

<http://jbh.ministers.treasury.gov.au/media-release/021-2015/>

<http://bettertax.gov.au/have-your-say/discussion-paper-submissions/>

27/5/2015

In response to the request for discussion with regard to taxation reform in Australia.

My interest is primarily as an owner of a Propriety Limited company. Earlier this year I wrote to Jamie Briggs on this and my email to him is included at the end of this response.

However, I have made an effort to answer some specific issues raised in the discussion.

I would like to address the PSI (Personal Services Income) rules.

It is interesting to note that the PSI barely rates a mention in the discussion paper yet it is my personal belief it is one of the most confusing, problematic and needless 'rulings' relating to small business.

The 2014 report with regard to taxation impediments facing small business (linked here: http://www.taxboard.gov.au/content/reviews_and_consultations/impediments_facing_small_business/report/downloads/taximpediments_report.pdf)

Covers the PSI in sections 4.36 – 4.52 and says (in part):

4.39 In 2009, the Board of Taxation undertook a comprehensive post-implementation review of the PSI regime. In its report, the Board found that the introduction of the PSI rules had improved integrity and equity in the tax system to a certain extent. However, the Board identified difficulties in applying the rules, along with a limited level of compliance activity by the ATO. The then Government referred the Board's report to the AFTS Review, which recommended consideration of a revised PSI regime that extends to all entities earning a significant proportion of income from the personal services of their owner-managers. This recommendation has not been implemented.

4.49 The profile of Australian workers is also evolving more generally, with more 'white-collar' workers adopting forms of contracting and self-employment in many sectors such as management consultancy and financial services. Closely connected to the proliferation of contractors is the growth in the provision of personal services.

4.50 Similarly to employees and contractors, the distinction between an individual operating a personal services business and working in an 'employee-like' capacity is not always clear. The use of multiple self-assessment tests may not always address this ambiguity, creating uncertainty for individuals in assessing their need to comply with the PSI rules.

So some of the problems and failings have been recognised.

The question needs to be asked: "What does the PSI ruling achieve?"

I would suggest, that in any business, whether the bulk of income is derived from 'personal services' or not, if proper accounting and business practices are followed there is no benefit to attempting to

differentiate the manner of work. Taxation rules apply equally and tax paid by any business and any individual should be 'fair' and equitable.

In the cases where businesses or individuals are not paying tax correctly, enforcement of existing tax, accounting and business rules negates the need for additional rulings such as the PSI rules. So, the issue is enforcement not the specifics of how the income is derived.

It seems the PSI rules are in response to the increasing number of contractors who (for all other purposes) are acting as, and treated as, employees. If this is the case, the solution is not to address the issue via taxation of the contractor/employees – but to change the law making the use of this arrangement (using contractors) unfavorable to the principles.

The government must decide, going forward, if it wants to encourage or discourage a contractor based workforce? Only once this is decided can fair and sensible tax laws be formulated with regard to 'contractors'.

Please also see the copy of the letter to Jamie Briggs below.

To address some of the specific discussion questions:

41. What effect is the tax system having on choice of business structure for small businesses?

I think this question itself goes a long way to describing the current problem. The tax system should have minimal influence on the way a business is structured or run. Those decisions should be made based on the best way to structure the business itself based on the operations it undertakes. If the taxation system is the driving force, it shows the tax system has become overly cumbersome and imbalanced.

In my particular case, for example, I created a propriety limited company to avoid unlimited liability. It was also necessary for a number of other business / insurance reasons. Taxation was very low on the list of considerations.

42. What other options, such as a flow-through entity (like an S-Corporation), would decrease the overall complexity and costs for small business involved with choosing a business structure? How would such an entity provide a net benefit to small businesses?

Primarily, removal of the PSI rules.

Maintain one set of consistent rules covering all business of the same type. It should not be necessary to decide how to bill clients (by the hour, or by the job), find out who owns clients, have many different clients based on some percentage of work etc.

There should not be any "flow through". A company is (and always should be) a financial entity in its own right. In that case there is no confusion. If a business is to be set up to 'share' earnings with the owner then the structure required is a sole trader / partnership.

Creating company structures which blur the line between owners, employees, share holders and at the same time have unclear liability boundaries is not a good idea.

