

The Institute of Public Accountants

Financial System Inquiry 2014



Introduction

The Institute of Public Accountants (IPA) welcomes the opportunity to present this submission to the Financial System Inquiry.

The IPA is one of the three professional accounting bodies in Australia, representing over 26,000 accountants, business advisers, academics and students throughout Australia and in 57 countries worldwide. The IPA prides itself in not only representing the interests of accountants but also small businesses and their advisers.

The IPA takes an active role in the promotion of policies to assist the small business and SME sectors, reflecting the fact that two-thirds of our members work in these sectors or are trusted advisers to small business and SMEs. The IPA pursues fundamental reforms which will result in easing the disproportionate regulatory and compliance burden placed on small businesses.

This submission has been prepared in the context of the IPA's ongoing advocacy on behalf of Australia's small business community; and we continue to focus on responding to the many and varied pressures faced by small business owners and operators.

Australia has an enviable growth record but is facing some significant economic policy challenges, including an ageing population, slowing productivity growth and a mining boom that has reached its peak. A strong and vibrant small business sector can play an active role in contributing to the economic growth of the Australian economy and help in addressing some of these challenges. However, in order to achieve its potential, it needs an efficient financial system based on an equitable and simplified taxation system; a superannuation system that rewards the efforts of small business people; ready access to affordable finance; and innovative technology solutions such as Standard Business Reporting.

We welcome the opportunity to discuss our recommendations in more detail with the Inquiry team. Please do not hesitate to contact Vicki Stylianou, IPA executive general manager public affairs at Vicki.stylianou@publicaccountants.org.au or on 0419 942 733.

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Executive Summary

The IPA has proposed a number of policy initiatives and recommendations; the core of which relate to taxation, superannuation and financial services. The following sets out the IPA's views and recommendations that the Inquiry could consider with respect to major reform of the financial system.

Taxation

Australia has experienced structural deficits for the last five years which have been masked by the mining boom and Global Financial Crisis (GFC). Recurring structural deficits inevitably lead to higher levels of debt which will limit the ability of governments to respond to future economic downturns. Our tax system which has served us well in the past now needs to be reformed in order to meet the challenges that lie ahead. The Government needs to make its case for tax reform as public understanding is required to accept the size of the problem and the need to take action. Public acceptance is made easier if the burden is shared across the community. Hence the importance of the Government's promised tax white paper which will be taken to the next Federal election for Australians to consider. Existing analysis such as the Henry Tax Review should be taken into consideration to create a blueprint that moves beyond the technical debate. Tax reform, combined with reform of the financial system, is an opportunity to improve lagging productivity and may represent one of the best levers we have to address many of our challenges.

Our current tax system is heavily weighted to taxes which place a comparatively high burden on economic growth, so reform is critical to Australia maintaining its enviable growth record.

Taxation related recommendations focus on the following:

- The adoption of a concessionary rate of tax for small business to assist and support this important employer through a differentiated concessionary rate of tax on business income.
- That the Government's white paper on tax reform has broad terms of reference to include the important reforms highlighted in the Henry Tax Review that must be addressed in order to remove impediments to growth and entrepreneurial activity.
- That the costs of financial planning advice fees be fully tax deductible. The IPA believes this measure would considerably increase consumer access to affordable financial advice and ultimately result in reduced consumer reliance on government provided benefits on retirement.

Superannuation

The IPA believes that superannuation policy needs to provide greater encouragement to Australians to save for their retirement, including the application of more innovative solutions and policies. The IPA particularly supports more generous concessional contribution rules for older Australians.

Access to finance for small business

The IPA has partnered with Deakin University to form a research centre into SME/small business issues. The Centre is undertaking research into small business financing and will release its findings and recommendations at the end of April 2014.

Standard Business Reporting

The IPA is a strong supporter of Standard Business Reporting (SBR) and its benefits for a range of stakeholders, particularly small business. We should all strongly support and encourage the use of SBR, including ongoing federal funding. As awareness grows, the rate of take up will increase. The release of more SBR-enabled software, especially by larger vendors, will also favourably impact take up levels, and should be encouraged.



