lucky; they have very little work which involves sales tax. Those people producing for stock like paper merchants, paper and board and ink manufacturers usually have no sales tax involved because it all goes into the cost of production, as is the case for many printers. You might be producing foods which are an aid to manufacture, but probably out of the printers there, about half of the goods invoiced across the board attracts wholesale sales tax…….

3.34 For this reason, the Committee does not consider that it would be appropriate to consider recommending a change to the $50,000 threshold for quarterly payments until further information is available to establish the number of small businesses which fall within the monthly remittance regime. In this context, it is not entirely self-evident that every sales tax remitter with an annual sales tax of below $50,000 is necessarily a small business. Therefore, consistent with the need to redress the imbalances caused by economies of scale available to large businesses, the Committee considers that an alternative measure could be adopted which directly relates to business size.

3.35 As an alternative, and consistent with the notion that small businesses are generally price takers in the market with their terms of credit generally being well over 21 days or even the 35 day average sales tax credit calculated by Treasury for monthly remitters, the Committee considers that the sales tax remittance deadline of 21 days after the month in which the transaction was made should be extended by 25 days to the middle of the second month following the transaction. Although this produces a notional average sales tax credit of 60 days (35 + 25), it is more consistent with the actual terms of credit extended to debtors by small businesses, who are not in a position to absorb the costs and cash flow restrictions generated by credit arrangements through the application of economies of scale.

Recommendation 3.1:

The Committee recommends that, in addition to the current threshold which enables quarterly remittances, businesses defined as 'small' by the Australian Bureau of Statistics in ABS Catalogue No. 1321.0 (Small Business in Australia 1993) be permitted to remit sales tax either:

(i) on a quarterly basis; or

(ii) 45 days after the end of the month in which the transaction occurs.

Exemptions and Classifications

3.36 Sales tax exemptions and classifications are listed in the *Sales Tax (Exemptions and Classifications) Act 1992* (the Act). As described in paragraph 1.7, tax rates depend on the classifications under Schedules 1 to 7 of the Act. Schedule 1 exempts goods and Schedule 4 applies the general rate (rising from 21 per cent to 22 per cent on 1 July 1995) to all goods not elsewhere listed.

Problems with Exemptions and Classifications

3.37 A number of submissions regarded the current system as too complicated and frequently ambiguous. SBP State Council asserted that there '...is the major problem of the uncertainty of classifications of goods for the determination of the appropriate tax rates', and recommended a single rate of sales tax for taxable goods.19 This recommendation was echoed by the Australian Earthmovers & Road Contractors Federation, the QCCI and COSBOA.

3.38 The Motor Trades Association of Australia (MTAA) submitted that, significant cascading effects of the current WST arrangements produced price distortions in the domestic market and undermined export opportunities. The MTAA commented in evidence

> There is a particular view amongst small traders that the current wholes sales tax system, with its different level on many items, is extremely complex. It runs the risk of significant mistakes being made in the calculation and for that to cause additional work when the mistakes are discovered ... there does not seem to be any rhyme or reason as to what attracts what rates ... The view has been put by our members is that they would prefer a simpler system.

The MTAA called for a review of the system which would examine equity and efficiency questions as well as revenue matters. The Australian Society of Certified Practising Accountants also called for a review of sales tax to broaden the revenue base.

3.39 The Small Business Development Corporation of Western Australia considered that sales tax and the FBT were primary areas of tax concern for small businesses because of their complexity and the time consuming compliance requirements. The inconsistency of the assessment of some sales tax items when establishing rates was also a concern. The corporation did not call for a review but recommended hat the legislation be clarified through tax rulings.

3.40 The South Australian Employers' Chamber of Commerce and Industry was appreciative of the improvements brought by streamlining the sales tax legislation but expressed concern about the classification of some items which are 'borderline between classes'.

3.41 The difficulties which arose with particular items was the subject of some discussion in evidence given to the Committee. Mr Brian Harmer of Bowman Manser and Associates offered the following example:

> …..there are some crazy anomalies. If you go and buy a mat for your bathroom and put it on your car floor, you do not pay sales tax on it, whereas if you go into the vehicle accessories department you do.

Example of *Ambiguity - Rice Milk*

3.42 There are numerous instances where sales tax classifications are confused by ambiguities in product description. In many cases, the ambiguities lead to disputes between the ATO and small businesses which are time consuming and costly. An example which came to the attention of the Committee was of a Melbourne based distributor of organic food which was attempting to gain a sales tax exemption on rice milk.

3.43 Mr Don Lazzaro, managing director of the distributor, PureHarvest, submitted that rice milk should be classified as food for human consumption and therefore exempt from sales tax, or that item 71 of Schedule 1 of the *Sales Tax (Exemptions and Classifications) Act 1992* should be amended to allow for rice milk to be exempt for exactly the same reason that plain milk and soy milk are exempt. He made the following points in his submission to the Committee:

- when the Government exempted soy milk from sales tax in the 1988189 Budget, it stated that plain milk was currently exempt from sales tax, and that soy milk was sold in competition with milk and in many cases used as a substitute:

- like soy milk, rice milk is consumed by people who are lactose intolerant and

- rice milk can be consumed by people who are allergic to soy products and is made the same way as soy milk except with rice as the basic ingredient.

3.44 An approach by Mr Lazzaro to the Cheltenham office of the ATO for a ruling on whether rice milk was exempt resulted in advice that it was taxable at the general rate of 21 per cent, apparently on the basis that it was not food for human consumption but a recreational drink. It also resulted in an audit and a consequent demand for payment of arrears of sales tax. Further approaches to the ATO and to various Ministers have also produced no result.

3.45 Mr Lazzaro provided the Committee with copies of correspondence sent to Ministers, endorsements from medical practitioners, including a consultant allergist, and letters from consumers. The Committee has also received correspondence and petitions from consumers, a clinical nutritionist, and other distributors of natural foods protesting at the sales tax treatment of rice milk.

3.46 This example raises a number of issues. The Committee considers that a taxpayer seeking advice or a ruling should not fear that their action will precipitate an audit. Many taxpayers find the complexity of the tax system combined with the enforcement function of the ATO to be an unpalatable mixture. Notwithstanding the ATO's efforts in formulating and implementing practical education and consultation strategies, the Committee considers that a considerable amount of progress could be made to encourage voluntary compliance if the provision of advice by the ATO was separate, *and seen to be separate,* from its audit function.

3.47 Other, larger issues raised by the PureHarvest experience include:

- the need to clarify procedures used to determine the sales tax classification of a product, especially a new product;

- the need to eliminate, as far **as** practicable, ambiguities and complexities in the classification regime.

Consequences of Technological Innovation

3.48 There are some areas of sale tax which have become complicated by the advent of new technology. The Printing Federation (PATEFA) gave evidence that changes in printing technology have outpaced changes in the sales tax regime causing the printing industry some problems, not the least being inconsistencies in the advice proffered by the ATO. An example was inconsistent rulings by various branches of the ATO concerning the need to collect exemption declarations for artwork. Confusion arises because print production is becoming more technologically integrated. This creates problems when the assumptions underlying sales tax classifications are based on outdated technology and separation of activities which may no longer occur.

3.49 Mr Jordan Reizes of PATEFA spoke of the example concerning artwork:

> There is no separation any more between someone who creates the artwork in terms of design and someone who creates the final product. It is the final product which is exempt there, but at the moment people are doing it on one Macintosh computer. The sales tax office said to us, 'Look, there is a way to overcome that. Tell people to buy two. They use one for design which they pay tax on and they can use the other one to do the final artwork and composition which is non-taxable.

3.50 The Committee agrees with Mr Reizes' evaluation that the purchase of two computers is not a practical solution, especially for a small operation. What is required is not merely upgraded legislation but a process for expeditiously upgrading that legislation before such anomalies are seriously compounded. The Committee was advised by the Federation that the ATO was aware of the problem and had formed a print focus group, although this was an internal group which, the Federation believed, did not consult with industry for input on the application of the goods it was discussing.

Conclusion

3.51 The Committee considers that there are serious problems and ambiguities inherent in the current application of the *Sales Tax (Exemption and Classifications) Act 1992* in relation to the classification of various goods, particularly new products emerging on the market. The above examples of car mats, rice milk, and printed artwork exemplify the variety of goods which do not neatly fall into the classifications listed in the Schedules to the Act. The evidence suggests that there are many more examples which arise on a regular basis. Furthermore, the PureHarvest experience and the problems confronting the print industry demonstrate that the procedures for resolving these anomalies are somewhat haphazard.

3.52 It is clear that the Exemptions and Classification legislation and its associated processes require clarification. The Committee acknowledges that simplification of this legislation to achieve greater efficiency raises considerations of equity. Nevertheless, equity and efficiency are not mutually exclusive notions, particularly when it can be demonstrated that the current inefficient and complex system of sales tax exemptions and classifications generates inequities which require time consuming and expensive remedies. It is a question of balance.

Recommendation 3.2:

The Committee recommends that the Government conduct a comprehensive view to:

(i) removing the ambiguities and complexities within and between the sales tax classification schedules: and

(ii) establishing a simple, effective process whereby the classification of new products can be quickly and simply achieved, thereby lessening reliance on the general rate sales tax as a default rate.

Small Business Exemptions

3.53 Small business exemptions are generally available to persons whose sales tax liability, over a 12 month period. Is $10,000 or less, and who pay tax on taxable inputs. As this is clearly intended to alleviate the administrative burden upon very small businesses, the threshold should be indexed in line with indexation of the quarterly remittance threshold.

Recommendation 3.3:

The Committee recommends that the $10,000 sales tax threshold for the small business exemption be indexed annually.

The Wine Industry

3.54 The Winemakers' Federation of Australia forwarded a lengthy submission expressing considerable concern at the impact of the sales tax increases resulting from the August 1993 Budget on the industry. That Budget resulted in legislation which progressively increased the rate of sales tax on wine to 22% from 1 November 1993, to 24% from 1 July 1994, with a further increase to 26% to come into effect on 1 July 1995. The Committee believes that the problems encountered by the wine industry provide a good example of the types of difficulties faced by many other industries in Australia which have a large number of small businesses as their base.

Wine Industry Inquiry

3.55 In October 1993, the Commonwealth Government announced that a Committee would be formed to inquire into the Australian winegrape and wine industry. The matters to be taken into consideration under the terms of reference include the appropriate form and level of taxation and cash grants for the industry, taking into account, amongst other issues,
the ability of the industry to achieve its domestic and export potential. In March of this year, that Committee 29 published a Draft Report, *Winegrape and Wine Industty in Australia.*

3.56 The Report proposed that the form of tax on wine should be changed through the imposition of a composite tax comprising an *ad valorem* component (the sales tax) for revenue raising purposes, and a volumetric tax levied on the alcohol content to address the external costs associated with alcohol consumption.

3.57 While a majority of the Committee proposed that the average level of such a composite tax be maintained at the 26% rate of sales tax to come into effect on 1 July 1995, the Chairman disagreed. He considered that there was evidence of some substitution between wine and other alcoholic beverages, especially beer. Accordingly, he suggested that there would be gains in economic efficiency from reducing the present disparities in tax treatment between wine and other alcoholic beverages and proposed that wine be subject to a sales tax of 32 per cent and a volumetric tax, lifting the composite rate of tax from 26 per cent to 50 per cent. He also proposed a five year transition to reduce adjustment costs.

3.58 The Committee received submissions from the Winemakers Federation of Australian (WFA) on the subject and heard evidence at its public hearing in Adelaide on 20 April 1995.

3.59 The WFA objected to both the minority and majority draft recommendations, taking particular exception to the volumetric component of the proposal, principally because of the atypically strong demands for working capital due to long lead times in production and delays in maturation. Although the WFA contended that wine is no more a substitute for beer than for non-alcoholic beverages, it conceded that there were some external costs of alcohol abuse from all forms of alcohol, including wine. Nevertheless, the Federation argued that these costs were cancelled by substantial health benefits from the consumption of wine in moderation.

3.60 The WFA also argued that the industry's funding requirements were compounded by full absorption trading stock valuation arrangements on long stock holdings which result in understated expenses for the income year, which in turn results in overstated profits. Consequently, taxation is paid in advance of sales which calls upon additional working capital. The WFA stated that Coopers and Lybrand had estimated that this treatment of wine stocks represented a four per cent increase in the rate of WST. Application of Own Use (AOU) charges on cellar-door wine tasting represented another one per cent equivalent increase in WST which apparently results in small wineries attempting to recoup this cost by charging for wine tasting. Finally, the $10,000 small business exemption has been eroded by the progressive increases in the sales tax rates on wine which have brought previously exempt operators into the WST regime.

3.61 The WFA also objected to the automatic application of the FBT to business meals at which wine is served, which impacts on the wine industry's promotional activities and wine sales to restaurants.

3.62 Citing ABS data, the WFA argued that winemakers have lost volume in recent years as a result of tax, price and cost rises. The Federation considers it unlikely that winemakers will pass on the added costs to the consumer, but will attempt to partially absorb the added costs through taking reductions in profits, and to pass the remainder on to the suppliers, the growers.

3.63 The Federation considers that the industry is now very exposed, as this flowthrough effect has occurred a number of times in the past and because it has a major capital problem in replacing old vines. Although these expenses can be written off by the property owners, and the draft Industry Commission report recommends extending this provision to leased properties, the Winegrape Growers' Council contended that many independent growers do not '...have the luxury of the ability to write it off,, they do not have the ability to raise the borrowings in the first place. The Council advised that banks would require a borrower to have 65 to **75** per cent equity in the property and to demonstrate the ability to survive with sharply reduced income during the period of development of the vineyard.