The US "S-corporation" idea is bad because Australian and US laws are significantly different. Work-cover, insurance and superannuation do not work the same way in the US as they do in Australia. (I have contracted to US managed companies and have discussed these differences). This is why US rules do

not work here. In order for “S-corporations” to work it is likely many Australian laws would have to be re-written and re tested. An “S-corporation” structure here could potentially leave workers in a position where they have inadequate work-cover, or worse, in a position where insurance companies (in states like WA) refused to honour policies completely, based on recent business losses and therefore low incomes.

When considering taxation and how it is to be applied to small business, related issues such as insurance, superannuation, leave entitlements, redundancy entitlements, work-cover and individual state laws must be carefully considered in conjunction with any change. Particularly where that change is made at a federal level. The ATO and taxation system do not exist in a vacuum, although all too often rulings are made without consideration of related factors (as is the case with the PSI).

Work-cover is already a considerable mess when working across state borders, further changes which could change the definition of a “worker” and a “working director” are more than just a bad idea, they would be a step backwards.

43. Is the interaction of the personal and business tax systems a problem? What can be done to manage the personal-business tax interactions?

No. The system is set up to separate businesses and individuals into different legal and financial entities. The main problem is lack of enforcement. The second problem is a matter of perception by increasingly uneducated individuals who seem unable to make the differentiation. The final problem is the repeated attempts to blur the line between these groups, including attempts by the ATO itself. See Comments below.

46. What other mechanisms (such as a single lower tax rate, improved technology deployment or other non-tax mechanisms) could assist small businesses to engage with the tax system while decreasing compliance and complexity costs?

A flat rate GST on all items (no exemptions). Review the provisional tax system. For small businesses, where income can vary wildly from year to year and even month to month, the current provisional tax system fails.

The discussion also specifically addresses Income tax averaging:

“Incomes of primary producers and specific professionals may fluctuate from year to year, for reasons such as adverse weather conditions or demand. The income averaging rules ensure that taxpayers with fluctuating incomes pay no more tax over a number of years than is paid by taxpayers with comparable but steady incomes.”

Also the "The incentive to retain profits":

“These incentives may provide a strong reason for privately-held companies to retain earnings as much as possible — for example, where the owner does not require the funds for their personal expenses. This can provide a cheap form of finance for future activities. Conversely, they generate the need for rules around private access to company funds and resources, such as those found in Division 7A of the tax law.”

The statement “where the owner does not require the funds for their personal expenses.” is misleading. It gives the impression that owners can somehow simply 'take' funds for personal expenses. This is not the

case. Taking tax free money for personal use from a business, and never paying it back, is illegal in a number of ways, as the government and the ATO well knows.

Division 7A does not allow “private access to company funds”, which again implies 'free money'. Division 7A allows companies to issue loans, which must be repaid, with interest, at a rate set by the ATO. Done correctly, there is no tax benefit, and the business receives interest which is taxable. Done incorrectly, the owner incurs a tax debt and possibly legal action too. This myth of 'free money' needs to be stamped out and it is disappointing to see it implied here.

The “incentive to retain profits” and “income tax averaging” (or rather: income smoothing) are in fact related. The implication of the discussion present seems to imply that this is bad practice? In fact, it is not only sensible but often a requirement in the successful management of a small business. What is not considered is that many types of insurance and financial institutions require that a steady or average income can be demonstrated. Without this steady income many insurances (including work-cover) are effectively worthless and it becomes impossible to obtain (personal) loans. Even with “income tax averaging” tax is still paid. The alternative is that during periods where small business owners / workers / employees have no income they should immediately be allowed access to government benefits with no stand down period?

On income splitting the discussion says:

Outside of the individuals income tax system, people may be able to use entities such as trusts or private companies to 'income split'. The potential benefits from income splitting arise from the progressivity and effective tax-free thresholds in the individuals income tax system (Box 3.3). Legitimate income splitting is not straightforward to do. This is because the general anti-avoidance rule and other integrity rules in the tax law are intended to counter schemes that have a 'dominant purpose' of avoiding tax, even though they comply with the technical requirements of the tax law. For example 'personal services income' is the reward for someone's personal efforts or skills and should be taxed according to that person's marginal rates. A special tax regime for personal services income exists to prevent people from reducing their tax by shifting this income to another person or entity (such as a company).

In order to stop trusts being used for tax avoidance, trusts such as discretionary trusts should not be allowed to operate as a small business entity in order to avoid tax. If tax concessions are to be given to trusts receiving business income, these should only be given to express trusts based on assessment by the ATO and where the terms of that trust are available for public scrutiny via ASIC or a similar body (as they would be for a company).

