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Via email

15 January 2010

Dear Sir/Madam,

SUBMISSION – TAX LAWS AMENDMENT (2010 MEASURES NO.1) BILL 2010

Taxpayers Australia is pleased to provide a submission to Treasury in response to the Tax Laws Amendment (2010 Measures No.1) Bill 2010 and in particular, the amendments to the 25% entrepreneur's tax offset.

The appended document sets out our views in response to the Exposure Draft and Explanatory Memorandum.

Should you wish to discuss any aspect of this submission please contact either myself or Andy Nguyen on 1 300 657 572.

Yours Faithfully,

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Taxpayers Australia Inc

Tax Laws Amendment
(2010 Measures No.1)
Bill 20010


25% entrepreneurs' tax
offset

Submission

15 January 2010

Roger Timms

Head of Taxation and Superannuation



Taxpayers Australia Inc
Tax Laws Amendment (2010 Measures No.1) Bill 2010
25% Entrepreneurs' tax offset

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1. Executive Summary

Our submission sets out our comments in relation to the amendments to the Entrepreneurs' Tax Offset (ETO) as contained in the Tax Laws Amendment (2010 Measures No.1) Bill 2010.

Our submission focuses on the following:

- the practical implications to taxpayers from the application of the proposed income test; and
- perceived shortcomings from a policy viewpoint in relation to the income test.

In the main, Taxpayers Australia, from a technical viewpoint, agrees with the application of the income test. However, from a policy perspective, we have reservations to a means test being applied to a tax offset.

Further, Taxpayers Australia is of the view that in order to promote the spirit of entrepreneurship and to encourage individual taxpayers, that the current ETO regime be updated to better target and reward those who operate a home-based or micro business. In this regard, we have outlined an alternative ETO in this submission.

We note that the details of our alternative ETO will also be included as part of our 2010-11 Budget Submission (which is due on 29 January 2010).

To the extent that the exposure draft is amended as a result of subsequent feedback or in light of any recommendations provided by the forthcoming Henry Review, we welcome the opportunity to comment on any future drafts of these provisions.

2. Specific comments

2.1 *Comments in relation to proposed changes*

Eligibility of income test to individuals only

As outlined in the Explanatory Memorandum at para. 1.9 - 1.10, the income test would apply to individuals as sole proprietors, beneficiaries of small business trusts and partners in small business partnerships. The income test does not apply to companies or trustees.

In addition, we note that at para. 1.11, a company and trustee claimants will not be required to apply the income test. A company is restricted on the basis that it would not be able to pass on the benefit of the ETO to shareholders due to the imputation system. A trustee's own income would not be relevant if a trust is liable to income tax and an ETO is calculated with respect to that income.

The main implications which we have identified with respect to application of the ETO and the implications from excluding the income test from companies are follows:


(i) ETO and PSI interaction

Under the personal services income rules under Division 86 of the Income Tax Assessment Act 1997 (ITAA97), income that is derived as reward from an individual's personal skill and effort via an entity may be attributed and taxed in the hands of that individual (as opposed to the entity).

To the extent that a company is deriving personal services income, as noted by the Commissioner of Taxation in ATO ID 2008/19, a company is entitled to the ETO. However, to the extent that the taxable income of the company represents PSI, then ordinarily no tax liability would arise in the company under section 61-505(2) ITAA97 and therefore, no offset would be available.

Similarly, under section 61-505(1) ITAA97, it appears that an offset would not be available to the individual where PSI is attributed to that person from a company, as that individual would ordinarily not be considered to be a "small business entity" with respect to the derivation of PSI income.

Taxpayers Australia views the inability of the individual in this instance not to be able to be access the ETO as an anomaly in the application of the provisions. Ultimately, the aim of the offset is to provide an incentive to small business and whether the income being derived from a personal services business (and taxed in that entity) or as PSI attributable to an individual taxpayer should not be distinguished.



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This is in light of fact that there are provisions under Sub-division 61-J ITAA97 in place which allow a beneficiary of a trust and a partner in a partnership to access the offset.

Based on the foregoing, as part of the changes to the entrepreneurs' tax offset, we recommend that a provision be inserted under section 61-505(1) ITAA97 such that an individual may be able to access the ETO irrespective of whether the income is taxed at the company level or attributed to the individual as PSI.

(ii) Income test creates distortion between company and individual taxpayer

To the extent that a company is conducting a personal services business and income is not required to be attributed to the individual taxpayer, the ETO would be available to the company provided that it satisfies the relevant conditions under section 61-505(1) ITAA97

However, given that the income test does not apply to companies, it appears that the income test and in turn, the availability of the ETO favours businesses operated from companies as opposed to sole proprietors, business trusts and partnerships.