List of Recommendations

1.0 Taxation

<u>Recommendation 1.1:</u> A concessionary rate of tax for small business income be introduced to take into account the regressive regulatory burden imposed on small business and to reward entrepreneurial activity.

Recommendation 1.2: A tax reform blueprint should be adopted, drawing on the Henry Tax Review and Tax Forum to prepare our economy for the challenges ahead.

<u>Recommendation 1.3:</u> The taxing point at which share options are taxed should be reviewed, particularly for small business start-ups.

<u>Recommendation 1.4:</u> A small business entity should be considered, that has features relevant to the small business community. Tax flow-through treatment options for small businesses operating through separate structures should also be considered.

Recommendation 1.5: That the costs of financial planning advice fees be fully tax deductible.

<u>Recommendation 1.6:</u> Trustee resolutions – a legislative amendment is needed to restore the previous position which existed prior to the change in ATO administrative practice.

Recommendation 1.7: A taxation discount for interest income should be considered.

<u>Recommendation 1.8:</u> That the alienation of personal services income rules be reviewed to take into account modern work arrangements, low levels of compliance and uncertainty.

<u>Recommendation 1.9:</u> More effort should be applied to assist the states and territories in achieving reform, including harmonisation of state and territory taxes.

<u>Recommendation 1.10:</u> That the GST margin scheme provisions should be replaced with a simpler and more streamlined alternative policy model that achieves broad policy aims.

2.0 Superannuation and Financial Services

Recommendation 2.1: There should be an increase in the annual concessional contributions cap.

<u>Recommendation 2.2:</u> Introduce the Low Income Superannuation Contributions (LISC) payment or increase the government co-contribution to past levels.

Recommendation 2.3: Repeal legislation that prohibits a personal concessional member contribution where the member earns more than 10% of their income from employment services.

<u>Recommendation 2.4:</u> Repeal the legislation that prohibits contributions to a superannuation fund by Australians aged 65 or over if not gainfully employed on at least a part-time basis.

<u>Recommendation 2.5:</u> Develop superannuation policy which provides a 'life-time concessional contributions cap' to make the contributions regime more efficient.

Recommendation 2.5.1: Develop superannuation policy which provides for a spouse to make concessional contributions on behalf of the member.



Recommendation 2.6: That the recommendations in Australia's Future Tax System Review in relation to annuity and deferred annuity products be adopted to encourage the use of annuity and other life pension products upon retirement.

Recommendation 2.6.1: That retirees be permitted to take a tax free lump sum up to their low rate cap, irrespective of their age. Any lump sum withdrawn in excess of their lifetime cap will be taxed at 16.5%.

<u>Recommendation 2.6.2:</u> That hardship provisions permit qualifying retirees to draw a larger tax free lump sum where hardship can be demonstrated.

Recommendation 2.6.3: That the minimum draw down factors for those receiving a superannuation pension be reduced. Since the requirement to withdraw a minimum pension amount was introduced in 2007, in the majority of these years drawdown relief has been afforded to pensioners, thereby reducing the minimum amount a pensioner must withdraw.

Recommendation 2.7: That legislation relating to LRBAs be amended to remove the requirement for the single acquirable asset to be held on trust so the superannuation fund trustee obtains a beneficial interest.

<u>Recommendation 2.8:</u> The small business superannuation clearing house should be brought under the jurisdiction of the ATO.

Recommendation 2.8.1: The threshold with regard to staff numbers eligible to use the small business superannuation clearing house should be increased from 19 to 100.

Recommendation 2.8.2: Another reporting option should be incorporated into the quarterly BAS to allow superannuation payments to be made to the ATO for it to pay into member's superannuation funds.

3.0 Access to Finance for Small Business

<u>Recommendation 3.1:</u> That small business financing be reviewed with policy developed to remove impediments.

4.0 Standard Business Reporting

Recommendation 4.1: That the use of SBR be encouraged by government and all stakeholders.



1.0 Taxation

1.1 Concessionary tax rate for small business income via tax offset

As the engine room of the economy, small business would benefit from a differential rate of income tax to compensate for their disproportionate regulatory burden.