From my observations: discretionary trusts allow the money to be redistributed in a way that would be considered a 'fringe benefit' if it was done under a company structure. In addition, trusts are not open to financial scrutiny in the same way a company is. The nett effect allows other obligations to be avoided too. Changes in the way trusts are managed for tax purposes need to be made law. Trusts are not companies.

To address this specific part of that statement:

For example 'personal services income' is the reward for someone's personal efforts or skills and should be taxed according to that person's marginal rates. A special tax regime for personal services income exists to prevent people from reducing their tax by shifting this income to another person or entity (such as a company).

This is written as a 'self evident' statement and is incorrect.

Why should (business) income for a personal efforts or skills be taxed at that person's marginal rate?

If that person is operating a business (such as a company) and is an employee of that business, then there is a separate legal and financial entity involved. Companies by law, are separate legal entities. Companies, by law, have their own legal and financial obligations. The PSI rules are at odds with this. They potentially place companies in a position where they may be operating while insolvent.

If a person is providing personal efforts or skills while working as employee of a company and is then accessing company funds incorrectly without paying the correct tax on personal income they are breaking the law. This was always the case. The issue is/was lack of adequate auditing and enforcement.

Other questions:

8. At what levels of income is it most important to deliver tax cuts and why?

It's not just about 'income' but about income per dependent. I support 4 people on my income for example.

Secondly, 'tax reform' needs to include 'concession reform'. As a worker, I get hardly any concessions. This effectively lowers my real income compared to someone who gets concessions.

11. How important is tax as a factor influencing people's decisions to work in other countries?

In Australia at the moment – critical. In fact the Australian tax system has discouraged me from doing any work outside Australia in the Asia Pacific region. This not only restricts my business but prevents me earning income which would be brought into Australia.

About 5 years ago I worked in Indonesia. I worked there as an Indonesian resident based on the requirements of the contract.

All the money earned was taxed in Indonesia. Then all the money was taxed again in Australia. There was no tax credit due to the Indonesian paperwork being wrong (big surprise!). So, not only was I paid at a lower rate than I normally get – I was taxed twice. In my industry nearly everyone has had the same experience. It's so bad it has driven people either out of the industry, or out of the country, completely.

Any work that results in money earned overseas being brought into Australia should be encouraged?

In the case of the zone tax offset, submissions to recent inquiries suggest that it may no longer meet its original policy intent. As the zone tax offset is administered based on geographic boundaries that were last updated in 1981, some people question whether the areas within the zone are truly those with the highest living costs or remoteness. Further, in a recent report tabled by the House Standing Committee on Regional Australia in February 2013, some of the submissions raised the concern that 'fly-in, fly-out' workers should not receive the zone tax

offset. This was on the grounds that fly-in, fly-out workers tend to spend and invest their money where their families reside, and do not necessarily incur the higher costs of living in the zone. (pg 53)

This is true, but also neglects to consider the other half of the issue: 'fly-in, fly-out' workers *do not receive the services available where their families reside* while they are living in the 'zone'.

This leaves FIFO workers effectively paying the full rate of tax for services they do not have access to while at work. This includes emergency medical and hospital services, telephone and internet services, banking and government services. It also includes access to education and training services (even services such as those offered by Open Universities often rely on inflexible arrangements and are therefore unavailable to FIFO workers) In many cases a limited service is supplied by operators / companies but there is no regulation on minimum standards so in some cases workers live under very basic conditions.

In addition, fly-in, fly-out (FIFO) workers 'lose' a vast amount of income paying for goods and services they are subsequently unable to use. Any sort of club membership, or subscription, or course fee paid is often forfeit when workers are unavailable.

The perception that FIFO workers make "tons of money" is outdated and incorrect. In fact, the industry is having trouble attracting and retaining workers due to the fact wages and salaries are no longer an incentive to take up the work when compared to other employment.

General Comment

Prior to any further discussion about taxes, Australians and the Australian government a need to make clear their philosophy going forward.

In the recent past Australia has become a nation that seems to begrudge anyone making a profit or being 'better off' than anyone else. There also seems to be a lack of basic business understanding by an increasing number of people (including those in the media and the government!). More and more there seems to be a perception that anyone who owns a business is somehow 'rich' and that they can somehow 'just help themselves' to the company bank accounts? In the media (and social media) we see talk of 'Gina Rineheart having all that money' when people are actually talking about the businesses she manages.

