Regulation Impact Statement – Lower business taxes

1. The problem

Australia has experienced strong economic performance over 25 years, even though large global economic shocks and continuing instability, as well as a range of domestic challenges. At the same time, extraordinary technological change and increasing global connectivity have created new opportunities and transformed how we live, work and do business. The tax system affects incentives to work, save and invest, and needs to adapt to these challenges so that it continues to support Australia's growth into the future. In addition, the tax system needs to be fair and sustainable. Tax reform is crucial to Australia's economic success and will help underpin the longevity of the system.

The Government considered a number of tax options to establish a tax system that supports greater investment, more jobs, higher wages, and helps maintain and improve growth in standards of living and has announced a number of changes as part of a tax reform package. This impact statement considers the tax reform measures that reduce the tax burden on businesses.

Corporate income tax is currently levied at a rate of 30 per cent on all taxable income earned by companies with turnover of $2 million or more. This means Australia's corporate tax rate is higher than many countries we compete with for investment. Australia relies more heavily on corporate income tax than most other countries. In 2013, Australia's corporate taxation was 4.9 per cent of gross domestic product (GDP), while the Organisation for Economic Co-operation and Development (OECD) average was 2.9 per cent. A relatively heavy reliance on corporate tax has been a consistent feature of our tax system over several decades.

While the legal incidence of corporate tax falls on companies, the economic burden of company tax is ultimately shared among its shareholders, consumers and employees. Empirical studies show that, in the long run, over half of the economic burden of corporate tax is likely to be shifted away from shareholders through lower wages for employees and higher prices for consumers. Individuals who rely on labour income could be expected to be affected more significantly from lower wages growth associated with higher company taxes.

Incorporated small businesses make an important contribution to the Australian economy and along with unincorporated small businesses, account for the vast majority of the active private businesses in the country and represent large shares of its employment and value add.

96 per cent of all Australia's businesses are small businesses (defined as having less than $2 million turnover) and approximately 70 per cent are unincorporated. There are currently over 3 million small businesses in Australia. According to the Australian Bureau of Statistics, small businesses provide around 44 per cent of non-financial private sector jobs in Australia and around one third of non-financial output in 2013-14. Small businesses added around $340 billion to the Australian economy in 2013-14. 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.

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 larger companies. On average, smaller businesses face disproportionately higher costs of complying with their regulatory obligations, per unit of turnover compared to larger businesses. This includes tax.

Currently, small businesses with turnover less than $2 million have access to a number of small business concessions to reduce their compliance costs and increase their cash flow, such as:

- lower corporate tax rate of 28.5 per cent and the 5 per cent tax discount for unincorporated small business;
- simplified depreciation rules including immediate tax deductibility for assets costing less than $20,000 until 30 June 2017;
- simplified trading stock rules, where businesses have the option to avoid an end of year stocktake if the value of the stock has changed by less than $5,000;
- a simplified method of calculating Pay-As-You-Go (PAYG) instalments by the Australian Taxation Office (ATO), which removes the risk of under or over estimating PAYG instalments and penalties that may be applied;
- the option to account for goods and service tax (GST) on a cash basis and pay GST instalments as calculated by the ATO; and
- other minor concessions (e.g. Fringe Benefits Tax exemption for car parking).

Currently, 2.3 million unincorporated small business owners are eligible for the unincorporated small business tax discount.

2. Case for government action / Objective of reform

A broad range of theoretical and empirical academic studies support the benefits of lowering tax rates on businesses. These benefits were discussed in the *Re:Think* tax discussion paper, released by the Government on 30 March 2015. The discussion paper noted that while company tax is paid by companies, the burden of taxation is passed on to shareholders, consumers and employees and that lower business taxes would encourage higher levels of investment in Australia and benefit all Australians through increased employment and wages in the long run. These benefits have also been highlighted by recent public tax reviews in the United Kingdom, New Zealand and Ireland.

A study of the efficiency and incidence of major Australian taxes, including company tax, was released by the Treasury as Working Paper 2015-01 in April 2015. The paper confirmed that the benefits of lower business taxes discussed in *Re:Think* were still apparent when analysis was applied to the Australian tax system and tax rates, using a model based on the Australian economy.

As part of the 2016-17 Budget, Treasury modelled the economy-wide impact of cutting the company tax rate from 30 per cent to 25 per cent (Treasury Working Paper 2016-02). This analysis was supplemented by independent modelling from two external organisations. These studies concluded that cutting the company tax rate to 25 per cent would raise the level of GDP and deliver significant gains to Australian workers. To realise the benefits associated with lower business taxes, the Government adopted a policy aim of reducing the tax rates faced by businesses from their present levels. The lower tax rates must be paid for within a fiscal envelope that is consistent with the Government's fiscal strategy.