With the exception of Capital Gains Taxation (CGT) concessions, most small business tax benefits currently merely provide for a deferral of tax; a marginal benefit at best.

Only those small business owners able to sell business assets at a profit are able to enjoy CGT tax concessions at the time of "exit".

The concessions currently available to qualifying businesses at the time of exit should be redistributed and applied at start up and in the subsequent growth years.

Small business income earned by individuals is subject to the same progressive tax rates as individuals; the majority of whom do not have the same regulatory burdens or exposure to risks.

The level of taxation compliance and complexity facing small business has increased substantially over the last few decades. With the introduction and development of Fringe Benefits Tax (FBT), CGT, Goods and Services Tax (GST), the paid parental leave scheme and compulsory superannuation, our taxation system has become excessively onerous and more than 95 per cent of businesses currently engage a tax practitioner. Tax compliance is in addition to the already heavy burden faced by small business in administration and reporting relevant to workplace and OH&S laws, and the superannuation guarantee.

The IPA proposes a concessionary rate of tax for small business income to compensate for the regressive nature of compliance costs and to reward entrepreneurial activity. The small business income component of an individual's total income should receive a tax offset to reduce the effective tax rate on small business income. All other income would be subject to existing tax rates. A lower tax rate would be more equitable, efficient and cost effective.

The proposal would operate on a similar basis to the entrepreneurs tax offset (ETO), which was recently abolished. This measure was originally intended to offer an incentive to small business in the early stages of development by way of a tax offset of up to 25 per cent for those with a turnover of less than \$75,000.

There is evidence to support the proposition that the majority of small businesses would prefer a lower tax rate and a simpler system than a plethora of complex tax concessions which they may not be able to fully access. The existing small business turnover threshold of \$2 million would determine eligibility. The current anti-avoidance rules provide the necessary integrity measures to discourage larger businesses from being separated into smaller entities to take advantage of a lower rate.

Measures to help fund the proposal

The removal of a host of existing small business tax concessions will help fund this initiative of reducing the tax rate applying to small business income. These would include:

- Rationalising and streamlining the CGT concessions recommended by the Henry Review. The four current and separate small business CGT concessions require taxpayers to navigate complex legislation. A number of existing concessions; such as the 50 per cent reduction and the 15 year exemption are highly concessional, and can eliminate any CGT liability when business owners exit their investment. These concessions are generally uncapped. Evidence suggests that only a small number of owners are able to sell business assets at a premium and take advantage of this concession.
- A review and rationalisation of other small business income tax concessions.
- A review of existing FBT concessions to enhance efficiency and equity. The use of uncapped FBT exemptions for restaurant meals and the hire of entertainment facilities for private



purposes by relatively high income professions costing revenue hundreds of millions of dollars and goes well in excess of original policy intent.

The ETO framework is already in place (or can be easily re-introduced) and provides the administrative capability to implement this proposal in a relatively short timeframe. The proposal represents targeted assistance to the largest employer group in Australia and will boost productivity and employment.

The proposal has the potential to be revenue neutral by limiting the concessions to the cost savings noted above and/or applying an income test eligibility threshold.

Recommendation 1.1: A concessionary rate of tax for small business income be introduced to take into account the regressive regulatory burden imposed on small business and to reward entrepreneurial activity.

1.2 Tax reform blueprint rather than piecemeal reviews with revenue neutral outcomes

Our current mix of taxes limits Australia's growth potential. A shift to growth supporting taxes is required to sustain Australia's economic momentum and meet all current and future spending needs. The current taxation mix is insufficient to meet expenditure commitments and Australia faces a revenue funding gap.

The Henry Review provided a comprehensive 'blueprint' for the future of our tax system. The recommendations of this review must now be developed into detailed, workable and affordable long term reform strategies.

Recent tax reform initiatives have been divided into discrete reviews, requiring each to be considered in isolation with an overall revenue neutral outcome. Tax reform in this manner will miss the synergistic benefits available from wider tax reform opportunities.

Company tax rate reduction, trust re-write, Division 7A and tax concessions for the Not-for-Profit sector, all fall into this revenue neutral category. The revenue neutral outcome dictated in the terms of reference of these reviews severely impacts the quality of the consultation process and outcomes. Most of these reviews will be hamstrung by narrowly defined terms of reference.