The Wine Industry Position

3.64 When asked by the Committee to nominate the most important issues, the wine industry representatives wanted:

- the establishment of a predictable tax environment free of the constant risk of change; and
- recognition that the normal taxation arrangements that are levied on the industry have a 'disproportionate and probably unintended' impact because of the peculiarities of the wine industry.

3.65 In relation to the latter point, be **the WFA considered the trading stock valuation arrangements to crucial** because the wine industry's future opportunities lie in having a quality

advantage. The wine industry could only sustain a quality advantage by investing in considerable maturation of wine stocks. The Federation pointed out that in the draft Wine Inquiry report, there was '...some discussion about whether the wine stocks are not in fact more akin in nature to investment than production for income'. If wine stocks were considered an investment, the required tax treatment would be different:

> It requires a tax treatment whereby there is an immediate write-off of **all** costs associated with the stock investment - in other words, it is really taking an appreciation regime concept but giving it a very short time frame and bringing it into the one year in which stocks are built up. Alternatively, it requires some depreciation treatment which had the desired effect...

3.66 The wine industry representatives commented that there were two elements to this approach, namely:

- valuation element on the stock itself; and
- a timing issue concerning the time frame within which the expenses associated with achieving that valuation are recognised.

3.67 The Growers Council was, however, extremely concerned about the possible impact of a volumetric tax, both in terms of its direct impact on the industry, and because it threatened to distract from other, important tax issues. The Council considered it the single most dangerous issue that has changed since it forwarded its submission to this inquiry. It agreed that the grape growers would probably end up bearing the brunt of a volumetric tax, particularly if the majority recommendations which recommended loading a greater tax rate on nonpremium wines, were adopted.

3.68 Finally, representatives were concerned that the brandy industry, which has traditionally used surplus non-premium grapes, will effectively cease to exist, resulting in surplus grapes being physically dumped.

Conclusion

3.69 The tax treatment of the wine industry is complex, involving close scrutiny and assessment of a number of contentious issues to which there is plainly little agreement between the Committee of Inquiry into the wine industry and the industry itself. The Committee is not in a position at this stage to fully evaluate even the major issues of contention that have arisen in the course of the Inquiry into the Winegrape and Wine Industry, and therefore has not attempted to influence the outcome of the Inquiry by making recommendations concerning the substantive tax issues. However, the Committee considers it of great importance that the key issues involving this important, successful and expanding export industry be properly addressed. Clearly, those key issue of contention remain the proposed imposition of a volumetric tax, trading stock valuation arrangements involving long term wine stocks, and the FBT.

3.70 The Committee of Inquiry and the wine industry are at odds over that Committee's draft recommendations. Clearly, it is unrealistic to expect agreement in relation to all the issues. However, if the winegrape and wine industry's long term development potential is to be realised, an important consideration must include the attitude of the industry itself towards the measures that the Committee of Inquiry will recommend for implementation in its final report.

3.71 The Committee considers that the successful resolution of this long, thorough and heavily committed inquiry into the winegrape and wine industry will not be achieved until the major protagonists find common ground.

CHAPTER 4

FRINGE BENEFITS TAX

Introduction

4.1 The FBT is administered under the *Fringe Benefit Act 1986* and is a tax payable by employers on the value- of certain fringe benefits. A fringe benefit is a benefit which is provided to an employee or an associate of an employee, in an employment context, by the employee's employer, by an associate of the employer, or by a third party under an arrangement with the employer or an associate of the employer. A 'benefit' includes any right (including any property right), privilege, service or facility.

4.2 In other words, FBT is designed to tax non-pecuniary remunerations, or salary sacrificing arrangements, which would otherwise not be subject to tax. Some examples include private school fees, cars, subsidised loans, and free or cheap travel for the employee and the employee's family. Before FBT, these benefits were generally provided in the area of executive rewards, both in the public and the private sector, particularly in the latter, although one early commentator noted that ,..even ... the Taxation Commissioner seem[ed] to benefit from untaxed remuneration.

4.3 The FBT is assessed annually. it is paid by three quarterly instalments during each year which are due on 28 July, 28 October, and 28 January for the quarters ending on 30 June, 30 September and 31 December. The balance is due on 28 April. An employer with an FBT liability of less than $3,000 need only pay on an annual basis.

4.4 The FBT year usually runs from 1 April to 31 March. Like sales tax, the FBT is not an income tax and is levied at 48.475 per cent from 1 April 1995, and will increase to 48.5 per cent from 1 April 1996, irrespective of the level of business income. An income tax deduction is allowed to employers for the amount of FBT paid.'

Government Review of the Costs of FBT

4.5 The Government recently completed a review of the compliance costs of the FBT and the Treasurer announced new measures in a Press Release on 24 February 1995. These included:

(a) exempting a range of items that appear to be used primarily for business purposes, including car phones and mobile phones;

(b) reducing the number of employee declarations required by an employer to reduce certain FBT liabilities;

(c) simplifying the valuation of entertainment meals;

(d) changes to rules concerning car parking; and

(e) a range of other measures.

A copy of the results of the Government's review of FBT compliance costs appears at Appendix V.

FBT Issues Raised in Evidence

4.6 In evidence to the Committee, FBT was subject to numerous complaints about its complexity and associated compliance costs. Issues raised included:

- FBT is a measure designed for large organisations with small businesses 'caught in the web' and that small businesses with less than 1 0 employees should be exempted from its requirements;
- the complexity and the frequency of change has resulted in the FBT becoming one of the more onerous taxes for small business to COMPIY with, causing excess paperwork and resulting in many companies overpaying FBT to avoid penalties,
- a business meal at which wine is served should not be automatically deemed to be entertainment.
- areas of FBT that are not salary packaging items but are should necessary due to award or general industry practice should not be subject to F BT;'
- the change in the 1993 Budget, which grossed up the amount against which the FBT is calculated, disadvantages businesses making losses because they cannot take advantage of the income tax deductions available on the increased FBT;8
- Tax Ruling TD931149 discriminates against travel agents who do not operate trust accounts or otherwise holds money on trust for a service provider
- A legislative anomaly exists between the tax treatment of independent travel agents and airline owned in independent travel agents in relation to the provision of free or discounted 'firm space' (as opposed to stand-by')
- the $3,000 threshold be increased to $8,000 to align it with the company tax threshold;
- FBT should apply only to items of genuine remuneration and not to items that are part of the process of conducting legitimate business activity;
- the FBT year be aligned with the financial Year;
- FBT is levied regardless of profits or losses made;
- FBT compliance costs should not be out of proportion revenue, and
- FBT exemption on child care applies only to businesses large enough to run a child care centre. Several small businesses pooling their resources to do the same would not be eligible for the exemption.

Some of these issues are discussed in detail below.

Broadening the FBT Base

4.7 In evidence to the Committee, the Motor Traders Association of Australia (MTAA) and the Queensland Chamber of Commerce and Industry (QCCI) argued that the taxation base for the FBT had expanded too much and was taxing not only items of remuneration, but also legitimate business costs'7 In addition, the MTAA remained opposed to entertainment expenses being subject to FBT, and continued to maintain that the FBT should be paid by the beneficiary, that is, the employee.

Fringe Benefits Tax

4.8 They argued that the FBT would be fairer if the employee were required to pay the liability, since fringe benefits are a form of income received by the employee, and should therefore be subject to tax at the employee's marginal rate. The fact that it is not a progressive tax on income has created

complications, including the fact that it is levied at a rate higher than the marginal rate paid by many taxpayers on income tax. (see also Compulsory Benefits below).

4.9 Along with many others, the South Australian Employers Chamber of Commerce and lndustry (SAECCI), submitted that the FBT should not be applied to areas that are genuine business expenses The problem is, as outlined by SAECCI, distinguishing between personal benefits that accrued to the employee and legitimate business expenses. For example, as pointed out by SAECCI, entertainment can be a necessary part of business dealings:

> If you are trading with Japan and you have Japanese guests here, you simply have to entertain them. It is as important as sitting down and talking about business that morning.

4.10 The difficulty for the Government is in distinguishing between entertainment which is for a genuine business purpose and entertainment which goes beyond that purpose. Much of the complexity of the FBT that annoys small business arises from rules concerning entertainment.

Compliance Costs

4.11 The recent Government review of FBT compliance costs reduced the complexities of FBT to some degree, but this was achieved by trading off reduced compliance requirements against higher imposts. The TIA suggested in evidence that if FBT payers take the option which results in the lowest compliance in terms of paperwork, they will end up paying 21 An example provided by the TIA was that if the 50/50 option (the simplest option) in relation to entertainment was taken, more FBT will be paid.

4.12 In a slightly different context, Bowman Manser & Associates, an accounting firm which services mainly very small businesses, also used the example of the 50150 option exercised by a taxpayer with an entertaining expense of $500, relating to an event such as a shearer's cutout or a picker's breakup . Using the 50150 option, and assuming the taxpayer has an income between $20,000 and $35,000, the net cost to the taxpayer is $43. The taxpayer:

> ... has got to file a... tax return or else break the law and, if he comes to any accountant who costs it properly, it is going to cost him somewhere between $100 and $150 to prepare the return.

4.13 Further evidence indicated that the cost of preparing returns by an accountant working for one of the national accounting firms could be considerably higher.

Complexity of FB T and Lack of Understanding

4.14 Another issue raised related to the inability of many, and some evidence suggests most small business operators to understand how FBT operates, leaving it to their accountants to sort out the complexities. Not only does this result in compliance costs, but generates another consequence:

> Very few small businesses do their fringe benefits return or know how it operates. The accountants do that, and they are probably the ones who have complaints because they are the ones who have to deal with the law. This is sad in a way because it is the small business people who are going to make the business decisions whether to lease or buy a company, whether to buy a car or a truck, whether to drive it home or park it at home. They are the ones who are going to make decisions which will expose them to a liability and yet they probably have no hope of understanding it.

4.15 When asked why small business operators could not work in conjunction with the accountant, Professor Walischutzky replied that:

> They know every time they ring an accountant that the clock starts ticking.

4.16 Mr Wayne Heathcote, National Director, Indirect Taxes, BDO Nelson Parkhill (Chartered Accountants), an adviser to PATEFA commented similarly. When asked if his firm had pro forma forms that are sent out to clients to ensure correct record keeping in relation to potential FBT liabilities, he commented that there were no such forms, because FBT '... is so wide that it is difficult to cover all aspects'. Nelson Parkhill relied on newsletters and information in letters to clients to advise them of what they should be doing:

> Then we try to liaise with the clients to get it correct. But, once again, they are having to pay us to assist them."

Exemption Threshold

4.17 The Committee considered that FBT policy and the benefits to revenue from collecting the FBT from the smaller end of the scale should be weighed against the costs incurred by small businesses in preparing and lodging returns relating to small liabilities.

4.18 Figures supplied by the ATO and the Treasury reveal that in the year ended 31 March 1994, a total of 71,506 private companies and 'other business taxpayers' remitted $696 million in FBT. Just over 20,000 of these taxpayers remitted less than $1,000 each, totalling $10 million, representing 1.42% of revenue collected from this group of taxpayers. Given the extraordinary complexity of the FBT, and the very high relative compliance costs associated with their collection from small business, the Committee considers that a threshold exemption should apply to the collection of small amounts. At the least, this threshold should reflect the cost of employing a large accounting firm to prepare an FBT return.

Recommendation 4.1:

The Committee recommends that small business be exempt from annual FBT liabilities of $200 or less.

Compulsory Benefits

4.19 The fact that some award benefits are subject to FBT is a cause for concern. One example provided to the Committee during its hearings was supplied by the Australian Society of Certified Practising Accountants. Under a certain award, children in the theatrical and entertainment industry

must be provided with transport to and from the place of business. The value of this transport is subject to FBT by the employer paying for the transport, frequently a taxi fare, thereby subjecting the employer to a further impost. The Committee does not consider this to be an appropriate use of the FBT, as the employer does not have the option of cashing out of the award.

4.20 When questioned about the practice of taxing compulsory benefits, the Treasury responded that this was not inconsistent with the tax treatment of other compulsory benefits, such as wages. This, however, misses the point that the FBT has not been constructed as an income tax, and is levied at the highest marginal rate, reflecting its function as a tax on 'lurks and perks'. This example highlights the fact that FBT has expanded its base well beyond the earlier non-salary items which it was designed to catch. The Committee believes that any tax on compulsory benefits should be treated as part of an employee's income, instead of being included in an employer's FBT liability, and should therefore be levied at the employee's marginal rate.

Recommendation 4.2:

The Committee recommends that statutory and compulsory award obligations from which an employer is prohibited from cashing out into salary or wages be exempt from FBT.

Car Parks

4.21 An area of considerable concern to small business is the application of the FBT to car parking. A number of submissions have pointed out that car parking facilities are a requirement of local councils yet simultaneously subject to FBT. In the words of the Queensland Chamber of Commerce and Industry:

> The company has built a car park. It can provide that facility. It is then taxed on that facility. It is taxed by the city council if it does not have it.

4.22 The QCCI amplified this comment as follows:

> You are really compounding the situation. Many of our small businesses, for example, service the import-export industry, They are constantly in and out. Yes, there is a public car park that they could access but in reality, it is always full. Therefore they have to provide their own parking, yet they will be deemed to be getting a benefit from this. We feel that it is splitting hairs down to the point that the cost to the business of generating the return for government outweighs the advantage you are receiving. It is a negative factor for the business itself."