In addition, small businesses are typically more vulnerable to shocks and changes in economic conditions than larger businesses. This makes it particularly important to ensure that policy settings support small business growth and innovation in the near term. Further, Government regulation is the source of high compliance costs for small business. Reducing compliance costs for small business will allow the owners of these businesses additional time to focus on their business while the economy is in transition.

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.

Option 2: Business tax rate changes

Given the current lower tax rate for small businesses, a reduction in the company tax rate could be implemented by reducing the higher headline rate, the small business rate, or changing the turnover threshold to which the rate applies.

Changing the headline company tax rate has a high direct cost to revenue, because a high proportion of company tax is paid by businesses with turnover above the small business turnover threshold. The high direct costs of changing the headline rate are partly offset in the long-run by the improvements to incomes generated by the economic benefits of the reform. Reducing the small business tax rate has more limited impacts, reflecting the smaller number of companies affected and that these companies are economically smaller.

It is also possible to vary the design of general rate reductions by changing the dates of commencement for the various elements. All of these variables were considered in the design of this option.

The first element of this option would reduce the small business tax rate to 27.5 per cent in 2016-17. The turnover threshold to qualify for the lower tax rate would be raised from $2 million to $10 million in 2016-17, $25 million in 2017-18, $50 million in 2018-19, $100 million in 2019-20, $250 million in 2020-21, $500 million in 2021-22, $1 billion in 2022-23 and removed entirely in 2023-24. The corporate tax rate for all companies would then be progressively cut to 27 per cent in 2024-25 and by one percentage point in each subsequent year until the corporate tax rate reaches 25 per cent in 2026-27.

The rate at which franking credits can be distributed will mechanically change as a consequence of changing tax rates. Currently, businesses facing the small company tax rate can apply franking credits at a rate consistent with the higher company tax rate (30 per cent). Under this option, the maximum rate for the distribution of franking credits will be based on the rate of tax paid by the company making the distribution, discontinuing the current treatment.

Reducing company tax rates does not provide a tax cut for those businesses that are not operated through a company. Approximately 70 per cent of small businesses are unincorporated. This means that 2.3 million businesses would not receive any benefit from a company tax cut. It is difficult to provide a tax cut for all businesses because of the differing tax treatment of each entity type. Companies are taxed at a consistent flat rate, whereas income earned by an unincorporated entity is taxed at its owner's marginal personal income tax rate. Finding a tax cut for companies and unincorporated businesses that is equivalent for every scenario is impossible without creating a large compliance burden. However, the 2015-16 Budget introduced a 5 per cent unincorporated tax discount for small businesses to provide them with a tax cut at the same time as small business companies.

The second element of this option would increase the tax discount for unincorporated small businesses with annual turnover less than $5 million incrementally from 5 per cent from 1 July 2016 until it reaches 16 per cent on 1 July 2026 (as the company tax rate reduces). The tax discount would increase by 3 percentage points in 2016-17 to 8 per cent, remain constant at 8 per cent for eight years, then increase to 10 per cent in 2024-25, 13 per cent in 2025-26, and reach a new permanent discount of 16 per cent in 2026-27. The tax discount would continue to be capped at $1,000 per individual per year. This further increase in the unincorporated tax discount is consistent with the original design parameters and attempts to mirror the company tax cut for small business.

Option 3: Increasing the small business turnover threshold

This proposal would see an increase in the small business entity turnover threshold for access to the small business concessions from $2 million per annum to $10 million per annum from 1 July 2016.

Currently, small businesses with turnover less than $2 million have access to a number of small business concessions such as those listed in section 1. Increasing this threshold would allow a larger number of businesses to access the benefits of the small business concessions. This would also provide incentives for small businesses at or near the existing $2 million turnover threshold to grow, as currently they would lose these concessions once they pass the threshold. The turnover threshold could be moved to any value above $2 million and would produce some deregulatory benefits because of the deregulatory nature of the concessions that are attached to the threshold.

A figure of $5 million for access to the small business concessions was recommended in both the *Australia's Future Tax System (Henry) Report* from 2009 and the Board of Taxation's *Tax Impediments facing Small Business Report.*

The $2 million threshold was established in 2007 and has not been adjusted since then to reflect changes in wages, incomes and costs of running a business. Enterprises may have lost access to small business concessions over time as a result of these changes. A higher threshold for the majority of concessions available as part of the small business entity definition is thought more appropriate as fewer businesses will face a barrier to growth presented by the small business threshold. Increasing the threshold to $5 million will allow an additional 60,000 to 70,000 businesses access to the concessions while increasing the threshold to $10 million will allow an additional 90,000 to 100,000 businesses access.