The Henry Review sought to address some of the fundamental imbalances that exist within the current system. The existing tax mix will struggle to achieve revenue adequacy in the long term in the face of rising expenditures as the population ages and workforce participation declines. Consumption taxes, being the most efficient and sustainable of taxes, are widely regarded by tax policy experts and others as integral to reshaping Australia's future tax reform agenda.

As recommended in the Henry Review, nuisance taxes should be removed and our reliance on income tax decreased; with a shift towards greater reliance on consumption taxes which will encourage savings and investment and provide a more sustainable source of revenue. Most nuisance taxes which are inefficient, distortive and inequitable are levied by state governments; and reform in these areas will require an examination of the adequacy of state and territory revenues.

As noted on numerous occasions by this Institute, the base and rate of GST must be included in any discussion of tax reform. Consumption taxes such as the GST represent one of the most efficient and sustainable tax bases available.

Australia's GST base is relatively narrow and covers less than 60 per cent of private consumption. In addition, the GST rate is relatively low compared to the OECD average of 18 per cent. A review of the base and rate of GST should be an option for addressing the fiscal imbalance between Federal and state governments. Australia's GST covers about 60 per cent of a comprehensive consumption tax base which gives Australia the seventh lowest coverage ratio amongst 32 OECD countries.

GST revenues have grown over time and represent a more robust and stable source of revenue than income taxes; the latter of which are more vulnerable to changed economic conditions.



It is acknowledged that the regressive nature of GST will mean that appropriate compensatory measures for low income households will be required if rates are increased. Any increase in the base or rate will need to be accompanied by increased welfare payments to mitigate the effects on those worst off.

It is noted that reform will only be possible if the case for change begins now and well ahead of implementation. The IPA believes that it is important for an open, mature debate on this issue.

There must be a shift of the tax burden to less mobile and less growth-damaging bases to support economic growth and meet spending needs. All taxes represent a drag on economic growth but the GST does not discourage earnings or investment nearly as much as income and corporate taxes.

The mining boom has masked structural deficits. Now that the boom has receded there will be a need to revert to the non-mining sector which is already exposed to higher rates of tax.

The Henry Review and the Tax Forum have provided a strong foundation to progress tax reform and the ability to commence the process of discussing recommendations to build support for a long term tax reform plan. We note that the Government has promised a tax white paper in its first term to review the tax system and has not ruled out the GST as part of its terms of reference.

Recommendation 1.2: That the Government carries out its commitment for a promised tax white paper. The terms of reference for the white paper should be broad and include the GST as part of the mix. The tax reform white paper needs to draw on all the existing work already undertaken including the Henry Tax Review and Tax Forum in formulating a blueprint to prepare our economy for the challenges ahead.

1.3 Employee Share Schemes

Changes to the tax rules in 2009 governing employee share schemes (ESS) effectively treat employee share options as income which is taxed at the employee's marginal tax rate. If no concessions apply, any discount on the market value of an interest in a share or right provided to an employee under an ESS is taxed as part of the employee's taxable income in the year it is acquired rather than on disposal.

Many overseas countries such as the UK, USA, Canada and Singapore generally defer the taxing point to when the securities are sold. This treatment puts a dampener on using share options for little or no upfront cost as a remuneration option for cash strapped entities trying to attract and retain talent.

If tax is paid by the employees and the value of the securities has fallen due to market forces, the employee is not eligible for a tax refund, but would instead have a capital loss under the capital gains provisions. This makes participation in an ESS an unattractive proposition especially when you consider the high failure rate of start up companies. The current ESS rules fail to recognize that unlike large well funded companies, start ups require employees to participate in long term equity incentives as they do not have cash to pay competitive salaries to incentivize employees.

Innovation is vital to a country like Australia which is transitioning away from its more traditional employment sectors to a digital economy. New innovative technology start-ups have the potential to generate new markets and significant employment growth. Without the cash flow to offer a competitive wage, an equity stake is the best option to attract and incentivize employees but the current rules make this strategy ineffective.