4.23 The Printing and Allied Trades Federation of Australia (PATEFA) similarly submitted that..

> The provision of employee car space which is now subject to FBT is at odds with council building approvals which are increasingly based on buildings having adequate parking facilities. Businesses are thus forced to provide facilities only to be taxed later on.

4.24 While not all car parking FBT is subject to these kinds of council on car parking seems to have regulations, the general issue of onerous burden of compliance. The Governments recent review on the issue has simplified the treatment of car parking considerably

created confusion and an on

4.25 Nevertheless, the Committee considers that the fundamental issue at stake is the provision of the car itself as a fringe benefit, and that the extension of the FBT to car parking arrangements adds unnecessary complications and therefore a compliance burden upon small businesses. In common with other 'fringe benefits', the cost of providing car parking facilities will in most cases have already been borne by employers. However, it is not a benefit which can easily be cashed out by employers,

and nor would it appear to be a benefit of which an employee could readily make private use. In many cases, car parking facilities are part of the structural assets of a business or its premises and as noted above, their existence can be a local government prerequisite for building approvals. While acknowledging that car parking facilities in CBDs constitutes a real and tangible 'benefit', the Committee does not believe that the cost to small business employers should be increased by imposing FBT on their use by employees.

Recommendation 4.3:

The Committee recommends that car parking be exempt from the FBT.

Child Care

4.26 The Committee received evidence that FBT exemptions on child care were unfairly applied. Included in the evidence was the following comment:

> Child care is one of the very few employee benefits not subject to FBT. However, the exemption only applies to a business large enough to operate the child care centre itself. A group of small businesses which combine to jointly operate a centre would not be eligible for the exemption."

4.27 The Committee does not consider that industry based child care should be discouraged or burdened with FBT in this fashion, particularly if small businesses are offering the benefit.

Recommendation 4.4:

The Committee recommends that child care be exempt from the FBT where a number of small businesses combine to provide child care exclusively for the children of the personnel employed by those businesses.

CHAPTER 5

COMPANY TAX

5.1 Company tax is levied on companies separately from the income of its shareholders. It was introduced in 1976/77 financial year. From 1978/79 it was collected mostly in quarterly instalments on an arrears basis. In l99o, the payment arrangements were changed to a lump sum system.

5.2 Then in 1993, a new system of company tax instalments was enacted. As proposed it applied to:

- small taxpayers (tax liability less than $8ooo) for the 1994-95 year of income;
- medium taxpayers ($8000 - $300 1000) for the 1994-95 year of income; and
- a large taxpayers (over $300,000) for the 1995-96 year of income.

5.3 Table 5.1 shows how company tax was paid between 1989/90 and 1993/94. Table 5.2 summarises the new arrangements that were to have applied from 1994/95 and 1995/96.

Compliance Dates

,Small Taxpayers

5.4 Upon notification of the proposed changes, opposition arose from small businesses and their tax agents because the new compliance dates meant that the year's flow of work would be compressed into a six month period. (Many accountants also lodged submissions to this inquiry protesting against the new arrangement.)

5.5 After consultation with the Tax Office, a compromise arrangement was reached (Appendix IV). The agreement, which will apply for 1994/95 only, allows small businesses with tax liabilities of $8,000 or less to revert to the previous lodgement arrangements. A review by the Tax Office is currently being undertaken to determine long-term arrangements.

Table 5.1: Operation of the payment system for companies with 30 June balance dates prior to 1994-95

<table>
<tr><th>Tax Liability</th><th>Payments required</th><th>Due date after end of year of income</th></tr>
<tr><td>$20,000 or more</td><td>Initial payment: 85% of notional or estimated tax

Final payment: balance of total tax liability</td><td>28 July (28 Sept for 1993/94 for $1,000 to $300,000)

15 March</td></tr>
<tr><td>Between $1,000 and $20,000</td><td>Initial payment: 85% of notional or estimated tax

Final payment: balance of total tax liability</td><td>28 July (28 Sept for 1993-94 for $1,000 to $300,0000)

15 March</td></tr>
<tr><td></td><td><u>OR</u></td><td></td></tr>
<tr><td></td><td>One single payments of 100% of total tax liability</td><td>15 December</td></tr>
<tr><td></td><td rowspan="2">One single payment of 100% of total tax liability</td><td rowspan="2">15 March</td></tr>
<tr><td>Less than $1,000</td></tr>
</table>

Table 5.2: New system of company tax payment arrangements.

Year of Income	Tax Liability	Payments Schedule	Due date after start of year of income
1994-1995 and after	Less than $8,000	Full amount by single instalment	1st day of 18th month after start of year of income (usually by 1st Dec)
1994-1995 and after	Less than $8,000 to $300,000	Quarterly instalments, 25% of likely tax in first three quarters with actual tax assessed less instalments already paid.	By the first day of the 12th, 15th, 18th and 21st months (usually 1 June, 1 Sept, 1 Dec and 1 Mar)
1995-1996 and after	More than $300,000	Quarterly instalments, 25% of likely tax in first three quarters with actual tax assessed less instalments already paid	By the first day of the 9th, 12th, 15th and 18th months (usually 1 march, 1 June, 1 Sept and 1 Dec)-except that the first instalment is waived for 1995-1996

Medium Taxpayers

5.5 Evidence to the Committee expressed some opposition payment schedules which will come into effect in 1994195 for small to medium businesses with tax liabilities of $8,000 or more. Whereas the previous payment system allowed for instalments to be paid in the following year of income (,Table 5.1), the new regime for businesses with tax liabilities of $8,000 or more will require payments to commence within the current year of income (Table 5 . 2).

5.7 The ATO and Treasury commented that:

> Although some company tax payments will be brought forward under the quarterly instalment systern, some will also be delayed. The changes should result in lower financing costs for small and medium expressed some opposition to the new businesses because, on average, they will result in a net deferral of tax payments.

5.8 However, some submissions asserted that as these 'medium' taxpayers (that is: with tax liabilities of between $8,000 and $300,000) will have their first instalment of 25% for 1994195 payable on 1 June 1995, they will pay 125% of what they would otherwise have paid in 1994195.

5.9 ATO and Treasury, in their joint submission to the Committee, advised that under recently enacted changes to the imputation system, a franking credit arises in a company's franking account at the time it pays a company tax instalment. They also commented that:

> For medium and large instalment taxpayers, who will pay their first instalment during the income year to which the company tax instalment relates, this means that companies will now be able to pay dividends during the income year which are franked with imputation credits corresponding to the first instalment ... This change to the imputation system effectively permits companies to distribute **as** franked dividends duriny the income year some of the profits which are derived in that year.

5.10 ATO/Treasury consider that this should largely alleviate concerns about the timing of the first instalment during the first income year, 1994195.

Small 'Medium' Taxpayers

5.11 One group of company taxpayers which may have been disadvantaged are those that are in the $8,000 to $20,000 bracket of annual company tax liability. Under the previous payment arrangements, these taxpayers had a choice of making an initial payment 85 per cent of their notional tax by 28 September (for 1993-94), with the balance being payable on 15 March following, or simply paying the entire company tax liability by 15 December after the end of the year of income. Under the new arrangements, these companies are now required to pay by quarterly instalments commencing on the first day of the 12th month after the start of the year of income, usually 1 June.

5.12 As the ATO/Treasury submission asserts, this may represent, on average , a net deferral of tax payments due to the fact that by 15 December, 75 percent of notional tax will have been paid against the 85 percent notional tax or 100 percent actual tax allowed under previous arrangements. Nevertheless, the volume of tax payments that have been brought forward represents a sudden and significant shift in cash flow which in many cases, particularly for companies that are in the bottom end of the 'medium' taxpayer spectrum, may only be readily absorbed if sufficient notice is given to allow forward planning.

5.13 A submission was received from one of these companies which complained that it had received inadequate notification of this change from the ATO , maintaining that the leaflet which it received

from the ATO tax agent had not been received until February 1995, although it was dated December 1994. The consequence for this particular company was that between December 1994 and February 1995, it had budgeted for its cash flow on the basis of a single December 1995 tax payment, and had committed substantial funds to non-urgent expenditure on their premises, which they maintain they would not have done if they knew that a first instalment was due on 1 June 1995.

5.14 The Committee is concerned that this apparent inadequacy of notification of significant changes to the legislation may have adversely affected a substantial number of company tax payers. Statistics reveal that in the 1992-93 income year, 22,83l companies paid net company tax of between $8,000 and $20,000 each.

Recommendation 5.1

The Committee recommends:

(i) that the Government investigate the adequacy of the notification of the new company tax arrangements, in particular, to those companies with company tax liabilities of between $8,000 and $20,000; and

(ii) that the Government ensure that taxpayers which are affected by changes in the legislation are properly notified well in advance.

Threshold to Quarterly Payments

5.15 KPMG Peat Marwick submitted that the $8,000 threshold was too low as many small businesses are classified as medium taxpayers liable to quarterly instalments, increasing their administrative burden.6 **A** number of submissions were received arguing the opposite view, namely, that small companies should be given the opportunity to make quarterly payments to ease cash flow which is easily disrupted with the imposition of a lump sum tax liability.

5.16 The question of thresholds was raised a number of times in submissions and in evidence. The Tax Office and Treasury acknowledged that there are some inconsistencies, for example between the FBT and company tax thresholds While the question of thresholds is clearly of importance to small business, as is the consistency between thresholds on the various taxes, they should not restrict the options available to small business. Clearly, lower thresholds are intended to cushion smaller businesses from the more rigorous requirements applying to larger businesses. Nevertheless, a number of small businesses would be happier paying their company tax liabilities on a quarterly basis, rather than as a lump sum. As the administrative systems which implement the quarterly arrangements are already in place, there seems to be no reason why small companies should not be given the opportunity to opt into alternative payment arrangements available to larger taxpayers.

5.17 An associated issue is that 'small' taxpayers for the purposes of company tax payment schedules do not necessarily equate with small businesses. The NTAA pointed out that a 'small' company taxpayer may be a very large business experiencing a downturns. A 'medium' taxpayer may be in the same situation. There seems no reason to force such a company into an alternative payment schedule for that reason.

Recommendation 5.2:

The Committee recommends that 'small' and 'medium' company taxpayers be permitted the option of

paying their tax instalments on a quarterly basis applicable to either 'medium' or 'large' taxpayers.

Company Tax Rate

5.18 Direct comparisons of company tax rates with other countries is not a particularly useful exercise, as a range of other variables, both tax and non-tax, influence domestic and international investment considerations. The Committee notes, however, that the high effective tax rates on investments faced by Australian investors in Australia and most overseas countries, has been attributed to the emphasis on income and company tax in the Australian tax system.10

5.19 The Committee heard evidence to the effect that a progressive or. semi-progressive (that is: two tier) company tax rate regime operates in a number of other countries. In the UK, companies with profits of below £250,000 pay 25 per cent company tax while companies above this threshold pay 35 per cent company tax." in addition:

> It is quite common to have some lower figure for the first so many hundred thousand dollars of income - in part, as recognition of the costs of collection for small business.

5.20 The idea of progressive tax is well entrenched within the PAYE and provisional tax regime, yet it is absent from the company tax regime. The relatively high tax rate (compared to overseas), coupled with high compliance costs sustained by small businesses, suggest that some compensation could be extended to small businesses to counter these disadvantages.

5.21 The threshold which could apply in these circumstances depends upon the extent of the concession sought and which measures are used to determine the threshold. The proposed elevation of the company tax rate to 36 per cent announced in the recent Budget leaves the way open for the rate for small companies to be left at 33 per cent, or even lowered. An important consideration would therefore be the question of what constitutes a small company.

5.22 There are several ways in which a small business can be defined: by the number of employees; the annual turnover of the business; the amount of assessable income received; the amount of taxable income received; or the amount of tax paid. Using a threshold based on profits may be a dubious measure as a majority of companies do not pay tax. Some 60 per cent of companies are classified by ATO/Treasury as 'non-taxable'. Of the remaining 40 per cent, 95 per cent were private companies which paid less than half the company tax revenues paid by the remaining 5 per cent (public and 'other' companies).

5.23 Because of the potentially conflicting definitions, it is not at all clear what really constitutes a 'small' company. There may not necessarily be a correlation between tax collections and business incomes, or between business incomes and number of employees receiving salary or wages. Progressive company tax scales used overseas often base company tax thresholds upon taxable income. The drawback with this approach is that taxable income is not necessarily a measure of the size of a business, as the bulk of company business (assessable) income is usually reduced through deductions. Furthermore, during periods of economic downturn even the largest company can post a loss. A more realistic threshold would therefore be a composite based in the number of personnel employed by the company and taxable income.

5.24 The Committee considers that the establishment of a lower company tax rate for low income 'micro-businesses' (with fewer than 5 employees) could compensate those businesses for the higher compliance costs they sustain. It suggests that the Government review the compliance costs of small companies with a view to setting a company tax rate to apply to small companies which is consistent

with offsetting these compliance costs. The Committee reiterates its recognition of the relative burden of compliance costs to small business vis~a-vis larger businesses and urges the Government to take this into consideration when framing new legislation.

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.

PART 2

THE IMPACT ON SMALL BUSINESS

THE TIMING OF TAX PAYMENTS

"Any tax... is going to be an imposition on the cashflow of small businesses. The issue is how you make that most manageable."'