There appears to be basic confusion with regard to the difference between revenue and profit, expenses and deductions, depreciation and handouts, tax avoidance (a crime) and tax minimisation (good business and accounting practice).

Then there is "Super-Profits"? Increasingly the finger is being pointed at any company that makes 'billions' while completely neglecting to mention turnover, assets, liabilities or contribution to Australian employment, economy and infrastructure.

There have even been moves to specifically target the 'top 300', 'top 500', 'big 4', 'major players', 'multinationals', 'richest companies'.

There is a Senate Inquiry where representatives of the Australian Government have interrogated representatives of companies (operating within the law) about "tax avoidance"?

This is shameful.

Tax avoidance is a crime. If any member of the Australian Government or Australian Public has proof that this is taking place they should take that information to the Australian Federal Police and/or the ATO. *It is*

NOT a matter for public debate, discussion or trial by social media. Elected representatives should not be allowed to use such terminology for short term political gain. That should be part of the tax law. Minimising tax is not illegal. If it was, yearly tax returns would not include any allowable deductions.

The Australian Tax Office should be publicly speaking in defense of legal taxpayers (including companies) on these matters. In my opinion it is part of the Taxpayer's Charter: "You can expect us to: explain the decisions we make about you". The ATO and all levels of Australian Government should be publicly speaking out against specific 'targeting' of any individual business or taxpayer.

If Australia wishes to become a country which operates a comprehensive 'income redistribution scheme', where no individual or business is permitted to do better than anyone else and everyone's income details are public – call it what it is – communism. If that is to be the approach, then all further 'discussion' is pointless.

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Copy of email sent to Jamie briggs 24/2/15

jamie.briggs.mp@aph.gov.au

RE: PSI Income tax / The Coalitions's Policy for Small Business

Dear Sir,

Lately I have been hearing in the media about how the government is attempting to reduce paperwork and bureaucracy for small business?

If so, could you please pass on this suggestion to those conducting the review?

I believe one of the things that should be reviewed / removed to assist 'small business' is the PSI (personal services income) rules.

What does the PSI achieve?

If anything, it adds an extra layer of complication to small business paperwork. Worse than that, it also has gone beyond the bounds of simply collecting tax to directing how a business does business.

In my view – this is stepping well outside the role of the ATO.

For example: The PSI rules dictate who I can, and cannot, employ.

I run a small business with very simple books. The assistance of a Book Keeper from time to time is a help. But I don't need much – probably 2 hours a week at most – just to handle payments and fill in BAS forms.

In my case my wife is a book keeper. By that I mean she is a qualified book keeper, with a TAFE

qualification in accounting.

So this is not simply a case of giving my wife a role just so I can dish out 'free money' and claim a deduction – its work that needs to be done and she is qualified to do it. But, under the PSI rules I cannot employ my wife for this role, regardless of her professional qualification.

"Therefore, your business:

■ can't claim payments to an associate for bookkeeping for the business, issuing invoices, secretarial duties, running the home office or any other non-principal work

■ can claim

– reasonable amounts you paid to an associate for principal work

– salary or wages for an arm's-length employee (not an associate)."

So my wife performs the role for free.

The government (and the ATO) should have a major problem with that because she is not getting paid, which means she is not paying tax (no income for work performed) and collecting no superannuation.

There is no work cover is being paid either, which is also a legal concern for the business.

The business can afford to pay my wife for her book keeping services and it would all be done correctly, with PAYG, Super and Work Cover – if not for the PSI rules.

It could be argued perhaps that employing family and friends is nepotism? Fair enough, if I was running a multi million dollar multi national company – but for small business – nepotism (if you want to call it that) makes sense both from a practical and organisational standpoint.

The "80% rule".

Apparently the business can't just do business either, it needs to know the business ownership details of the clients/customers as well? If the business is in any way related to other business the company may have done business with? The business also has to have multiple clients – even if one client provides all the work the business can possibly handle.

My limited understanding of business is that each business is its own separate legal and financial entity. That is established by law. Yet according to the ATO and the PSI rules I need to ask not only my clients, but their clients as well, who owns them? I need to establish this this in order to pass the 'unrelated clients test'. Is there any other business in the world that operates this way?