In particular, this applies in situations where funds are not distributed by the company to the shareholder as a dividend but rather is retained in the company for working capital purposes.

An example of the potential difference is illustrated as follows:

Example 1

Background facts

Taxpayer A – Individual taxpayer

- Single, no spouse or dependents
- Income from employment– \$80,000
- Net income from sole proprietor business is \$40,000 (aggregated turnover of \$50,000 less \$10,000 expenses)

Taxpayer B – Company Taxpayer

- Sole shareholder owns 100% of company taxpayer
- Company Taxpayer is a personal services business


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- Net income of business income is \$40,000 (aggregated turnover of \$50,000 less \$10,000 expenses)
- Income from shareholder's employment - \$80,000
- For working capital purposes, the income of the company is not distributed to the shareholder.

	Current application - Individual	Taxpayer A – Individual	Taxpayer B – Company
Taxable income	\$120,000	\$120,000	\$40,000
Basic income tax liability ¹ (excluding Medicare levy)	\$33,050	\$33,050	\$12,000
Small business percentage	33.3%	33.3%	100%
ETO = 25% x basic tax liability x small business percentage x phase out fraction ²	\$2,754	\$2,754	\$3,000
Reduction due to income test:	N/A	(\$80,000 - \$70,000) x 20% = \$2,000	N/A
Net ETO:	\$2,754	\$754	\$3,000
Total tax payable after offset:	\$30,296	\$32,296	\$9,000
Taxable income of shareholder of Taxpayer B	-	-	\$80,000
Total tax payable by shareholder (excluding Medicare levy):	-	-	\$17,850
Total tax payable for the year	\$30,296	\$32,296	\$26,850
Effective tax rate	25.2%	26.9%	22.4%

¹ Based on 2009-10 personal and company tax rates

² In this case, phase out fraction is 100%



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In the above example, by choosing to undertake business in a company structure, that structure is better off by \$2,246 (ie. \$3,000 less \$754) compared with the income test applying to the individual as a sole proprietor. Previously, that difference was \$246 (ie. \$3,000 less \$2,754) without the income test applying.

Notwithstanding that the imputation system would have given rise to the same tax outcome had retained profits in the company been distributed as dividends, in having this income test apply, there is an increased distortion favouring the company structure in scenarios where funds are retained for working capital purposes.

Therefore, the income test appears unfair to individual taxpayers who have not adopted a company tax structure, despite the fact that the individual's circumstances, in absence of a company, are comparable. In addition, there are additional costs and obligations should an individual taxpayer wish to transfer their business to a company structure (for example, legal obligations under the Corporations Act).

On this basis, Taxpayers Australia suggests that Treasury give consideration to the income test to determine whether such a distortion (as outlined above) is an intended outcome to affected taxpayers.

Application date

At para. 1.21 of the Explanatory Memorandum, we note that the proposed income tests would be applicable to eligible taxpayers on or after 1 July 2009.

There may be taxpayers who are relying on the ETO for the 2009-10 income year and the fact that the proposed changes will apply from the start date means that such taxpayers may receive a reduced offset or may be ineligible to any form of the offset altogether due to the application of the income test. The proposed application date appears unfair to certain taxpayers.

On this basis, we recommend that the application date begin from 1 July 2010 to allow taxpayers to undertake any necessary tax planning.

2.2 Comments in relation to ETO policy

Introduction of income test

When the ETO was initially introduced in Tax Laws Amendment (2004 Measures No.7) Bill 2004, we understood that the intention of the ETO was to assist micro and home-based businesses.

Notwithstanding our comments in relation to the application of the income test, from a policy perspective, Taxpayers Australia has reservations as to whether the proposed changes achieve the underlying aims of having an ETO in the first place

In particular, our observations with respect to income testing the ETO centre on the following:

(i) **\$70,000 threshold restricts individual's transitioning into business**

As an observation, to ensure that their proposed business venture is viable, individuals typically do not directly move from their current employment directly into a new business venture.

Given the substantial outlay, administrative burden and commercial risks involve in establishing a business, we would expect such individuals to transition from their main income producing source (i.e. their employment) into their business.


On that basis, the income threshold of \$70,000 for individuals penalises individuals transitioning from their job into their business venture.

Arguably, a better option may be to have the income test apply to non-employment income.

(ii) **\$120,000 family threshold restricts stay-at-home spouses establishing businesses**

As an observation, the \$120,000 family threshold does not provide incentive to stay-at-home spouses from undertaking entrepreneurial activities.