7.1 Evidence to the Committee in this inquiry has indicated that the payments upon the cashflow of small business can significantly affect both the initial and ongoing viability of many small businesses. The following comments by the Institute of Chartered Accountants in their submission to the Committee summarises popular sentiment on the issue:

> The issue of timing within the taxation legislation can represent a most crucial aspect of the implication of any legislation. Business operators, generally, earn their income and subsequently receive that income. This contrasts to employment salaries where the income is earned and received at the same time. Several taxes are raised on business operators at the time income is earned. These included include provisional tax, company tax, income tax, and sales tax. In these cases those business operators are required to fund those tax payments from other sources of cashflow. These issues impact greater on Small Business operators as they do not have the level of cashflow to self fund those payments, and alternate resources are more difficult to obtain.

7.2 While timing of payments is an issue which involves all taxes paid by business, provisional tax and associated uplift factor, wholesale sales tax and company tax attracted the greatest concern in evidence to the Committee. There were also minor concerns about timing of certain aspects of capital gains tax, the prescribed payments system, and about FBT.

Major Problems

Provisional Tax

7.3 Problems with timing with respect to provisional tax relate to the fact that tax payments are required to be made before some of the income is derived. The Committee has addressed this issue with recommendation 1.1, reproduced below:

Recommendation 1.1: The Committee recommends that where provisional tax is payable in quarterly instalments, the earliest due dates be 30 October, 30 January, 30 April of the year of income, and 30 July immediately following the year of income.

PAYG

7.4 Widespread dissatisfaction with the current provisional tax system has prompted the Government to propose alternative payment arrangements, the PAYG system, which has been proposed as a voluntary instalment system available, *as an option,* to unincorporated non-wage and salary earners.

7.5 Most, if not all, of the tax payable would need to be paid within the year of income, although the ATO canvasses the possibility that 90 per cent may be sufficient within the year of income, with the balance becoming payable by 30 November. Understating taxable income may result in a PAYG taxpayer being forced back into the provisional tax system. The PAYG system would place a premium on meticulous accounting and record keeping.

7.6 There is some concern at the seemingly narrow margin of error available for estimating the end of year instalment. The Committee's comments and recommendations need to be read in the context that the PAYG proposal is in the early stages of development and consultation, and that its fundamental viability in relation to ATO's administrative machinery is dependant upon a reasonably high take up rate from provisional taxpayers. Nevertheless, the Committee endorses the concept of PAYG conditional on some refinement outlined in Recommendation 1.2, below.

Recommendation 1.2:

The Committee endorses the concept of PAYG as an option and further recommends that:

(i) the proposed PAYG system be refined to enable maximum flexibility of voluntary payment arrangements to recognise the reality of the volatility of small business incomes and the difficulties encountered by small businesses in containing compliance and accounting costs; and to this end

(ii) the proposed PAYG system allow flexibility to small businesses in estimating their end of year instalment; and

(iii) small businesses be ensured of retaining any provisional tax credits upon electing to enter the PAYG system.

Provisional Tax Uplift Factor

7.7 The provisional tax uplift factor is currently set at 8 per cent, with the Government proposing that this level remain for 1995196. It is essentially a timing device, rather than an added impost, as it anticipates growth in incomes subject to provisional tax. Tax that is overpaid as a result of provisional incomes growing at less than the PTUF are refunded or credited against the following year's tax liability.

7.8 Historically, the uplift factor has not been a good predictor of income growth. This is probably because the very concept of anticipated average growth for all provisional income is essentially meaningless. The PTUF has been less effective than a predictor set at a constant rate. More importantly, however, it has resulted in considerable inequity because the changes in the annual rate of growth in incomes which have fluctuated considerably for all groups to which the factor has been applied have produced uneven results, advantaging some, and disadvantaging most of the rest. In addition the majority of provisional taxpayers do not experience growth in income at the level predicated by the uplift factor.

7.9 A provisional taxpayer, anticipating a reduction in income or even a lower than 'average' rise in income, can choose either to pay tax at a rate higher than appropriate to their income, or to lodge an

application to vary their provisional tax instalments based on their estimated income for the remainder of the year. The second option often has an associated accountancy cost and it may be difficult, or impossible, to make an accurate prediction about movements in taxable income. If taxable income is understated by more than 15 per cent, the taxpayer is automatically liable to a tax penalty with the onus on the taxpayer to prove their case, subjecting the taxpayer to further costs in time and money.

7.10 The majority of the Committee favours linking the uplift factor to the consumer price index.

> Recommendation 2.1:
>
> The Committee recommends that the provisional tax uplift factor be set at a level no higher than the current or projected annual movement in the Consumer Price Index.

7.11 The Committee also suggested that the Government also examine the following alternative, namely that:

(i) The Provisional tax uplift factor be abolished in its current form and replaced by individual provisional tax uplift factors which are calculated by using a five year average based on the movements in the taxable income of each provisional taxpayer for the previous five years, or less if the taxpayer has not been paying, provisional tax for that length of time;

(ii) such an uplift factor should be capped at a level to be determined by Parliament;

(iii) either:

- **(a) two applications to vary Provisional tax be allowed annually, or**

- **(b) applications to vary Provisional tax should allow a margin of error greater than the current 15 per cent (perhaps 25 per cent) to reflect the volatility of annual changes in the movements in the taxable incomes of the provisional taxpayers; and**

(iv) if, and only if, suggestions (i), (ii), and (iii) above are accepted, that provisional taxpayers be required to lodge variations if they reasonably expect that their taxable income will *increase* by an amount greater than the margin allowed as a result of recommendation (iii) above.

7.12 The Committee also favours changing the penalty for understatement of income which is subject to provisional tax.

> Recommendation 2.2:
>
> The Committee recommends that the only penalty for understating taxable income when lodging an application to vary provisional tax be a levy calculated by applying the highest commercial rate of interest to the unpaid tax resulting from understated income.

7.13 The timing of sales tax remittances was of particular concern to many small businesses. They maintained that the current monthly deadline for sales tax remittances adversely affected their operations because of the need to fund tax liabilities before receipt of the income from which these liabilities are derived. Businesses affected considered that the payment deadline should extend well beyond the 21 days after the end of the month in which the transaction occurred.

7.14 Important alternatives that were suggested were for sales tax to be remitted within 21 days after the end of the month in which payments are received**,** and for the access threshold for quarterly remittances to be lifted to $100,000 from $50,000. Changing the; date of remittance to 21 days after receipt of income is not considered to be feasible because of the implied shift from accruals based accounting and the concomitant scope for tax avoidance through deferring receipts of income. Increasing the access threshold is complicated by the fact that the total amount of sales tax remitted by a business is an uncertain way of determining the size of a business.

7.15 The Committee considers that further relief from financing tax liabilities in advance of cash receipts should be based on business size as defined by the ABS (see Introduction to this Report).

Recommendation 3.1:

The Committee recommends that, in addition to the current threshold which enables quarterly remittances, businesses defined as 'small' by the Australian Bureau of Statistics in ABS Catalogue No. 1321.0 (Small Business in Australia 1993) be permitted to remit sales tax either:

(i) on a quarterly basis; or
(ii) 45 days after the end of the month in which the transaction occurs.

7.16 The current small business exemptions are based on a threshold which is contingent upon the annual ongoing sales tax liability of a business remaining less than $l 0,000. The threshold should be indexed.

Recommendation 3.3:

The Committee recommends that the $10,000 sales tax threshold for the small business exemption be indexed annually.

Company Tax

7.17 The Committee has identified two problems with timing in relation to company tax. The first is a matter of notification to small businesses of changes made to taxation arrangements. The second is

matter of options open to small businesses as to whether payments are made on a quarterly basis or as a lump sum. These two problems have been addressed with recommendations:

Recommendation 5.1

The Committee recommends:

(i) that the Government investigate the adequacy of the notification of the new company tax arrangements, in particular, to those companies with company tax liabilities of between $8,000 and $20,000; and
(ii) that the Government ensure that taxpayers which are affected by changes in the legislation are properly notified well in advance.

Recommendation 5.2:

The Committee recommends that 'small' and 'medium' company taxpayers be permitted the option of paying their tax instalments on a quarterly basis applicable to either 'medium' or 'large' taxpayers.

Capital Gains Tax

7.18 Evidence suggests that capital gains tax limits the scope of small businesses 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 months. Such rollover relief is a timing issue which continues the deferral of tax liabilities upon capital gain and is recommended as a means of achieving capital and human mobility in the small business sector.

7.1 9 An extensive analysis of the issue by the Beddall Committee in 1990 remains relevant to the issues.

Recommendation 6.1:

The Committee recommends that capital gains tax 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.

7.21 if the CGT should be progressively phased out in relation to fixed assets which are held for more than 10 or 15 years, it would act as an incentive to hold assets for a long period rather than making speculative gains in the short term.

Recommendation 6.2 (I):

The Committee recommends that the Government examine the proposal to phase out the capital gains tax on fixed assets once they have been held for a certain period of time, say 25 years.

Prescribed Payments System

7.22 A problem arises when payment is not received until the year of income following completion of work and rendering of an account (for example, in the period June to July). The income is assessable on those earnings in the earlier year even though the PPS tax is not deducted until the later year because it is withheld at the time of payment. The person cannot, therefore, gain a credit for that tax.

7.23 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.

7.24 The suggested solution was to allow the credit in the year in which the income is assessable despite the fact that the tax will not be remitted until the following financial year. The ATO has the power to exercise a discretion to allow this.

Fringe Benefits Tax

7.25 Suggestions were made to the Committee that the FBT year be aligned with the financial year.

Other Matters

Wine Industry

7.26 Many winegrape growers are provisional taxpayers whose incomes from grape sales to wineries are received after delivery in three instalments straddling the financial year: 30 April, 30 June and 30 September. Small growers whose lump sum provisional tax (of $8,000 or less) is due by 31 March will not have received any payments for income which has been accrued and assessed, which may force payment through debt financing.

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7.27 The ATO has advised that it is willing to grant extensions of time in which to pay tax but, for reasons which are. not clear, will not permit growers to adopt a substituted accounting period to compensate for the seasonal nature of their industry. The Committee considers that either the proposed PAYG system or a substituted accounting period is the appropriate remedy and has accordingly recommended.

Recommendation 1.3:

The Committee recommends that winegrape growers industry look at taking advantage of the new PAYG system of payments if it is implemented. The Committee also recommends that in the event that PATG turns out to be unsatisfactory to the industry, the Government consider granting use of a substituted accounting period appropriate to the industry's financial and seasonal circumstances

Accruals vs Cash Basis of Accounting

7.28 Some of the discussion about the timing of tax payments on complications arising from accrual accounting which has evolved within the Australian and international financial systems Under the accruals system, income is accounted for when all the events which determine the right to receive have occurred. It is not the actual receipt of income but the right to receive income which determines when liability arises.

7.29 Mr Paul Greenwood, immediate Past Chairman of, COSBOA coined an expression which described the early payment feature of provisional taxation as 'pay as you send out your invoices', which to some extent describes an important functional element of the accruals system of accounting.

7.30 Trading income is generally derived when the right to receive it arises as a debt due and owing. Professional fees for individuals are subject to either the accrual method and the cash basis for accounting depending upon the profession involved. Salary and wages (including back pay and arrears) are derived when the money is received - they are assessable in the year of receipt.

7.31 The accruals system of accounting is a timing issue which needs to be carefully distinguished from the timing issues which arise from the requirement to pay tax liabilities before all the taxable income is actually received.

7.32 The Committee considers that while taxable income will generally be calculated in accordance with the accruals method, there is some scope to refine the payment schedules applicable to various tax liabilities, regardless of whether an enterprise is operating on a cash or accruals basis.

Cash Flow Management

7.33 The Australian Chamber of Commerce and Industry (ACCI) commented that there were two schools of thought within small business:

(a) those Who want regular, predictable timing, e.g.: quarterly; and
(b) those who prefer to pay when they have the capacity, in tune with their actual cash flow.

7.34 The ACCI expressed the opinion that the difficulties faced by many small businesses in meeting tax commitments were not so much related to the timing of lodgement dates, but relate to poor cash flow management and record keeping skills. Commenting that this raised issues of improved business planning and the capacity by the Tax Office to exercise flexibility in receiving payments, the ACCI complimented government support in promoting a computer based training package in record keeping skills for small enterprises. However, it expressed the belief that current industry support and training programs are still not adequately addressing fundamental skill deficiencies evident in meeting compliance requirements in regulatory areas like taxation.

7.35 The issues of record keeping and cash flow management are equally applicable to the whole range of taxes and imposts to which small businesses are subject. This is especially the case where a small business is subject to several taxes particularly those which are complex, such as the FBT, the WST and the CGT.

Carry Back of Losses and Carry Forward of Profits

7.36 The Committee received submissions from Mr Shann Turnbull of M.A.I. Services Pty Limited, and Mr Robert Lunney of Grant Thornton advocating what was referred to as either the carry back of losses or the carry forward of profits.

7.37 The current tax system in Australia allows losses to be carried forward to a subsequent year of income when the loss may be offset against a profit, thereby reducing the taxable income in that subsequent year. However, '...the business has suffered in the meantime.'

7.38 Mr Lunney suggested that an assessment received in a previous year, for example 1994, may be amended to allow a deduction for the loss incurred in 1995. While the current carry forward of losses:'...appears at first glance to be generous, the tax benefit of those losses is received when the business is profitable.' Mr Lunney makes the point that **the tax benefit is needed when the business is making losses** and the granting of a carried back deduction on a loss at the time the loss is incurred could make the difference to whether a business, and particularly a small business, survives.