To reduce the cost to Government revenue the current $2 million turnover threshold could be retained for access to the small business capital gains tax concessions and access to the unincorporated small business tax discount could be limited to entities with turnover less than $5 million, as proposed in Option 2.

Ultimately, the $10 million threshold ($2 million turnover threshold for small business capital gains tax (CGT) concessions and $5 million turnover threshold for access to the unincorporated small business tax discount) was identified as delivering the best combination of support for small business, reductions to small business compliance costs and the cost to revenue in tight fiscal circumstances.

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 Section 1: *The Problem*.

Option 2: Business tax rate changes

Benefits

Currently, the corporate tax rate is 28.5 per cent for companies with turnover less than $2 million and 30 per cent for all other companies.

Lowering the company tax rate will have economic benefits. These benefits were discussed in the *Re:Think* tax discussion paper. As part of the 2016-17 Budget, Treasury modelled the economic impact of a company tax cut, and found that cutting the company tax rate from 30 per cent to 25 per cent would raise the level of GDP in the long-term.

The results of this modelling exercise were released publicly, alongside related modelling results from two independent consultancies. These studies found that changes to company taxation affect the economy primarily through a change in business investment.

The Treasury analysis found that a change to company taxation made more investments viable to investors, who require returns equal to the rate set on global markets. Higher investment, sourced from foreign investors, raises the amount of capital in the economy. With more capital available, the productivity of Australian workers rises, driving an increase in real wages. Overall, the majority of the increase in incomes generated by a cut to company tax accrues to domestic workers.

An expanded tax discount for unincorporated business income would provide increased cash flow to profitable unincorporated businesses. Unincorporated small business owners will have higher after tax earnings which they will be free to reinvest in their businesses.

Unincorporated small businesses will use the tax discount in the way that they deem to be most valuable. With the extra cash flow from the tax discount, a small business could increase paid worker hours, invest in business assets or increase personal consumption. We are not able to assess what each small business will do with the tax discount, but it can reasonably be assumed that, in aggregate, the benefit will flow to each of these pathways in some proportion.

Both the lower company tax rate and the unincorporated tax discount may lead to an increase in consumption for small business owners, which is a good thing in itself. It increases the reward for many hard-working small business owners. Beyond this, re-investment in the business will have a long term pay off for the owners and potentially any employees. Employing more (increasing paid working hours) or purchasing new assets is the equivalent of deferred consumption for future increased benefit. This effect has not been quantified.

Unincorporated businesses with turnover of less than $5 million and companies with turnover of less than $10 million will benefit from a $5.3 billion cash flow improvement over the forward estimates under this option and option 3, combined.

Costs

As the corporate tax cut option is changing rates that are currently part of the tax system, this is not expected to generate regulatory costs.

The cap on the unincorporated small business tax discount will limit the cost to revenue to $1,000 per individual per year. The cap also reduces the proportional magnitude of the tax cut for those with higher business incomes. This will retain an incentive for business owners who are considering incorporating when their business earnings have grown.

There is a minimal increase in the regulatory costs caused by the tax discount calculation. This is because taxpayers will need to be aware of and familiar with the changes, but this is expected to be relatively straightforward and potentially part of the routine update processes.

The expected fiscal impact of this option over the forward estimates is a reduction in revenue of $5.3 billion. This includes the cost of raising the small business turnover threshold (option 3).

Net Benefit

A more competitive corporate tax rate will encourage investment, enhance productivity, increase the level of economic activity and over time increase real wages and living standards. The additional investment that will flow into Australia will increase national income by building a larger capital stock and by generating technology and knowledge spillovers that would boost the productivity of Australian businesses.

A lower company income tax rate will also reduce incentives for foreign multinationals to shift profits out of Australia.

The Treasury analysis and independent modelling found that cutting the company tax rate to 25 per cent would raise the level of GDP and deliver significant gains to Australian workers. The studies released with the 2016-17 Budget also estimated the net benefit of lower company tax rates by modelling the outcomes generated by alternative assumptions to offset the fiscal impact (personal income tax increases, non-distortionary tax increases, and changes in government spending). All of these studies found that substantial net benefits accrue under each of the three alternative offset assumptions. The Treasury analysis for the 2016-17 Budget also found the results were not sensitive to alternative specifications for key parameters in the model.

Changes to tax rates do not increase the regulatory burden beyond what is already imposed by the existing tax system.