Encouraging the growth of innovative start ups is in the national interest as it can lead to benefits for the economy more broadly. ESS provider wider benefits to the economy as research has shown that employees involved in ESS have improved performance which can contribute to the growth of the business. In addition, Australian technology firms have made significant contributions to the ability of Australian firms in other industries to take advantage of the digital economy by providing the tools to do business online affordably and easily.



A more supportive regulatory environment for start ups could help address one of the main challenges of attracting and retaining experienced skilled employees faced by start ups. Other tax jurisdictions will only tax the gain when it is realised making Australia's system uncompetitive.

Last year, Treasury issued a discussion paper on ways to improve the current operation of ESS which called for submissions by 30 August 2013 acknowledging that the new rules could be improved to better support innovative companies. The consultation process for reviewing ESS rules was put on hold during the election. On 21 January 2014, Treasury announced a review of ESS for start ups which is a welcomed announcement to address current criticism of the rules.

Recommendation 1.3 Review the taxing point at which share options are taxed particularly for small business start-ups. Securities provided by companies that meet certain eligibility criteria should have the option of deferring the ESS taxing point to when the securities have been realized and are able to be traded. By deferring the taxing point it avoids the need to value the shares when they are granted and also provides the employee with the funds required to pay the resulting tax on any discount given.

1.4 Simpler structure options and/or flow-through regime for small business to streamline and reduce regulation and red tape

One of the Institutes long term aspirational goals is the simplification of the small business taxation system through the application of a structure which eliminates the need for multiple structures. Multiple structures are commonly needed to achieve tax outcomes which would be otherwise unavailable through a single entity. A simplified small business entity regime can significantly reduce regulation and red tape for small businesses.

Small businesses seek measures which promote asset protection, the retention of profits for working capital, lower tax rates, access to CGT discounts, succession planning and income distribution. A combination of entities is generally used to achieve these outcomes. A typical example may be where a business operates through a partnership whose interests are held by a discretionary trust with a company among the trust beneficiaries. When a small business operates through separate legal structures; the current taxation system treats the structures as taxation entities separate from their owner(s); resulting in a quantum leap in tax compliance and complexity.

International evidence exists of entities specifically designed for small businesses. For example in the United States, small businesses may set up using an S-Corporation that offers a number of advantages such as asset protection and flow-through tax treatment. The creation of a new small business structure allows small business entities to use a single simplified structure rather than the current complicated ownership structures such as trusts. If such a structure allowed the optional retention of income at the corporate tax rate, it would allow most of the benefits that can currently be obtained via the use of a company and discretionary trust via a cheaper and simpler vehicle to administer. A simpler structure option could represent a better pathway to avoid the complexity that exists in relation to Division 7A and trusts.

As an alternative, entities that choose to retain a multiple entity structure should have the option to adopt flow-through taxation treatment. This option can significantly reduce the complexity of small business taxation.

The Ralph Review of taxation recommended this in 1999 as a way of providing small businesses with the benefits of a tax consolidation group without the compliance burden. The adoption of such a regime will allow SME's flow-through tax treatment for commonly used entities such as companies or trusts.

A solution for SME's would be to allow access to a flow-through regime when separate entities are used which effectively gives them the benefits of a tax consolidation regime without the complexity. The small business tax concessions do not deal with using structures and minimizing compliance.

Recommendation 1.4: That the Government considers the adoption of a small business entity that has features relevant to the small business community as part of its ongoing efforts to



streamline and reduce regulation and red tape for small businesses. That the Government also considers reviewing tax flow-through treatment options for small businesses operating through separate structures.

1.5 Tax deduction for financial advice

The IPA believes there is a strong case to support the tax deductibility of all of the costs of financial planning advice.

Currently, a fee for service arrangement for the preparation of an initial financial plan is not tax deductible under Section 8-1 of the ITAA 1997 as it is not considered to be an expense incurred in producing assessable income.

Tax Determination TD 95/60 issued by the ATO draws a distinction between a fee for (a) drawing up a financial plan and (b) fees for management or annual retainers. TD 95/60 states that any of the expense incurred in drawing up a plan is not deductible for income tax purposes because the expenditure is not incurred in the course of gaining or producing assessable income but is an expense of putting the income earning investments in place and therefore capital in nature.