7.39 Mr Turnbull made similar points, and added that in the US the practice was described as the carry forward of profits and provides several advantages (in addition to the arguments put forward by Mr Lunney):

- it creates an incentive for business to pay tax as it makes the government a business partner who will provide cash in times of need;
- it would allow more srnal11 businesses to survive resulting in an increase of the nations tax base and so avoid loss of revenue, loss of employment and other social costs of allowing businesses to fail when there may be no long term reason for such failure;
- it would allow small business to even out liquidity requirements over the business cycle as is possible to some degree in rural activities;
- it would make Australia internationally competitive with other countries which allow carry forward of profits as well as losses; and
- it would justify the use in Australia of accounting practice, used in the USA, which recognises the tax value of losses as an asset.

7.40 Mr Turnbull added that:

> The carry forward of profits is of special value to small businesses who do not have access to capital markets to make up for loss of liquidity when losses are incurred. In addition, banks are unlikely to provide carry-on cash to small business when losses are incurred and liquidity is most desperately required."'

7.41 Carry back of losses has been adopted in various forms in some OECD countries, including the USA, which allows a three year carry back, and the UK, which allows a one year carry back. The schemes vary according to the extent of carry back allowed, or according to the proportion of carryback allowed. Carry back proposals have been the subject of previous inquiries, including those conducted by the Ligertwood Committee in 1961 and the Asprey Committee in 1975.

7.42 The Ligertwood Committee rejected the proposal on the grounds of:

(a) the possible dislocation to revenue in a depressed period;

(b) the lack of finality in assessments (probably the most important); and

(c) the complications inherent in amending the assessments of certain classes of taxpayers, for example, trusts and private companies.

7.43 in 1975, the Asprey Committee recommended that carry-back of losses for all taxpayers (except trust estates) be allowed for two years. The Asprey Committee commented that the '..,difficulties foreseen by the earlier committees do not appear to be sufficiently formidable to justify the continued absence of any loss carry-back':

(a) carry-back of losses will involve some dislocation to revenue, but this will be minor having regard to the total revenue now flowing from taxation;
(b) the degree of the lack of finality in assessment depends largely on the period for which losses may be carried back. A short carry-back period should not cause undue administrative difficulty', and
(c) carry-back of losses should not be allowed to trust estates.

7.44 Mr Turnbull suggests that the reasons given in 1961 for rejecting carry-back are even less relevant today than in 1975. In this regard, it is clear that the revenue base has expanded considerably and that the ATO's modern computerised administrative systems should be more than capable of dealing with the complexities of retrospective assessments.

7.45 Although there are some very limited carryback opportunities available in the current legislation, the Committee considers that, at the very least, carry-back of losses should be allowed to businesses which meet the ABS definition of 'small'.

Recommended 7.1:

The Committee recommends that the Government investigate the efficacy of implementing carry-back of losses for a limited period.

Statutory Warranties and Accrued Leave

7.46 Submissions were made to the Committee that income tax is frequently assessed on a level of taxable income which is significantly higher than the real business profit.

7.47 Horwarth and Horwarth, chartered accountants, put a submission to the Committee through the MTAA that statutory warranties on goods such as motor vehicles sold in a particular year of income, but for which warranty costs will not be met until a subsequent income year. Asserting that the future warranty costs are easily calculated based on the history of costs incurred in the past, they maintain that the deduction for future warranty costs at the time of sale is justifiable as the total revenue from the sale is taxed at the time of the sale. 'It would be a proper matching of the expense with income.

7.48 A similar situation arises in relation to accrued long service leave and recreation leave. Like some warranties, they are statutory requirements. The liabilities crystallise at the time leave fails due, regardless of whether an employee uses the leave within the year that it accrues. Horwarth & Horwarth maintain that the tax deduction should arise at the time the liability fails due, and not when it is paid.

7.49 White and Lewis Consulting Pty Limited put a similar case with some vigour. The company, originally employing sixteen workers, was created by a management buy-out funded by loans raised against the personal assets of its four directors. After several years, the firm had increased its work force and reported its first profit of $180,000, which was shared with its staff and shareholders as bonuses and dividends. The tax liability on the taxable income turned out to be $125,000, not $60,000 as originally anticipated.

7.50 The problem arose when the company set aside the amount required to fund liabilities arising from accrued long service leave and recreation leave which had not yet been taken, as well as '...a number of other critical events that sensible accounting standards require prudent business men to anticipate before declaring a "profit" to the essential stakeholders in the business. The amount set aside had been assessed as taxable income.

7.51 Under the ITAA, deductions cannot be claimed for funds which have been set aside for such liabilities until the costs have actually been incurred, which 'in this circumstance is considered to occur when the employees have been paid for taking leave. The situation is similar for bad debts:

> Many companies make provision for bad debts in their accounts but that specify conditions that there are specific provisions in the law must be met before a deduction **is** allowed for bad debts. 16

7,52 The Treasury elaborated on this issue, advising that although provision for liability had been made in a particular year, there was no guarantee that payment would have to be made:

> That is the distinction between setting aside amounts and actually incurring an expense. They may set aside an amount of money for a particular person who does not stay there for the 15 years, in which case they have never actually had to incur that expense.

7.53 Notwithstanding that the deductions will eventually be allowed once an employee takes leave, the current arrangements clearly create cash flow problems for small businesses which cannot easily 'be absorbed. In addition to the timing issue, accounting complications arise:

> In terms of some of the accounting Policies... the liability arises immediately [and] has to be placed in the balance sheet and to that extent provision made for it. Therefore it is a properly incurred expense at that point... our association was advised by our accountants last year that ' although it is not a taxpayer, it had to start cash funding long-service leave and annual leave provisions. My members were astonished to find that 1 had to charge them this large amount of money which then had to be put aside separately and we incurred both a liability and an asset on the balance sheet in order to do it ....

7.54 The Committee observes that the prohibition against deductions being made, or more specifically against being exempt from consideration as assessable income, before the liability is discharged does not distinguish between voluntary provisions for events such as bad debts, and for provision made for statutory liabilities such as warranties and long service leave. To this extent, the Committee draws attention to an analogous and equally unsatisfactory situation in relation to the FBT which can impose a tax liability upon an employer for the provision of a statutory award which cannot be cashed out.

7.55 Although making provision for long service leave, recreation leave and the like arises in response to statutory obligations, and is clearly a responsible business and accounting practice, it appears from ATO/Treasury's evidence that it is not tax deductible because '...there is no guarantee that [the employer] will have to pay it.'

7.56 Cash flow restrictions which characterise much of small business existence need to be recognised and a distinction needs to be drawn between provisions which are made for liabilities arising from statutory requirements, but which may not be discharged in the year in which the provision is made, and provisions which are set aside because of other requirements. The Committee agrees with the ATO and Treasury that such a provision should not be a deduction until the expense is actually incurred, but considers that it should be exempt from assessment until that time.

7.57 The Committee considers that a facility should be established to enable provisions set aside to meet statutory liabilities to be quarantined from access by the employer, for example in a rollover fund or equivalent, until an event triggers its payment to the eligible recipient. Once the provision for that liability is safely 'parked', it should then be exempt from assessment. Such a facility would be supported by anti-avoidance provisions which limit the rolled-over amount to the extent of the accrued liability.

Recommendation 7.2:

The Committee recommends that the Government investigate the possibility of allowing the providing of money for statutory liabilities (such as long service leave) to be placed in approved deposit schemes, or equivalents. Money deposited in such a scheme should not be treated as assessable income until such time as it is withdraw from the scheme.

Income Averaging and income Equalisation Deposit Scheme

7.58 Income averaging allows unincorporated primary producers and certain classes of 'eligible persons', such as artists, composers, inventors, performers, production associates, sportspersons and writers, who have fluctuating incomes, to apply an averaging calculation which ensures that they do not pay greater tax over a number of years than those on comparable but steady incomes.

7.59 In 1990, the Beddall Committee expressed the belief that there were clearly disadvantages in extending income averaging provisions on the current basis of selecting specific business or professional categories, because individual businesses within these categories may take advantage of a benefit regardless of whether they actually experience large fluctuations in income. Consequently, the Beddall Committee recommended that these provisions be extended on an individual basis to other small businesses which can demonstrate large income fluctuations across income years.

7.60 The Committee endorses an opinion expressed by the Beddall Committee that the Income Equalisation Deposit scheme has considerable merit not only for primary producers but for any small business which experiences income fluctuations and would benefit from an incentive to put aside funds in 'good'years for use in 'bad years'.

7.61 The Government's reasons for not implementing the Beddall Committee's recommendation to small businesses which experience large income fluctuations across income years were contradictory:

- it acknowledged the Beddall Committee's reasoning that the current system should not be available to categories of business but should be limited to individuals or businesses which actually demonstrate wide fluctuations in income from year to year;

- it reiterated that income averaging is currently granted only to those categories of taxpayers whose income typically fluctuate markedly from year to year; and yet

- it commented that to extend income averaging to small business generally would raise problems with regard to the equitable tax treatment of other tax payers.

7.62 The Beddall Committee recommendations appeared to this Committee to be attempting to establish equity in regard to the income averaging provisions which were structurally deficient in this respect because of their inclusion of categories of taxpayers, regardless of whether each individual met the typical criteria. The rationale for income averaging is clearly and specifically designed to assist taxpayers who regularly experience widely fluctuating incomes. The Governments rejection of recommendations aimed specifically at achieving and refining its own objective is difficult to understand.

Recommendation 7.3:

The Committee recommends that the Government the Beddall Committee's recommendation to introduce an income averaging facility and an income equalisation deposit scheme of the type currently enjoyed by primary producers, to assist (on an individual basis) other small businesses which experience large income fluctuations across income years.

Training and Establishment Costs

7.63 The Beddall Committee had recommended that small business establishment costs should be allowable as deductions against income subsequently derived from a small business and that this entitlement be restricted to 'trading' businesses as defined in paragraph 5.139 (Recommendation 34) of its report. That Committee had acknowledged that establishment costs relating to a small business which are incurred prior to its establishment are viewed as capital rather than recurrent costs and are not therefore allowable deductions against income subsequently derived by that small business. The tax system also did not encourage people to undertake appropriate training to maximise the prospects of the success of a new small business. Nevertheless, it argued that allowing these costs as deductions would encourage rather than discourage potential new small business entrants.

7.64 The Government's response was to reject the recommendation on the grounds that its implementation would represent a significant policy shift because business establishment costs are considered to be capital in nature which are not deductible under current tax law. The Government also argued that it would lead to pressure from larger businesses for comparable deductions and create a precedent for other capital costs to be deducted.

7.65 The Committee appreciates the Government's difficulty in implementing such a measure. Notwithstanding these reasons, business establishment costs should be tax deductible to bring them into line with the same tax treatment as those incurred after a business has commenced operation. The Committee agrees with the submission by the MTAA that it is only the timing of the expenses which render them capital in nature.

7.66 The Committee therefore reiterates the Beddall Committee's recommendation.

Recommendation 7.4:

The Committee recommends that the Government implement recommendation 41 of the report by the Beddall committee that small business establishment costs be allowable as deduction from income subsequently derived from a small business.

Imputation Credits

Bates and Pickering, Chartered Accountants, submitted that the loss of unused imputation credits is inconsistent and inequitable as it is the equivalent of a policy of no refunds for excess tax paid by certain classes of income earners. This affects lower income earners who receive a high level of income in fully franked dividends.

The Committee suggests that the ATO review and, if necessary, move to enable amendment of the provision which purportedly results in loss of unused imputation credits.

CHAPTER8

THE BURDEN OF TAX

Changes in Taxation Rates

Wholesale Sales Tax

8.1 The 1993 budget resulted in one per cent increases in the sales tax rates applicable to items affected by Schedules 2, 3, 4, and 5 of the *(Exemptions and Classifications) Act 1993.* Schedules 1 *Sales Tax* (exempt goods) and Schedule 6 (luxury motor vehicles, taxed at 45 per cent) remained unchanged. Schedule 7, relating to alcoholic wine and cider, commenced on 1 November 1993 at 22 percent, increased to 24 per cent on 1 July 1994, and will again increase on 1 July 1995 to 26 per cent.

8.2 The majority of submissions which raised sales tax as an issue were primarily concerned about the timing of payments. However, the wine industry was concerned about the level of sales tax imposed on wine. In October 1993, the Government announced that a Committee would be formed to inquire into the winegrape and wine industry. That Committee of Inquiry published a draft report in March of this year and proposed that the form of the tax on wine should be changed through the imposition of a composite tax consisting of a sales tax component and a volumetric tax levied on the alcohol content. The majority of the Committee proposed that the average level of the composite tax be maintained at the 26 per cent of sales tax to come into effect on 1 July 1 995. The minority report considered that the composite tax should be 50 per cent, with a five year transition to reduce transition costs.

8.3 In addition to the submission received from the wine industry, the Committee heard evidence in Adelaide on 20 April 1995. The major points of contention remain the proposed imposition of a volumetric tax, the existing trading stock valuation arrangements involving long term wine stocks, and the FBT.

8.4 The Committee does not consider that it is in a position to fully evaluate the issues involved and therefore has not attempted to influence the outcome of the inquiry by making recommendations concerning the substantive tax issues. Nevertheless, the Committee considers that a successful outcome to the Inquiry into the Winegrape and Wine Industry will not be achieved until the major protagonists find common ground and unless the attitude of the industry towards the measures which may be implemented as a result of the recommendations of the Committee of Inquiry are taken into account.

8.5 A number of submitters were unhappy with the requirement that sales tax payers act as unpaid tax collectors. The Beddall Committee had considered this to be a legitimate complaint by small business and had recommended that compensation in some form be provided to small businesses, possibly by providing a tax credit based on an agreed reasonable compliance time spent dealing with sales tax paperwork.