Rather than penalise, stay-at-home spouses should be encouraged to derive supplementary income whether through employment or setting up their own business.



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Again, a better option may be to have the income test apply to non-employment income of both spouses.


In both of the above instances, we consider that the means testing and the reduction of the ETO appear to penalise middle class Australians from establishing their own business.

In addition, as noted above, it also does not serve the initial intentions of assisting micro and home-based businesses (such as businesses established by stay-at-home spouses).

From a policy perspective, Taxpayers Australia is of the view that there should be no discrimination between the availability of the offset due to an individual or their family's income.

However, to the extent that the Government's policy objective is to means test the ETO, we suggest that income test thresholds be increased to a level such that middle class earners and middle class families are able to benefit and the offset phased out for high income earners (such as those paying tax at the top marginal rate).

Further, given that the ETO is an offset available for small business, we question whether the intermingling of means testing (which is a transfer system based concept) with respect to the receipt of a tax offset is appropriate. In means testing the ETO, the offset may be perceived as a Government "hand-out".



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Improvements to the ETO

Taxpayers Australia is of the view that as currently legislated, the ETO does not provide adequate incentive for individual taxpayers to undertake their own business ventures.

In our view, a salary and wage earner would be unlikely to give up their gross salary (excluding superannuation guarantee) of \$50,000 to undertake their own business venture (coupled with additional outlay and expenses in that business'infancy).

Arguably, entrepreneurs should be better rewarded for undertaking the additional risk in establishing a business (such as uncertain income stream, financing and increased administrative burden).

Therefore, to encourage and better reward entrepreneurship in the Australian community, we recommend the following improvements to the entrepreneur's tax offset:

- the turnover threshold for eligibility to the entrepreneur's tax offset be increased from \$50,000 to \$75,000, with phasing out as \$100,000.
- the rebate be increased from 25% to 30%. This increase in the rebate can be introduced at an appropriate time by Government and in our view, provides a better reward for the additional risks borne by entrepreneurs;
- to the extent that the taxpayer makes PAYG instalments, the rebate be factored in as part of quarterly instalment activity statements to assist with improving the businesses cash flow over the course of the year (as opposed to receiving the rebate at the end of the year when the tax return is lodged); and
- the offset not be available after the third year in which the taxpayer is in business (unless there are exceptional circumstances which may warrant an extension). We consider that at this point, the business is not considered to be an "entrepreneurial" business. The ETO as it current stands does not impose any time limit.
- If the above turnover threshold is adopted, in doing so and based on the policy reasons outlined above, we recommend that the income test be scrapped.

This is on the basis that increased income thresholds implicitly acts as an income test by aligning the ETO with what we consider to be the appropriate recipients. Albeit, we concede that the increased thresholds does not reduce the ETO as the income tests do.

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An example of how our proposed changes will impact a sole proprietor with a business turnover of \$75,000, net income of \$60,000 and no other external income is as follows:

Example 2.

	Salary and wage earner	Current 25% ETO (including income test)	Proposed 30% Taxpayers Australia ETO
Taxable income	\$60,000	\$60,000	\$60,000
Basic income tax liability ³ (excluding Medicare levy)	\$11,850	\$11,850	\$11,850
Small business percentage	N/A	100%	100%
ETO = ETO % x basic tax liability x small business percentage x phase-out fraction ⁴	-	\$1,778	\$3,555
Reduction due to income test:	N/A	N/A ⁵	N/A
ETO:	N/A	\$1,778	\$3,555
Total tax payable after offset:	\$11,850	\$10,072	\$8,295


Based on the foregoing, under the proposed ETO regime, there is an additional benefit to the individual taxpayer of \$1,777 (ie. \$3,555 less \$1,778) (effectively double in this instance).

Further, to compensate for the risk of being in business, under the proposed ETO, an individual is better off by \$3,555 over a salary and wage earner.

³ Based on 2009-10 personal and company tax rates

⁴ In this case, phase out fraction is 60% (being \$75k - \$60k/\$25k)for current ETO and 100% for proposed ETO

⁵ Does not apply as income below \$70,000



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We consider that proposed increase to the turnover threshold and rate of the rebate from 25% to 30% provides a better reward for entrepreneurs and better compensates for the additional risks undertaken.

It will also provide additional, on-going cash flow in the business' infancy and the three year time limit will allow the ETO not to be abused and is better aligned with its intended purpose and provide Government with cost savings.

2010-11 Budget Submission

We note that submissions have been sought by the Treasurer in his Press Release dated 27 November 2009 in relation to the 2010-11 Budget.

Our proposed improvements to ETO will also be included in Taxpayers Australia's 2010-11 Budget Submission.