The unincorporated tax discount results in a minimal increase to the regulatory burden imposed upon smaller businesses. However, this discount ensures that there is minimal distortion between the choice of entity type that small businesses could operate their business through. A corporate tax cut alone would leave around 70 per cent of small businesses with no benefit. By looking at both components of this option together, we see an increase in cash flow for businesses, offset by the same amount of reduction in Government revenues. However, the increase to economic growth as a result of the company tax cuts provides a clear rationale for selecting this option.

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

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	..	$0	$0	..
Key: .. not nil but rounded to nil				
Cost offset ($ million)	Business	Community organisations	Individuals	Total, by source
Agency				
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				

Option 3: Increasing the small business turnover threshold to $10 million

Benefits

Increasing the threshold to $10 million will allow an additional 90,000 to 100,000 businesses to access the benefits of the small business concessions, decreasing the compliance costs (such as for record keeping and calculation requirements) and increasing cash flow. This will enable greater reinvestment in small businesses and provide the opportunity for these businesses to increase employment and increase wages. It also provides incentives for small businesses at or near the existing $2 million turnover threshold to grow, as currently they would lose these concessions once they pass the threshold.

This option would reduce the regulatory cost on smaller businesses by $32 million per year.

As more businesses become eligible for the lower tax rate, the broader economic benefits discussed in option 2 will become more widespread. The benefits of this option are included in the revenue implications outlined in option 2. Small businesses are expected to experience a $2.2 billion cash flow benefit over the forward estimates from the increase in the threshold. However, it should be noted that the benefit to smaller businesses is the same as the cost to Government revenue.

Costs

Taxpayers will need to be aware of and familiarise themselves with the new changes. This is expected to be relatively straightforward and potentially part of the well-established update process.

This option is expected to result in a medium overall compliance cost impact, comprising a low implementation impact and a medium decrease in ongoing compliance costs.

It is expected to have an impact on revenue of approximately $2.2 billion over the forward estimates. The benefits to small business through higher cash flows are equally offset by the cost to Government revenue.

Table 2: Financial implications ($ millions):

	2015-16	*2016-17*	*2017-18*	*2018-19*	*2019-20*	*Total*
Australian Taxation Office	-	-300	-700	-550	-650	**-2,200**

Net Benefit

The proposal to increase the small business turnover threshold would potentially benefit over 90,000 small businesses as more of them will be able to benefit from mot of the small business concessions resulting in potentially higher after-tax earnings which small business owners can reinvest.

This option provides a net benefit to small business. There is a reduction in regulatory costs of $32 million per year and there is an improvement to cash flow from various concessions attached to being classified as a small business. The cash flow benefit matches the cost to Government revenue.

Table 3: Regulatory burden and cost offset estimate table for option 3

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	-$26.2	$0	-$5.8	-$32

5. Consultation plan

As part of the Government's release of the Tax Discussion Paper, extensive consultation was undertaken on potential elements of reform. This process involved a number of key stakeholder engagements through face to face meetings, as well as an open submission process. In total, over 800 formal submissions were received, many which are available online. The Government and/or Treasury conducted more than 130 meetings with stakeholders throughout Australia.

The Government's consideration of tax proposals have also been informed by targeted and confidential consultation with tax specialists outside Government, including the Board of Taxation.

The Treasury also consulted extensively with the ATO in order to identify any implementation issues, integrity concerns with the proposals, or any potential flow-on impacts they might have within the broader tax framework.

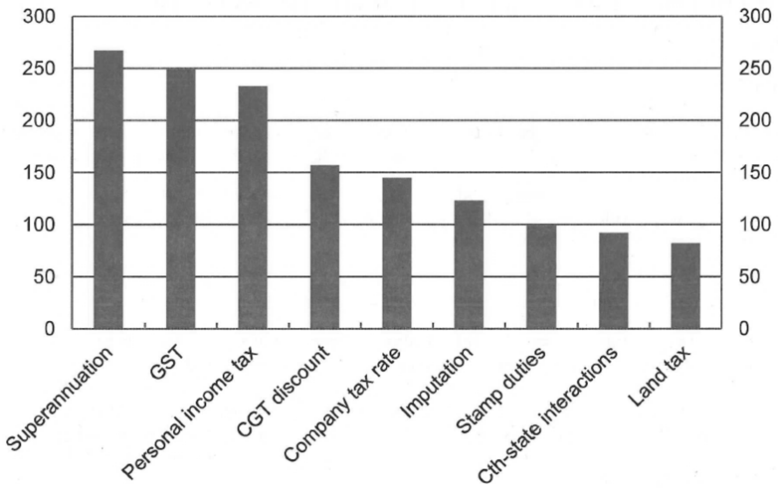
Stakeholder submissions

Submissions were provided by the following types of organisations:

- large and small businesses (e.g. Qantas, BHP, Westpac);
- professional services firms (e.g. KPMG, Deloitte);
- peak bodies and industry groups (e.g. Business Council of Australia, Council of Small Business Australia, Property Council of Australia);
- trade unions (e.g. Australian Council of Trade Unions, Australian Services Union);
- social welfare groups and religious organisations; and
- private individuals.