8.6 The Committee recognises these factors, the fact that the burden of sales tax collection is not readily absorbed within the economies of scale available to large businesses. and considers that it would be appropriate for the Government to address this issue at some future stage.

Excise

8.7 No major concerns were expressed to the Committee about the increase in excise since the 1993 budget. However, the *Customs and Excise Legislation Amendment Bill* 1995, which proposed to exclude certain categories of

taxpayers from diesel fuel rebates attracted considerable adverse comment. It was referred to the Senate Economics Legislation Committee which conducted a public hearing on 23 June 1995. A report was tabled in the Senate on 26 June 1995 dealing with the matter.

Company Tax

8.8 Australia levies a relatively high company tax rate which, coupled with high compliance costs associated with the range of taxes affecting small businesses, provides grounds for a concession to small business. There is a problem of establishing a suitable threshold for such a concession as it is difficult to establish from available statistics any reliable correlation between tax collections, business incomes, and number of employees receiving salary and wages.

8.9 Overseas countries, such as the UK, which use a two tiered company tax system, rely on levels of taxable income to establish an access threshold to the lower tax rate. However, this is not necessarily a reliable indicator of business size because the bulk of company business income is reduced through deductions. Furthermore, even very large businesses can experience a downturn which temporarily reduces their level of taxable income. The Committee considers that this issue should eventually be addressed and if implemented, an appropriate composite threshold be adopted which takes into account both profits and number of personnel within the company.

Compliance Costs

Wholesale Sales Tax

8.10 The current application of the *Sales Tax (Exemptions and Classifications) Act 1993* contains complexities and ambiguities in relation to the classification of many goods, and categories of goods, particularly new products emerging in the market. it is clear that the Act needs clarification, as do the associated processes which determine the classification of new products.

Recommendation 3.2:

The Committee recommends that the Government conduct a comprehensive review of the sales tax exemptions and classifications system with a view to:

(i) removing the ambigu8ities and complexities within and between the sales tax classification schedules; and
(ii) establishing a simple, effective process whereby the classification of new products can be quickly and simply achieved, thereby lessening reliance on the general rate of sales tax as a default rate.

Fringe Benefits Tax

8.11 The complexity of FBT, and its associated cost of compliance, leads the Committee to consider that a small business which has a very low FBT liability, and whose contribution to revenue is less than the cost of calculating the amount payable (about $200), be exempt from FBT.

Recommendation 4.1:

The Committee recommends that small business be exempt from annual FBT liabilities of $200 or less.

8.12 The fringe benefits tax (FBT) was introduced to tax non-cash remuneration which were not previously taxed. Although these fringe benefit are items of remuneration received by the employee, they are not taxed as employee benefits at relevant marginal rates, but as employer benefits at the top marginal rate.

8.13 The Committee is concerned that the fringe benefits tax base, which was originally designed to trap 'lurks and perks', has expanded to include statutory and other compulsory benefits. The employer has no choice but to offer these benefits and does not have the option to cash them out into wages or salary. These should not be subject to FBT but should be treated as part of an employee's income and levied at the employee's marginal rate.

Recommendation 4.2:

The Committee recommends that statutory and compulsory award obligations from which an employer is prohibited from cashing out into salary or wages be exempt from FBT.

8.14 The Committee does not believe that car parking should be subject to the FBT as they are often required by local government, cannot in any case be cashed out as they represent structural assets of a company, and do not readily lend themselves to private use by employees.

Recommendation 4.3:

The Committee recommends that car parking be exempt from the FBT.

8.15 The Committee does not consider that industry based child care should be discouraged or burdened with FBT. particularly if small businesses are offering the benefit.

Recommendation 4.4:

The Committee recommends that child care be exempt from the FBT where a number of small businesses combine to provide child care exclusively for the children of the personnel employed by those businesses

Notification of Changes

8.16 The Committee was concerned that changes to the company tax payment arrangements which took effect from 1 June 1995 may be adversely affecting company taxpayers with tax liabilities in the $8,000 to $20,000 range. These taxpayers, which number over 20,000, were previously able to exercise the option of paying their liability in a single lump sum instalment in December. The new arrangements require quarterly instalments commencing from 1 June 1995. Evidence indicates the possibility that some of these companies may be suffering cash flow disruptions because the first instalment was brought forward without adequate notification.

Recommendation 5.1:

The Committee recommends:

(i)	that the Government investigate the adequacy of the notification of the new company tax arrangements, in particular, to those companies with company tax liabilities of between $8,000 and $20,000;
(ii)	that the Government ensure that taxpayers which are affected by changes in the legislation are properly notified well in advance.

Double Taxation

8.17 The Committee suggests that subsection 47(1A) of the ITAA, which may result in small companies being subject to double taxation on the disposal of an asset and subsequent liquidation, be amended.

> Recommendation 6.2(ii):
>
> The Committee recommends that section 47(1A) of the ITAA which ignores nominal capital losses and depreciation when calculating capital gain to be added to income, be reviewed and amended, if necessary.

Small Business Statistics

8.19 COSBOA submitted that there is very little information in circulation to support any policy discussions which may occur concerning the treatment of firms on the basis of size, pointing out that analysis is based mainly on other criteria.' Contending that the relative absence of size related data is a major impediment to public debate, COSBOA recommended that the ATO be required to assist small business policy debate by publishing aggregated tax data, arrayed by business size.

8.20 ATO and Treasury officials advised the Committee that there are no real impediments to publishing the kind of size related information sought by COSBOA. Discussions had been held between the ATO and COSBOA to ascertain what sort of information they were seeking to enable the ATO to determine what work would need to be done to their administrative systems to accommodate COSBOA's request.

8.21 An associated problem appears to be the question of thresholds which are designed to take business size into account. There appears to be inconsistencies in the various thresholds that have been adopted in relation to the various taxes. When questioned about these anomalies, the ATO acknowledged the issue, giving as an example the different thresholds applicable to FBT return lodgement and quarterly payments compared to the arrangements that apply to company tax.

8.22 COSBOA argued in their submission that the inconsistency in business thresholds '... spring from a practice in government of thinking from the top down', and that when a new policy is implemented, it is done so '... with too little appreciation of its full impact on small firms. 'Unintended consequences' then emerge and a "threshold" is applied later to isolate the problem... which invariably relate to *on costs* which develop for small firms through excessive "paper burden".

8.23 Variations upon this theme er-nerged consistently throughout the evidence. For example, Howard Pender suggested in his submissions to the Committee that one of the greatest problems faced by small business dealing with

regulation and tax is a "big business paradigm" held by those drafting legislation. He gave the examples of FBT exemptions on child care being available only to businesses large enough to operate the child care centre itself, the proposed changes to the tax treatment of employee share ownership plans (ES0Ps), quarantining of use of losses compounded by various tests such as 'continuity of ownership' and 'same business', and the distinction between portfolio and direct investment in the treatment of foreign source income.

8.24 The Committee considers that small businesses should be explicitly taken into account when contemplating changes in the tax legislation. To this end it endorses the need for statistics which relate directly to various measures of size, and for the need to assess the impact of proposed changes. Changes to the tax legislation need to account not only for the impact on taxpayers generally, but also for the differences between key groups. The economies of scale which are available to large businesses which enable them to deal with compliance costs associated with ever increasing complexity of tax law, cannot be assumed to be available to small businesses. To the contrary, the unavailability of economies of scale need to be directly addressed whenever changes are contemplated.

Recommendation 8.1:

The Committee recommends that:

(i) the ATO compile and publish aggregated tax data, arrayed by business size; and
(ii) changes to tax law preceded by the preparation of small business impact statements prepared after consultation with small business and its representatives through existing fora.

Conclusion - The Burden of Tax

8.25 Small businesses face a plethora of tax regulations. Both the combination of many taxes to comply with and the sheer complexity of each tax, frequently results in an overbearing burden of responsibility on small businesses.

8.26 The complexity of tax laws means that many small businesses must either spend an enormous amount of time, in addition to that spent running the business, understanding their obligations under the Tax Act and calculating liability, or pay an accountant to take most of the responsibility for that task. Paying an accountant of course means an additional cost to the business.

8.27 Small business owners are generally concerned about miscalculating their tax obligations, or their accountants miscalculating. If calculations of tax liability are not correct, businesses may suffer. If an error favours a business, a penalty may be imposed by the ATO. If the error favours the ATO, the business loses the use of that money for the period until the error is corrected.

8.28 Taxes are not static. Changes are perpetually made to tax laws in order to accommodate the ever changing business environment, or because of changes to the revenue requirements of government. This means that small business owners must be constantly aware of changes relevant to their businesses to enable them to understand their tax obligations.

8.29 Many small businesses are run by sole traders, families or small partnerships. The effort put in to understanding the tax laws and in to calculating tax liability is considerable. In other words, the economies of scale that benefit a large business, or a group of business operated by the same group or company, cannot be applied to a small business.

8.30 However, the same rates of taxation, and the same compliance costs apply to both small and large businesses. The Committee believes that small businesses are at a considerable disadvantage compared to large businesses with

respect to tax compliance. Given that Australia is characterised by a very high proportion of small businesses, the relative disadvantage to them may be a significant factor inhibiting economic growth. The Committee concludes that it would be worthwhile for governments to consider the conditions faced by small businesses when changes to the taxation law are proposed.

Senator A B Ferguson

Chairman,

PART 3

MINORITY REPORT

MINORITY REPORT - GOVERNMENT MEMBERS

The Government Members of the Committee do not support all of the recommendations set out in the majority report. After careful consideration of the issues raised in submissions to the inquiry and at public hearings, we share the concerns about the cost and complexity of small business compliance with tax laws. However we do not believe that some of the recommendations proposed in the majority report are the most appropriate ways to address those concerns.

Accordingly, the Government Members dissent from the following recommendations:1.1, 2.1, 2.2, 3.3, 4.1, 4.2, 4.3, 6.1, 6.2, 7,1 and 7.3.

We fully support the aim of simplifying the tax administration of small business. However we believe that measures introduced by the release of the Beddall Report have already Government following d tax Procedures. We believe that the significantly streamline report that we have agreed with, recommendations in the majority already been made, will combined with the changes that have significantly improve small business tax management.

Senator B K Childs Senator C Evans Senator S. Murphy

APPENDIX 1

LIST OF SUBMISSIONS RECEIVED FROM ORGANISATIONS AND INDIVIDUALS

No.	Submission	State
1	SBP State Council Inc., Sydney	NSW
2	Australian Earthmovers & Road Contractors Federation, Hawthorn	VIC
3	Mr Herman A.C. Odijk, Mount Morgan	QLD
4	Assoc. Prof. I.G. Walischutzky and Mr Brian Gibson, Newcastle	NSW
5	Brotherhood of Man of Nebadon, Runaway Bay	QLD
6	Richardsons Financial Services, Bowen	QLD
7	Bates & Pickering, Forrest	ACT
8	Loftus & Associates Pty. Limited, Summer Hill	NSW
9	The Printing and Allied Trades Employers' Federation of Australia, St. Leonards	NSW
10	Mr Daryl Guppy, Outstation Self Management Consultancy, Katherine	NT
11	J.B. Murray & Associates, Campsie	NSW
12	Progress Library Supplies, Currajong	QLD
13	Vince Filocamo & Associates, Burwood	VIC
14	M.A.I. Services Pty. Limited, Woollahra	NSW
15	Pureharvest (Ceres Natural Foods Pty. Ltd.) East Bentleigh	VIC
16	Mr Russell H. Jones, Eden Hills	SA
17	Fehons, Burwood	VIC
18	Lo Surdo Braithwaite & Company, Drummoyne	NSW
19	Grant Thornton, Brisbane	QLD
20	R.G.C. Fletcher and Associates, Smithfield	NSW
21	0'Neill & O'Brien Pty. Limited, Bexley North	NSW

22	KPMG Peat Marwick, Brisbane	QLD
23	Wong & Fong Chatswood Pty. Limited, Chatswood	NSW
24	Queensland Chamber of Commerce and Industry Brisbane	QLD
25	Economic Development Authority, Government of South Australia	SA
26	Burwood Discussion Group, Five Dock	NSW
27	National Tax & Accountants'Association Ltd, Melbourne	VIC
28	Australian Small Business Association Limited, Kent Town	SA
29	Winegrape Growers' Councif of Australia Inc., Magill	SA
30	Winemakers' Federation of Australia Inc., Magill	SA
31	Australian Tax OfficefTreasury, Canberra	ACT
32	Australian Society of CPAS, Sydney	NSW
33	Small Business Development Corporation, Perth	WA
34	Department of Industry, Science & Technology, Canberra	ACT
35	Mr Gregory T. Smith, Wentworthville	NSW
36	Parramatta Practising Accountants Discussion Group/S.T. Velia & Associates, Parramatta	NSW
37	Masselos Graham Masselos Pty. Ltd, Sydney	NSW
38	Retailers Council of Australia Ltd, Melbourne	VIC
39	Taxation Institute of Australia, Sydney	NSW
40	Motor Trades Association of Australia, Barton	ACT
41	PGA Technology (Aust) Pty. Ltd, Chatswood	NSW
42	The Taxpayers'Association of New South Wales, Sydney	NSW
43	Mindo Australia Pty. Ltd, Kingsgrove	NSW
44	T J Smith & Co, Walkerville SA	

