Regulation impact statement — Unincorporated small business tax discount

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Background

The Australian economy is in transition and faces significant structural challenges due to both domestic and international factors. Mining investment is now detracting from GDP growth. The switch to broader-based growth driven by activity in non-resource sectors is occurring, but perhaps more slowly than is desirable.

Below trend economic growth is leading to spare capacity in the labour market and increasing unemployment, particularly youth unemployment. Economic growth has been below its long run average in five of the past six financial years, weighing on job creation and contributing to a gradual upward drift in unemployment.

Low interest rates, a falling Australian dollar and real wage adjustment over time are expected to support employment and encourage business growth over the longer term.

There have been some positive signs the required adjustment is underway, including job advertisements showing a slight upward trend in recent months.

However there is a risk of the adjustment being a protracted one, particularly given businesses remain reluctant to invest and take on new workers in the absence of stronger sustainable consumer demand. Investment in the non-mining sectors continues to be subdued, and small businesses have responded by scaling back the level of their capital spending. Treasury anticipates that longer-term capital expenditure will be lower than previously anticipated in the non-mining sector, notwithstanding solid growth this year.

In the 2015-16 Budget, the Treasurer announced unincorporated small businesses will be able to claim a non-refundable tax offset (otherwise known as a tax credit or a rebate) calculated at 5 per cent of the tax payable on business income, limited to $1,000 per taxpayer. This tax discount was announced along with a 1.5 percentage point tax cut for incorporated small businesses.

1. The problem

Small businesses make an important contribution to the Australian economy. They account for the vast majority of the active private businesses in the country and represent large shares of its employment and value added.

There are currently around 2.3 million small businesses in Australia (defined as having less than $2 million turnover). According to the Australian Bureau of Statistics, small businesses provide around 43 per cent of non-financial private sector jobs in Australia and around one third of non-financial output in 2012-13.[1] The small business sector has the potential to contribute strongly to national growth and competitiveness, including providing greater employment opportunities. Small businesses have the advantage of being adaptable and flexible and the ability to respond profitably to changing circumstances. Studies indicate that it is small businesses that are often the entities that test and pioneer innovative ideas and business practices which are critical to future economic growth, job prospects and improved living standards.

However, while small businesses play a significant role in the Australian economy, they also face a unique set of operational challenges, and as a consequence typically have higher failure rates than those for larger companies. A comparison of the outcomes of the National Australia Bank survey of large companies, with the Sensis survey of small businesses undertaken by the Reserve Bank

1 ABS, Cat 8155.0, Australian Industry.

suggests that conditions for small businesses have been weaker than for larger businesses since the global financial crisis in 2008-09.[2]

A further challenge for small companies is access to finance. Funding for small businesses is essential to facilitate productivity growth and job creation. Improving small business's access to finance was a Government election commitment.[3]

2. Case for government action/objective of reform

There is a clear role for Government to address impediments and create the right conditions for Australian small businesses to grow and become more productive, creating more jobs. With the economy facing below-trend growth, the Government's objective is to stimulate small business investment, growth and employment.

The Australian economy is in transition. The declining terms of trade and the ageing of the population are placing downward pressure on income growth. Small businesses are a key driver of Australia's economy, underpinning growth and innovation and providing jobs for millions of Australians.

Small businesses are typically more vulnerable to shocks and changes in economic conditions than larger businesses. This makes it particularly important that, during this period of economic transition, policy settings support small business growth and innovation. This proposal will reduce the tax burden on many unincorporated small businesses.

The Government committed to introducing a 1.5 percentage point small business tax cut from 1 July 2015 in the Coalition's Policy for Small Business.[4] On 2 February the Prime Minister announced a small business and jobs package would be announced in the 2015-16 Budget.

Reducing the rate of company tax for incorporated small businesses without offering a tax cut for unincorporated entities might have inadvertently encouraged small business owners to structure their business differently from how they would prefer in order to gain a tax advantage. Business owners may choose not to incorporate because the reporting requirements are less onerous or because they desire more flexibility in how operate their business. These decisions are not always about tax, but rather what structure best suits the business and its owners.

For businesses that are operated by a sole trader, through a partnership or through a trust, the business income is usually taxed in the hands of the business owner/s at their marginal rate of personal income tax. That is, unincorporated businesses are not taxed like a company; the income from the business flows through to individual owner/s according to the tax rules applying to that structure type and then taxed at the individual level along with any other income the individual earns.

Providing a tax discount for unincorporated small businesses, which broadly mirrors the small company tax cut, will help to improve the cash flow of small businesses by reducing the amount of tax payable in the financial year, and help to alleviate the problem of higher regulatory costs.

The tax discount, and the increase in business cash flow, may also help some small businesses to secure finance. Providing unincorporated small businesses with a tax discount may encourage extra business activity as previously marginal activities become more profitable. Businesses can re-invest

2 Ibid 4.

3 See www.liberal.org.au/latest-news/2013/08/19/tony-abbott-coalitions-policy-jobs-and-growth-small-business.

4 See www.liberal.org.au/.

in their business with the cash-flow from the discount in the way they consider best for their business. This increased investment is expected to lead to higher employment and wages over time.