Then there is work through an agency to further complicate the whole matter. Again, I fail to see how this is any of the ATO's business? There is a client/customer... and invoice is issued... payment is made... tax is paid. That should be where the ATO's involvement ends. If the ATO has any reason to believe there is any fraud, embezzlement or illegal activity then there are legal remedies for this – there always were. It becomes a Police / ASIC / Legal / Court matter. It is not up to the ATO attempt to police these issues on

the sly via their 'rulings'. In any case, so long as the business is legal and the correct tax is paid how are any additional details any concern of the ATO?

The ATO also wishes to stipulate *how clients are to be billed!*

In my case, I work in a primary industry sector (Oil and Gas Exploration) and my business is often at the mercy of nature and reliant on factors well outside my control, so *in my industry the standard worldwide is to bill by the day*. But not according to the ATO. Under the ATO's simplistic model of 'Jim builds a house...' work needs to be billed by the job based on task completion and any complications should be resolved by legal action.

If I was to conduct my business the way the ATO suggests I would have dozens of pending legal cases already – many involving multinational companies and very complicated business arrangements. Not to mention, none of my clients would ever do business with me again.

The PSI system is also retrospective.

As a business owner I need to know in advance what tax rules I am operating under. The PSI doesn't allow this. The PSI assessments are made at the end of the year, retrospectively. They also seem assume, as a contractor, I can plan and control my future employment for the year ahead. It also seems to assume that I have the luxury of being able to accept and decline work and clients at my leisure and my clients will accept this.

The PSI rules also put many businesses (including my clients and their clients too) in a position where they cannot correctly assess their taxation and business liabilities.

Workcover is one area in particular where liabilities are assessed based on income. In order for the system to work there cannot be any confusion or uncertainty with regard a persons' income. In some states (West Australia for example) many businesses on a contractual chain are affected – not simply the contractor judged as a "PSI".

It has always been the case in Australia that a Propriety Limited business is a separate legal and financial entity.

As a separate entity, that business has its own legal and financial liabilities under law. The PSI rules ignore this – in some cases to the point where I believe they even put businesses in a position where they are operating illegally.

If the ATO is dissatisfied with the way Sole Traders, Partnerships, Propriety Limited companies or Trusts work with regard to taxation then those issues need to be specifically addressed. But there are ways to do this. Not by using some morphing fuzzy pseudo-legal rulings from the ATO which attempt to bypass well established legal precedents and worldwide established business practices.

It seems to me, in part, that the PSI rules are a partial response to the growing number of contractors working in the Australian workforce?

While it is true that there are a growing number of employers that are attempting to shift their responsibilities from being employers by using 'contractors' the PSI rules do not address this.

If the Australian government is dissatisfied with this work trend then the solution is for the government to address this via legislation (as the WA government has done with Workcover there) removing the incentives to employ 'contractors' and confusing these workers with businesses. Placing the burden on small business is not a solution.

A large part of the problem appears to be the perception (by many uninformed members of the public) that owning a business is somehow an endless source of 'tax free income'. As a small business (Pty Ltd) owner I certainly don't believe this is the case. If there is anyone in the ATO who does believe this is the case, and/or knows how to *legally* obtain tax free income from my business then please have them contact me and my accountants at once!

In summary, PSI rules attempt to direct:

- whom I may employ and under what conditions
 - whom I may have as clients / customers and under what conditions
 - how I can bill my customers and how contracts are to be written
- and they do this retrospectively, so that I do not know prior to doing business what tax rules apply.

It costs time, and money (accountants fees) to comply with PSI assessment requirements.

The nett result for all this is next to nothing. I attempted to calculate the taxation obligations using a PSI assessment and a company / personal assessment and the difference was less than a couple of hundred dollars over a year. In fact, there would have been no difference had I been employing my wife correctly. Not even worth the time to figure it out.

If the government is serious about reducing the paperwork burden on small businesses then removing the PSI rules would greatly assist in this.

The taxation / accounting rules are (and were) already in place to make sure these businesses pay tax correctly.

The failure was to correctly audit and follow up on cases where taxation was not paid correctly.

The PSI rules have not assisted with this.

If the ATO wants to direct how my business is to be run on a day to day basis, whom I do business with and on what terms, perhaps they can provide me with a business manager and a legal team at their expense?

I hope that you will investigate this as part of the small business tax review.

Thanks and regards

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