45	Australian Chamber of Commerce and Industry, Barton	ACT
46	The Hon Vin Heffernan OAM MP, Minister for Small Business, Melbourne	VIC
47	Dobrigh & Winterbottom, Lilydale	VIC
48	Anthony Lee & Co, Sydney	NSW
49	Mr Gerry Schembri CPA, Knoxfield	VIC
50	Council of Small Business Organisations of Australia Ltd., Parkes	ACT
51	Victoria Hotel Restaurant, Ouyen	VIC
52	Fatozan Proprietary Limited, Winston Hills	NSW
53	P. & G. Modde, Valley View Nursery, Arcadia	NSW
54	Australian Gift & Homewares Association, Crows Nest	NSW
55	Small Business Combined Association of NSW	NSW
56	Mr Robert H. Lambert, Armadale	WA
57	Tooleybuc Sporting Club Limited, Tooleybuc	NSW
58	Mr Howard Pender, Visiting Fellow, Centre for International and Public Law, ANU, Canberra	ACT
59	Furnishing Industry Association of Australia, Parkes	ACT
60	Byfields, Certified Practising Accountants, Perth	WA
61	South Australian Employers' Chamber of Commerce and Industry, Adelaide	SA
62	Bowrnan, Manser & Associates, Adelaide	SA
63	Inbound Tourism Org. of Aust. Ltd, Kings Cross	NSW
64	The Institute of Chartered Accountants in Australia	NSW
65	Royce Burkett & Associates	NSW
66	Tucker, Glynn & Co, Chartered Accountants, B'vale	NSW
67	Australian Employee Ownership Association, Sydney	NSW
68	White & Lewis Consulting	NSW
69	Confidential	

LIST OF WITNESSES

24 March 1995 - Canberra

Council of Small Business Organisations of Australia

Mr Robert Bastian	Chief Executive Officer
Mr Paul Green Wood	Immediate Past Chairman

Furniture Industry Association of Australia (Vic/Tas)

Mr Matthew Hughes-Gage	Vice-President

Motor Trades Association of Australia

Mr Michael Delaney	Executive Director
Mr Geoffrey Gardner	Deputy Executive Director

Mr Howard Pender	Visiting Fellow, Centre for International & Public Law, ANU

19 April 1995 -Brisbane

Oueensland Chamber of Commerce & Industry

Mr Laurence Murray	Business Liaison Officer
Mr Peter Ranson	Small Business Officer

Grant Thornton. Chartered Accountants

Mr Robert Lunney	National Tax Director
Mr Herman Odiik	Consultant

Progress Library Supplies Pty Ltd

Ms Patricia Rocke	Director

20 April 1995 - Adelaide

Sth. Aust. Employers Chamber of Commerce & Industry

Mr Michael Browne	Member of Business Council
Mr lan Harrison	General Manager, Finance, Administration & Policy

Bowman Manser & Associates

Mr Brian Harmer	Director

Economic Development Authority

Mr Peter Lockett	General Manager, Business Policy
Mr Nigel Trewartha	Project Officer, Business Policy

Austrailan Small Business Association

Mr David Macklin	Treasurer

Winegrape Growers' Council of Australla,

Mr Chris Pritchard	Chief Executive Officer

Winemakers Federation_of Australia

Mr Paul Van Der Lee	General Manager

26 April 1996 - Sydney

Printing and Allied Trades Employers Federation of Australia

Mr Phillip Anderson	National Director
Mr John Fisher	State President/Nat. Vice-President
Mr Jordan Reizes	Services Manager

Taxation Institute of Austrlia

Ms Annamaria Carey	Technical Director

Business Combined Associations of New South Wales

My Geoffrey Hughes	President
Mr Paul Greenwood	Past President
Mr Donald Lemsing	Treasurer
Mr Scott Arnold	Representative

Burwood Discussion Group

Mr Brian Loftus	Treasurer (CPA)
Mr James Poilifrone	Program Officer (CPA)
Mr Bruce Askew	Member (CPA)

BDO Nelson Parkhill (Chartered Accountants)

Mr Wayne Heathcote	National Director

Taxation Centre of Excellence, Australian Society of Certified Practising Accountants

Mr Chris Knoblanche	Chairman

Australian Society of Certified Practising Accountants

Mr Terry Rooney	Director, Taxation

MAI Services Pty Ltd

Mr Shann Turnbull	Principal

Australian Employee Ownership Association

Mr Shann Turnbull	President
Professor Ian Walischutsky	Assoc. Professor, Taxation University of Newcastle

12 May 1995 - Melbourne

Furnishing Industry Association of Australia

Mr Peter Wilson	Managing Director
Mr Robert Bastian	Director, Governrnent Liaison
Mr Rex Carr	Vice-Chairman
Mr Matthew Hughes-Gage	Vice-President
Mr James Radda	Councillor

ACIL Economics and Policy Pty Ltd,

Mr George Brownbill	Senior Consultant

Retailers Council of Australia

Mr Laurie Eakin	Executive Director

Pure Harvest, Ceres Natural Foods Pty Ltd

Mr Donald Lazzaro	Managing Director

National Tax and Accountants Association Ltd

Mr Ray Regan	National President

Corporate Dynamics Pty ltd

Ms Christine Rowe	Director
Mr Michael Taplin	Director

29 May 1995 - Canberra

Department of the Treasurery

Mr Keiran Davies	Officer, Forecasting Section Economic Conditions Branch
Mr John Eyers	Assistant Secretary Business Taxation Branch
Mr Ron Foster	Executive Officer
Ms Deidre Gerathy	Assistant Secretary Personal Taxation Branch
Dr Barry Gray	Senior Advisor, Economic Conditions Branch

Australian Taxation Office

Mr Richard Highfield	Second Commissioner
Mr Geoffrey Miller	Executive Officer, Legislative Services
Mr Vincent Mitchell	National Program Manager, Small Business Income
Mr Matthew Ryan	Assistant Secretary, Indirect Taxation & Taxation Review Branch

APPENDIX Ill

TAX OFFICE DISCUSSION PAPER ON PAYG

Background

The purpose of this paper is to attempt to address the many requests being made of the ATO from representatives of small business organisations for alternative payment arrangements to provisional tax.

The proposed alternative arrangement outlined in this paper is presented for discussion and debate at this stage, on the understanding that any changes to the existing methods of collecting taxes will require the support of Government before they can be implemented. The ATO is now seeking input from interested parties on this proposal, in order to determine if it meets the requirements of non-salary and wage taxpayers, excluding companies, and the ATO as the collector of revenue.

The Proposal

The option under consideration as an alternative to the current Provisional tax payment system is a voluntary, Pay-as-you-go (PAYG) instalment system for all non-salary and wage individuals.

The broad outline of the method Proposed under PAYG is:

(1) Taxpayers who wish to use the PAYG system will need to make an election to this effect. (No election will be required if the taxpayer wishes to adopt or stay with the existing provisional tax system)

And, upon electing to use the PAYG system, the following apply:.

(2) Taxpayers will make self-assessed payments on a 'regular' basis

(3) All tax payable within a year is to be paid in that year with some allowance for adjustments.

(4) No interest will be paid by A TO on credits held on behalf of the taxpayer.

(5) No monies will be refunded by h, A TO until assessment.

(6) Credits held on file will be allocated by the A TO upon assessment.

How Will the Proposal Work?

(1) Taxpayers who wish to use the PAYG system will need to make an election to this effect.

Under this proposal, taxpayers will have a choice of payment system, either the existing provisional tax system or PAYG instalment system. (See later for discussion on switching between the two systems)

PAYG
PAYG will be an optional payment system, and taxpayers will need to make an election if they wish to use this, instead of provisional tax, as a method of paying tax.

The reason for making an election is to enable the Government and the ATO to determine likely revenue streams, and to facilitate monitoring. It is also to enable taxpayers to make some provision to meet the payment pattern chosen. (See later for discussion *on payment patterns).*

Upon choosing the PAYG method, the ATO will issue a payment booklet to the taxpayer. This will only be issued on demand and will probably contain the taxpayer's Tax File Number (TFN), personal details, and the year to which the payment is to apply. The ATO will hold the credits on the taxpayer's behalf until assessment of the relevant year's income, at which point it will be allocated to offset the debits raised.

(2) Taxpayers will make self-assessed payments on a 'regular' basis.

The regularity of the payments may be chosen by the taxpayer, but it will have to be suitable to the ATO as well as the taxpayer.

Payment Patterns
The payment pattern should be tailored to suit the taxpayer's income stream.
For example:

* for regular monthly income, the taxpayer could be expected to pay monthly;
* while for less regular income it could be expected to be quarterly; and
* in circumstances where a taxpayer receives income twice a year (as is the case for some interest income), tax would be payable twice a year.

The payments made must be calculated on actual tax payable in the period. If a taxpayer had chosen to pay quarterly, and for one quarter had no income, then no tax would be payable in that quarter. Should a taxpayer have irregular income with, for example, 80% received in the latter (or early) part of the of the financial year, then that payer would pay 80% in the latter (or early) part year. (see later for Compliance).

Should a taxpayer find that his/her circumstances have changed after electing to pay in a specified pattern, he/she may request to change the pattern of payment**.**

A quarterly payment pattern may be as follows-.

First payment:	7 October
Second payment.	7 January
Third payment:	7 April
Fourth payment:	7 July

with adjustments for the year to be paid and by 30 November or on assessment (whichever is the sooner); and

A monthly payment pattern:

Payments for a month to be made on the 7th of the following month; and

A bi-annual payment pattern:

Payments to be made in the quarters closest to receipt of income.

(3) All tax pay able within a year is to be paid in that year with some allowance for adjustments.

Under the PAYG method of payment, tax payable in a year must be paid in the year of income.

It is recognised that this may not always be possible, so it may be that the ATO will accept 90% to be paid by 30 June, and the remaining 10% paid by 30 November or on assessment (whichever is - the sooner). If these conditions are met then no provisional tax assessment will be raised for the following year.

If $1000 or more of tax is outstanding as at 30 November then a provisional tax assessment for the following year will be raised. An exception to this may be that if instalments have already been paid against the following year's liability, those credits could be allocated to the year being assessed, and no provisional tax assessment will be raised. In these circumstances, penalty may have to be imposed for late payment.

If 100% is not paid by 30 November and there is less than $1000 tax outstanding, then penalties may be applied to the outstanding amount (from 30 June?) but no provisional tax assessment for the following year will be raised.

(4) No interest will be paid by ATO on credits held on behalf of the taxpayer.

As this is a voluntary pay-as-you-go system, and not a payment in advance, the
ATO will not pay interest on credits held on a taxpayer's behalf

(5) No monies will be refunded by flee ATO until assessment

This is self-explanatory. However, it may be that if a taxpayer's income were to change dramatically due to unforeseen circumstances, the ATO may review this rule.

(6) Credits held on file will be allocated upon assessment.

The ATO will allocate credits held on file upon assessment, and the taxpayer will not need to claim them in his/her tax return.

Taxpayers may want some indication of the credits to which they are entitled, in which case the ATO would consider producing a Statement of Account. (On request, prior to lodgement of the return?).

SWITCHING BETWEEN SYSTEMS OF PAYMENT

If the ATO raises a provisional tax assessment for a taxpayer who has elected to pay under the PAYG system because of short payment then the taxpayer will be required to pay the outstanding tax for the year of income, as well as the provisional tax for the following year in April (if a lump-sum payer), and a first instalment on 1 September (if a QPT payer).

Can the taxpayer move back into PAYG?

If a taxpayer is already in the provisional tax system and elects to pay under the PAYG system, then he/she cannot move back to provisional tax unless the ATO moves him/her back because of short or non-payment. (There may be some exceptions to this, but the taxpayer would have to show good cause.)

First-time non-salary and wage taxpayers may elect to go into PAYG initially, but may still move into the current provisional tax system at some time in the future if they so choose.

The ATO would carry out systematic payment analysis to monitor taxpayer behaviour in meeting the requirements under the PAYG system.

As the spirit of the system is pay as you go, the law would need to provide for abuses, for example, in situations where taxpayers hold up payment until the end of the year.

ISSUES FOR FURTHER CONSIDERATION

- initial transition from provisional tax to PAYG.
- Application of credits on file to other outstanding debts

HOW DOWS PAYG ALIGN WITH THE CURRENT PROVISIONAL TAX SYSTEM?

See Attachment A.

PAYE and PROVISIONAL TAX

The ATO is also currently looking at the possibility of enabling non-salary and wage earners to register under the PAYE system as a method of paying as they go. This requires extending the definition of salary and wages employment, and the likely impacts of this are still being analysed. However, the analysis conducted to date leads the ATO to recognise that, while this could be a more timely solution, there are a number of administrative constraints, mostly in the areas of monitoring and compliance.

CONCLUSION

The model outlined in this paper is intended to provide a starting point for discussion and debate on the whole issue of alternative payment arrangements to provisional tax, and is not to be considered as the method the ATO will necessarily adopt. It has not yet been given sufficient consideration by the ATO, and other views have not yet been canvassed.

It is currently being distributed to a number of people representing the ATO, other concerned organisations and some tax practitioners, with **a** view to obtaining their views on this and any other model they may wish to put forward on alternative payment arrangements to provisional tax.

If you have any queries or comments to make on the matters raised in this paper, please contact Paula Lane on (06) 216 1308.

ATTACHMENT A

HOW DOES PAYG INSTALMENT SYSTEM ALIGN WITH THE CURRENT PROVISIONAL TAX SYSTEM?

The current provisional tax system for non-QPT payers is as follows:

(Chart is available on Page 139 of the hardback copy of the report. It does not transfer into electronic form)

APPENDIX IV

LODGEMENT ARRANGEMENTS FOR COMPANIES AND SUPERANNUATION FUNDS

As a result of extensive consultation between the ATO and representatives of major tax agent bodies, the Commissioner has announced changes to lodgement arrangements for companies and superannuation funds classified as 'small'.