Submissions generally considered a number of tax topics, with a broad range of views being presented on each. The number of submissions mentioning particular tax topics is summarised in Chart 1.

Chart 1: Number of submissions per tax topic



Feedback obtained from consultations

From submissions and broader consultation, a number of key trends in stakeholder sentiment were identified in respect of particular policy areas. Those of relevance to this Regulation Impact Statement are summarised in the table below.

Topic	*Stakeholder views*
Changes to the company tax rate	Company tax was mentioned in 145 submissions. Submissions from large businesses and associated peak groups generally argued that the company tax rate should be lowered as this would make Australia more competitive internationally as an investment destination. There was a level of consensus among this group that the company tax rate should be reduced to 25 per cent. One social welfare group argued that higher tax rates should be imposed on the banking and mining industries. Some peak bodies also argued that the company tax rate and the top marginal personal tax rate should be harmonised.
Changes to small business rules	Small business was mentioned in 66 submissions. Many submissions from both peak groups representing businesses and private individuals argued that the threshold for access to small business tax concessions should be more generous (for example, that they should be available to businesses with turnover up to $5 million, as mentioned in the *Australia's Future Tax System* report). Some argued that the rate of company tax that applies to small businesses should be reduced below its current rate of 28.5 per cent.

6. Option selection / Conclusion

Acknowledging the overall benefits associated with lowering company tax rates from their present level, the preferred policy incorporates lower tax rates and increases in the threshold for the lower company tax rate currently available to small businesses, along with an increase in the rate and scope of the tax discount for unincorporated small businesses. It is also proposed to increase the threshold to allow a larger number of small businesses to access the small business concessions other than the lower corporate tax rate.

Under the preferred option the small business tax rate will be cut to 27.5 per cent in 2016-17.

The turnover threshold to qualify for the lower tax rate will be raised from $2 million to $10 million in 2016-17, $25 million in 2017-18, $50 million in 2018-19, $100 million in 2019-20, $250 million in 2020-21, $500 million in 2021-22, $1 billion in 2022-23 and removed entirely in 2023-24.

The corporate tax rate for all companies will then be progressively cut to 27 per cent in 2024-25 and by one percentage point in each subsequent year until the corporate tax rate reaches 25 per cent in 2026-27. The maximum rate for the distribution of franking credits will be based on the rate of tax paid by the company making the distribution.

The tax discount for unincorporated small businesses with annual turnover less than $5 million will be increased incrementally from 5 per cent from 1 July 2016 until it reaches 16 per cent on 1 July 2026 (as the company tax rate reduces). The tax discount will increase by 3 percentage points in 2016-17 to 8 per cent, remain constant at 8 per cent for eight years, then increase to 10 per cent in 2024-25, 13 per cent in 2025-26, and reach a new permanent discount of 16 per cent in 2026-27. The tax discount will continue to be capped at $1,000 per individual per year.

The Government opted to increase the small business entity turnover threshold for access to the small business concessions from $2 million to $10 million per annum from 1 July 2016. The $10 million threshold was chosen over the $5 million threshold to minimise impediments to growth. By increasing the threshold to $10 million, around 30,000 additional businesses will gain access to the small business concessions than if the threshold was increased to $5 million. The economic benefits from potentially increased employment, higher wages, removing disincentives to business growth and reduced compliance costs were considered to outweigh the cost of foregone revenue.

The current $2 million turnover threshold will be retained for access to the small business CGT concessions. As the Government's intention in increasing the threshold is to minimise impediments to growth, expanding access to the CGT concessions would not further this aim. The concessions are aimed at small businesses at the end of their life with the purpose of helping small business owners to save for their retirement. Businesses with turnover greater than $2 million are likely to have greater capacity to save for their retirement. Access to the unincorporated small business tax discount will be limited to entities with turnover less than $5 million, as entities with turnover over $5 million generally find it to their advantage to incorporate.

This is a Regulation Impact Statement for final assessment as there have not been any earlier decision-making points and there will be no further decision-making points in relation to these matters.

7. Implementation and evaluation / Review

Legislation is required to implement the proposals. 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 is experienced in implementing this type of reform.

Evaluation of this proposal would be ongoing. 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.