3. Policy options

Option 1: No policy change

Under this option, no new actions would be taken by the Government and existing policy settings would be relied upon.

Unincorporated business income is added to an individual's other income and taxed at their marginal personal income tax rates.

Option 2: 5 per cent unincorporated tax discount for small business, capped at $1,000

This proposal would provide individual taxpayers with business income from an unincorporated small business with aggregated annual turnover less than $2 million with a 5 per cent discount on the tax payable on their taxable income from that source. The discount would be capped at $1,000 per individual in an income year, delivered as a tax offset. The proposal would apply to income years beginning on or after 1 July 2015.

The tax discount would be calculated by summing all net small business income (net business income from businesses which pass the small business entity test), multiplied by the individuals average tax rate, multiplied by 5 per cent. This formula ensures that the discount is only available for small business income and not the entire income of an individual who has small business income. The $1,000 cap applies at the individual taxpayer level. An individual can receive income from any number of small business entities, but the offset cannot exceed the cap. If a small business has multiple owners, each of those owners may receive the offset, up to the $1,000 cap.

There is no requirement for individuals to calculate this offset as the ATO will do this in E-Tax software and other IT systems. There will be some minor reporting requirements at the business entity level to inform individual taxpayers of the net small business income from that entity.

This proposal would directly affect the owners of small unincorporated business entities (those with aggregated turnover less than $2 million). The costs and benefits of this proposal should be considered alongside the small company tax rate cut of 1.5 percentage points.

Option 3: 5 per cent unincorporated tax discount for small business, uncapped

This option would operate in the same way as option 2, above. However, instead of being capped at $1,000 this option would only be bound by the $2 million turnover threshold. For example, a business with an aggregated turnover less than $2 million and a taxable income of $1 million would be able to claim a tax discount of over $20,000. Not many businesses would fit this scenario, but it highlights the value of the tax discount for more profitable small businesses, if the discount is uncapped.

This option may require extra integrity measures which limit the tax advantage which businesses receive from restructuring for the sole purpose of benefitting from this discount.

4. Cost benefit analysis of each option/impact analysis

Option 1: No policy change

This option involves no new actions by the Government and relies on existing policy settings. Consequently, it would introduce no new impacts on businesses, community organisations or individuals. At the same time, it would not address the issues identified in the problem section.

In addition, this option would mean that most small businesses would not receive a tax cut. The 1.5 percentage point small business tax cut for companies will not flow through to unincorporated entities and may cause a distortion in the decisions of small business in how they choose to structure.

Options 2 and 3: A 5 per cent tax discount for small business

Benefits

In Australia, most (around 70 per cent) small businesses tend to operate as a sole trader, partnership or trust, rather than a company, so these businesses would not be eligible for a cut in the company tax rate. A 5 per cent discount on the tax payable on their taxable income would reduce the tax rate on income from an unincorporated business in the hands of its owner/s and so broadly mirror the tax cut proposed for small companies.

Unlike a tax cut for companies that satisfy the small business test, this proposal would give a tax cut to *unincorporated* businesses with turnover below $2 million — around 1.5 million businesses.

> Mary and John own a small greengrocer business run as a partnership. Their turnover is $600,000 and the taxable income of the partnership is $120,000. Mary and John each receive $60,000 and would ordinarily pay tax of approximately $11,000 each.[5] To calculate the offset, they would each multiply their net small business income ($60,000) by their average tax rate (11,000/60,000 = 18.3%) and then multiplied by 5 per cent. (Note that they do not include any income any than the net small business income in the tax offset calculation.) The offset is approximately $550. Mary and John would each end up with a tax liability of approximately $10,450 ($11,000–$550).

This proposal will result in unincorporated small business owners having higher after-tax earnings which they will be free to reinvest in their businesses. While the average proportion of the additional cash-in-hand that owners would reinvest is unknown, on average, this is expected to increase growth and productivity in the small business sector.

The design of options 2 and 3 prevents individuals from applying for an ABN to get a discount on their other income. It does this using the existing rules for a small business entity: that the entity must be carrying on a business, not just having an ABN. Another aspect of the design that prevents manipulation is that measure only calculates the tax discount on income from a small business, not the entire income of a small business owner.

Costs

Revenue loss for government in the short term is estimated to be $1.8 billion over the forward estimates for option 2, which is capped at $1,000 per individual. Considering the cost to revenue of option 2, the uncapped option (3) has not been costed. The high cost to government revenue of option 3 is not considered appropriate in the current fiscal circumstances.

5 Medicare Levy has not been included for the purposes of this calculation.

The proposed cap in option 2 will limit the cost to revenue of this proposal, but means that the proportional tax cut for those with higher business incomes will be less. This will retain an incentive for business owners to consider incorporation when their business earnings are larger and take them into higher personal income tax brackets.