The Commissioner has approved the following arrangements:

Non taxable companies:

1. lodge by 1 May 1996, and

- no late lodgement penalty will apply if lodged by this date;
- should the return not be lodged by 1 May, the late lodgement penalty will apply from 1 December 1995 to the date of actual Judgement, in which case the maximum penalty of $500 will apply.

Taxable companies:

2. pay their 'likely tax', (that which was paid last year or an estimate made by the taxpayer) on their total liability on 1 December 1995

3. lodge their tax returns electronically and pay the balance of their liability (if there is any) by 23 February 1996; or

4. lodge their tax returns on a paper form and pay the balance of the liability (if there is any) by 1 February 1996;

5. payment of any balance must be made at the time of lodging the return;

Penalty and Interest Concessions:

6. no culpability component of the late payment penalty will apply to any amount provided the "likely tax" is paid on 1 December 1995, and the electronic return is lodged and the balance of tax payable is remitted by 23 February 1996, or in the case of paper returns, lodged and the balance of tax payable remitted by 1 February 1996.

7. the interest component of the late payment penalty will be remitted where:

   the company concerned has had an income increase which is less than $20,000 from the - 1994 to the 1995 year. This equates to a variation, between the "likely tax" amount paid on 1 December and the balance payable with the lodgement of the return, of less than $6,600. It also equates to a calculated interest amount of $163 accrued for the period 1 December 1995 to 23 February 1996. These penalties will be automatically calculated and applied.

8. no late lodgement penalty will apply provided that:

- the electronic returns. are lodged with the ATO by 23 February 1996.
- the paper returns are lodged with the ATO by 1 February 1996.

Default on this arrangement

9. The usual late payment culpability and interest will apply and be calculated from 1 December 1995 in the following circumstances,:

- ·the "likely tax" amount is not paid by 1 December 1995;
- ·the paper return is lodged and full payment made after 1 February 1996; or
- ·the electronic return is lodged and full payment made after 23 February 1996.

10. late lodgement penalty will be applied to the period 1 December 1995 until the actual date of lodgement where:

- ·the "likely tax" amount is not paid by 1 December 1995;
- ·the paper return is lodged and full payment made after 1 February 1996; or
- ·the electronic return is lodged and full payment made after 23 February 1996.

To whom do these arrangements apply?

June balancing companies classified as "small".

Substituted Accounting Period (SAP) Company Arrangements

The above arrangements are based on the relative workloads of return preparers where the 1 December due date clashes with other lodgement priorities and traditional holiday periods.

This workload problem is not considered to exist to the same extent for SAPS, given the number of companies involved and the timing of lodgement (1 June 1995 for early December balancers).

At this stage, Assistant Treasurer George Gear has written to the Corporate Tax Association providing relief for small companies which allows for payment in full on the first day of the eighteenth month of the year of income (1 June 1995 for early December balancers) followed by the lodgement of the return on the first day of the twentieth month of the year of income (1 August 1995 for early December balancers). This will enable the preparation of the "small" classified company returns closer to the lodgement date of their parent company "large" classification returns which are due on 15 September.

It is proposed that this arrangement (which does not include penalty concessions) will apply for SAP Companies.

APPENDIX V

GOVERNMENT REVIEW OF FBT COMPLIANCE COSTS

General

The legislative changes required for the measures set out in this attachment will be amendments to the *Fringe Benefits Tax Assessment Act 1986 (FBTAA)*

After Hours Taxis

Current position

FBT applies w here an employee pays for an employer's trave1 between home and work, including taxi travel. An exception is where the taxi travel is provided on an unexpected and infrequent basis, for instance, because the employee is ill.

Change to FBT treatment
An FBT exemption will be made available to all employer-provided taxi travel directly between home and work where the employee arrives at or leaves work before 6 am or arrives or leaves work after 8 p.m., or is sent home sick. The exemption would apply whether the taxi travel covered all of part of a direct journey between home or work.

Car Parking

Current Position

Under the *FBTAA* a car parking fringe benefit may arise where, amongst other things, car parking is provided by an employer to employers and that parking is located within 1 kilometre of a commercial parking station.

Change to reduce compliance costs

No benefit will now arise unless a commercial parking station within a 1 kilometre radius of the employer's car parking facilities charges more than $5 for all day parking. The valuation of the car parking benefit will remain unchanged from the current arrangements, that is, the employer can base the valuation on the lowest cost commercial car park within 1 kilometre (including any commercial car parking within 1 kilometre that charges $5 or less).

Comparable changes will also be made to the provisions under which car parking for self employed persons is non-deductible under circumstances that would make it subject to FBT if it was employee car parking

Current Position

The FBTAA currently provides for a car parking fringe benefit to be valued by reference to the, lowest fee charged by a commercial parking station operator within a 1 kilometre radius of the employer's car parking facilities on a particular day.

Change to reduce compliance costs

To avoid the necessity for employers to constantly monitor changes in car parking fees an alternative method of valuation will be made available. This method will allow the value of car parking to be determined by reference to an average value and will operate as follows:

(a) The valuation of car parking fringe benefits provided by an employer over the FBT year win be based on the average of the lowest fee charged by the operator of a commercial parking station located within a 1 kilometre radius of the employer's car parking facilities on the first day of the FBT year and the first day of the next FBT year.

(b) Where there is more than one commercial parking station within a 1 kilometre radius of the employer's premises, the lowest fee charged by any operator of a commercial parking station will be acceptable.

(c) The fees that are used for the valuation must be representative of the fees charged during the period between the two dates.

Current Position

The Commissioner of Taxation issued Taxation Ruling TR 93/18 which sets out several methods available to an employer to determine the number of car parking benefits provided to employees during the FBT year of tax.

Change to reduce compliance costs

In determining how many car parking benefits are provided in an FBT year, an employer will be able to choose one of three methods of calculation. These methods are based on record-keeping over a full year, 12 weeks of record keeping, or a statutory formula:

(a) Where an employer makes no election, the employer must determine the number of car parking benefits using actual records kept over the full year,

(b) Where an employer elects to use, the 12 week register method, a register is to be maintained by the employer for a continuous 12 week representative period in a FBT year of tax in order to determine the number of car parking fringe benefits provided during that period. The number of benefits provided during that period can then be used to determine the total yearly number of benefits provided in the FBT year of tax. This number of benefits can be used in later years until the number of car parking spaces (or the number of employees allowed to park if this is less) increases by more than 10 per cent. In any case, a new 12 week register would be required every five years.

(c) Where an employer elects to use the statutory formula method, the number of car parking benefits provided will be calculated by multiplying the number of spaces available to employees (or the number of employees allowed to park, if this is less) by a statutory number of days per year. The statutory number of days will be set at 240.

Entertainment provided by way of food and drink to employees and non-employees

Current Position

From 1 April 1994 employers are generally liable for FBT on entertainment provided to employees and their associates and entitled to an income tax deduction for the cost of providing that entertainment. Employers are required to keep records of entertainment expenditure to, amongst other things, determine any apportionment between employees and non-employees. The Commissioner of Taxation has issued a Taxation Determination which provides that where an employee entertains non-employees the cost of the employee' s meal can be determined on a 'per head' basis rather than an exact expense basis.

Change to reduce compliance costs

In order to reduce compliance costs:

(a) In determining what proportion of entertainment is provided by way of food or drink to employees and non-employees, an employer will be able to choose one of three methods of calculation.

(b) These methods are an employee/non--employee break-up over the full year based on actual expenditure; an employee/non-employee ratio based on 12 weeks of record keeping; or a predetermined employee/non-employee ratio of 50150:

(i) Re employer may determine the employee/non-employee proportion of entertainment by way of food or drink (meal entertainment) using actual records of expenditure kept over the full yew (the per head basis currently available will remain).

(ii) Where an employer elects to use the 12 week register method, a register is to be maintained by the employer for a continuous 12 week representative period in a FBT year of tax in order to determine the employee/non-employee ratio of meal entertainment. That employee/non-.employee ratio can be applied to the total yearly expenditure on meal entertainment. That ratio can continue to be used in later years until the total yearly expenditure on meal entertainment varies by more than 20 per cent from the first year in which the register is kept. In any case, a new 12 week register would be required every five years.

(iii) Where an employer elects to use the 50/50 split method, the total yearly expenditure on meal entertainment must be apportioned 50/50 between employees (and associates) and non-employees, with 50 per cent subject to FBT and deductible and 50 per cent non deductible and not subject to FBT. 'Re total yearly expenditure includes all expenditure on meal entertainment regardless of whether the expenditure is subject to Fringe Benefits Tax (FBT), is non-deductible for Income Tax purposes, or is an allowable income Tax deduction.

Corporate boxes

Current Position

An employer is required to keep records of entertainment provided to employees/non-employees in corporate boxes or other similar hospitality arrangements. This is necessary so the portion of hiring or leasing costs that relates to the entertainment of employees can be determined.
The term "business premises" is defined for FBT purposes in such a way that a corporate box could, in some limited circumstances, be business premises of the employer. In such casts, any food and drink provided to employees (and their associates) in the corporate box would be exempt from FBT.

Change to reduce compliance costs

The changes are:

(a) An option will be provided in relation to the hire or leasing costs of corporate boxes and other similar hospitality arrangements, so that a 50/50 split between employees and non-employees will be accepted for the purpose of determining what proportion is subject to FBT.

(b) The definition of "business premises" for FBT purposes will be clarified to ensure that corporate boxes and other similar hospitality arrangements are not treated as "business premises". Thus, food and drink provided to employees in corporate boxes will continue to be subject to FBT.

Declarations

Current Position

Generally, an employer cannot reduce an FBT liability for an employee's business usage of a benefit unless the employer obtains a declaration from the employee which states the split between business and private use. A declaration must be provided every time a benefit is provided.

Change to reduce compliance costs

The following measures will substantially reduce the number of declarations required:

(a) Where a series of identical benefits is provided, a declaration need only be provided by the employee for the first benefit provided. Where there is a change in the business use by the employee for that type of benefit of more than 10 per cent a further declaration will be required. In any case, where the benefit is still being received, a further declaration will be required five years after the last declaration. This measure will apply to declarations where the business/private proportion of the benefit is the only matter required to be shown on the declaration (some declarations require more than the business/private proportion of the benefit to be shown on the declaration, eg. declarations for car benefits require details about the period of use of the car and whether log books were kept).

(b) Where an employer has a defined policy of only reimbursing business expenses, or where the employer has in place procedures that effectively prevent private usage of a benefit, the employer can replace the employee declarations with an annual declaration that no private benefit was provided.

(c) As a further measure, certain items will no longer be subject to FBT. These benefits are:

(i) laptop and other portable computers

(ii) protective clothing (required for employment)

(iii) briefcases

(iv) calculators

(v) tools of trade

(vi) subscriptions to trade and professional journals

(vii) airport lounge memberships

(viii) business related software

(ix) electronic diaries and similar items

(x) corporate credit card membership fees

(d) Car phones and mobile phones will not be subject to FBT where private use is only minor or incidental to the primary business use.

Period for Keeping Records

Current Position

An employer is required to keep FBT records for a minimum period of 7 years.

Change to reduce compliance costs

To bring FBT record keeping requirements into line with Income Tax record keeping requirements. employers will be required to keep FBT records for a minimum of 5 years.

Living-away-from-home Allowances (LAFHA)

Current Position

A LAFHA is an allowance paid by an employer to an employee to compensate for additional expenses incurred or other disadvantages suffered for living away from his or her 'usual place of residence'. The taxable value of the benefit provided is reduced by any reasonable amounts paid in compensation for accommodation and for increased expenditure on food.

The Commissioner has issued guidelines as to when an employee is taken to be living away from his or her usual place of residence. These guidelines have been difficult for employers to apply in practice.

Change to reduce compliance costs

Under the new arrangements, an allowance will only be a LAFHA subject to FBT where:

(a) the allowance is paid by the employer to the employee to compensate the employee for expenditure on food, drink, accommodation and other disadvantages which the employee may incur while living away from his or her usual place of residence., and

(b) the employer provides a declaration that it is intended that the employee will be employed in the new location for a set period of time (supported by appropriate documentation). With respect to appropriate employer documentation, the following documentation will be accepted:

(i) an employment contract where the length of the contract does not exceed 12 months; or

(ii) where the employee is not employed under a contract, a written agreement between the employer and the employee that the employee will be away from their usual place of residence for a period not exceeding 12 months', or

(iii) documentation that it is the usual practice for a class of employees of the employer to be employed away from their usual place of residence for a period not exceeding 12 months.

(c) the employee provides a declaration to his or her employer stating that he or she is living away from his or her usual place of residence; and

(d) the employee is living away from his or her usual place of residence. An employee will be taken as living away from his or her usual place of residence where the employee is away from his or her usual place of residence for a period which does not exceed 12 months.

If the employee is in Australia on a temporary work visa, or is an Australian resident for tax purposes and is working overseas, the periods mentioned above will be 4 yews.

Where an allowance is not a LAFHA, it is subject to Income Tax in the employee's hands.

The employer's liability to FBT on LAFHA benefits can be reduced by the following amounts:

(a) The amounts actually expended by the employee on accommodation while living away from his or her usual place of residence; and

(b) Reasonable amounts to cover the additional cost of food. The Commissioner has advised that he will issue a Taxation Determination setting out what is considered to be a reasonable food component for a particular FBT year. This Determination will generally be issued at the beginning of each FBT year