There will be some transitional compliance costs for around 1.5 million unincorporated small business entities, as well as the estimated 785,000 individuals who receive distributions from trusts and partnerships. These implementation costs relate to understanding and adjusting to the new arrangements and have been assessed at around $14.8 million per year. The assessed regulatory costs assume that the majority (around 90 per cent) of both unincorporated businesses and individuals receiving distributions use a tax agent or accountant.

Option 3 has the same regulatory costs. Although there would be some reduction in complexity from not having a $1,000 cap, any compliance savings are expected to be offset by the increased integrity measures required for option 3. These integrity measures would be required to prevent larger businesses from artificially structuring into multiple entities to qualify as small businesses and gain access to this proposal and other concessions. While not directed at small business, integrity rules may impose a compliance burden on a large number of small business taxpayers.

Ongoing compliance costs are expected to be minor. Partnerships and trusts will need to determine and advise individuals receiving distributions of the amount of the income distributed which will be eligible for the tax discount. Individuals receiving the tax discount, or their tax agent, will also be required to complete a new label on their tax return reflecting this information.

Net benefit

Options 2 and 3 would potentially benefit around 1.5 million small unincorporated businesses including sole traders, partnerships and trusts. Like the tax cut proposed for incorporated small businesses, because the proposal is a tax-based assistance measure, the benefit will be proportional to the amount of tax the business pays up until the $1000 cap 'binds', for option 2. At what business income level the $1000 cap binds will be dependent on the average tax rate of the individual, but would be around $80,000 of business income per individual assuming they have no other income sources.

The tax discount will result in unincorporated small business owners having higher after-tax earnings which they can reinvest in their businesses. To the extent this occurs, it will tend to increase growth and productivity in the small business sector.

Overall the proposal is assessed as having a low overall compliance cost impact, comprising a low implementation impact, and a low increase in ongoing compliance costs relative to the status quo. Average annual compliance costs are detailed in the table below.

Table 1: Regulatory burden and cost offset estimate table for options 2 and 3

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$12.0 m	$	$3.6m	$15.6 m
Cost offset ($ million)	Business	Community organisations	Individuals	Total, by source
Agency	$15.6 m			$15.6m
Are all new costs offset? ☑ **Yes, costs are offset** ☐ No, costs are not offset ☐ Deregulatory—no offsets required				
Total (Change in costs — Cost offset) ($ million) = $0				

The regulatory costs associated with this measure are offset by the regulatory cost reduction associated with a measure to simplify transfer pricing records.

5. Consultation

The tax proposals have been informed by targeted consultation with tax specialists outside government, including the Board of Taxation (the Board), on a confidential basis. Options were discussed with the Board on a couple of occasions, to give particular Board members an opportunity to provide feedback and to ask follow-up questions. This included the incorporated tax cuts and accelerated depreciation options. The Board's positive feedback was a factor in deciding on particular parameters in the final policy design.

The Treasury also consulted with the Australian Tax Office in order to identify any implementation issues, integrity concerns with the proposals, as well as any potential flow-on impacts they might have within the broader tax framework.

The limited consultation on the proposals reflects the cabinet-in-confidence nature of the decision making process. However, this proposal needs to be considered alongside the incorporated tax cuts for small business, which was an election commitment. One of the benefits of this proposal is that it complements the incorporated tax cuts by providing a tax cut to unincorporated small businesses. Without this proposal there would be a disincentive to structure as an unincorporated entity.

The legislative change requires careful consideration and targeted consultation to determine an approach for implementation will occur between the drafting process and introduction to parliament.

As the implementing legislation is to be introduced as a 2015 Winter A Bill, it is not possible for public consultation to occur on exposure draft legislation. Feedback provided in the public domain by businesses and industry organisations, including the Council of Small Business Australia, on the Budget announcement has indicated broad support for the measure.

6. Option selection/conclusion

The preferred option is to provide a tax discount capped at $1,000 to individuals with small business income, which would broadly mirror the small company tax cut. This option will provide increased cash flow to unincorporated small businesses allowing them to re-invest in their businesses. The greater re-investment from this and other announced measures of the Government are likely to lead to increased productivity and employment.

The high cost to government revenue of option 3 is not considered appropriate in the current fiscal circumstances.

This option strikes a balance between encouraging investment and economic growth and ongoing budget repair.

7. Implementation and evaluation/review

Legislation is required to implement the proposal. As the Government has set the start date as the 2015-16 income year, a 5 per cent tax discount for small business, capped at $1,000, is scheduled to be introduced to the Parliament during the Winter sittings.

The design of the legislation is expected to be relatively straightforward largely relying on current models in the tax system.

The ATO would be responsible for administering the tax rules applying to small businesses. The ATO and Treasury are experienced in implementing this type of reform.

Evaluation of this proposal would be on-going. It is expected that the ATO’s normal compliance and data analysis activities would identify tax avoidance activities occurring as a result of this proposal.

The benefit of this proposal should not be assessed in isolation, but considered as part of the small business package.