However, ATO guidance in Taxation Ruling IT39 states that where expenditure is incurred in 'servicing an investment portfolio' it is incurred in relation to the management of income-producing investments, has an intrinsic revenue character and is therefore deductible.

Allowing initial fees to be tax deductible would considerably assist consumer access to affordable financial advice. As it stands, the absence of a tax deduction for these fees discourages many Australians from pursuing important strategic advice which will assist in their organisation of finances and financial independence. Increased financial independence will reduce demands on public funding.

The tax deductibility of initial financial plans would encourage larger numbers of Australians to seek financial advice.

It is estimated that 20 per cent of Australians currently use a financial planner. Recent changes to acceptable remuneration arrangements for the financial advice sector as part of the FOFA reforms will see advisers move from a commission based to a fee for service remuneration regime. The imposition of a fee which is not tied to performance (viz: commission) but to service, exposes clients to risk and may reduce the numbers seeking the assistance of a qualified adviser.

Members of the professional accounting bodies are uniquely positioned to assist taxpayers in the organisation of their finances and to plan for retirement by providing independent and non-product specific advice when the new limited licensing regime commenced on 1 July 2013. Already more than 70 per cent of the population seeks the services of a tax agent for assistance. One of the policy intentions of FOFA is an improvement in consumer access to low cost, affordable financial advice and making the cost of advice deductible is consistent with this outcome. The new limited licensing regime provides an ideal opportunity for accountants to provide strategic non-product affordable financial advice to the community.

Tax deductibility carries a cost which will be significantly outweighed by the longer-term benefits of the assistance provided to taxpayers as they plan for independent retirement as well as improving financial literacy.

Recommendation 1.5 That the costs of financial planning advice fees be fully tax deductible to boost accessibility and affordability of financial advice.

1.6 Trustee resolutions

A trust compliance matter that has caused significant compliance issues to a large number of our members servicing SMEs is trustee resolutions. Since 30 June 2012, there has been a requirement for



trustees to complete trustee distribution resolutions by 30 June each year. This change was brought about by the ATO on 1 September 2011 when it withdrew its long standing practice of allowing trustees an additional two months to prepare trust distribution resolutions. This administrative practice had been in place since 1966. It recognised the practical difficulties faced by trustees and their advisors in making trustee resolutions prior to the end of the financial and income tax year ended 30 June.

The ATO acknowledged this administrative difficulty in paragraph 31 of IT 328 of the now withdrawn administrative statement:

"Where a trustee is carrying on a business, it will be impossible to determine the amount of the net income of the trust estate until after the close of the year of income."

In recognition of that practical difficulty, which still remains almost 50 years later, the ATO allowed trustees and their advisors a two month extension until 31 August to draft appropriate resolutions. This enabled trustees and their advisors to draft trustee resolutions using completed financial statements.

The withdrawal by the ATO of this administrative practice meant that for the income tax year ended 30 June 2012 and thereafter, all trustees were strictly required to ensure that these resolutions were made by 30 June each year.

The compliance issues this causes can be summarised as follows:

- this additional work of estimating 30 June balances is not otherwise required, if a trustee is
 able to prepare its distribution resolutions on actual finalised accounts for the income year;
- no incremental commercial benefit flows to trusts and their advisors from requiring trustees to make trustee resolutions earlier. The additional work is *purely* a compliance issue. The change in ATO practice, however, meant that a lot more work was required in order to reach that same outcome;
- this increased work load arose and will continue to arise at a particularly busy time for SME groups and their advisors as they are also required to prepare at this time Business Activity Statements, group certificates and payment summaries, WorkCover reconciliation documents, Tax File Number withholding reports, and alot more 30 June compliance related documentation:
- advisors had to perform this additional work with full knowledge that, in this current difficult
 economic climate, many SME clients could not, or would not; bear the additional cost caused
 by the change of ATO practice. As a result some, or all, of the related time cost would have to
 be written off thereby reducing their income; and
- all these compliance issues are likely to cause similar compliance problems annually and into the future.

Recommendation 1.6 The IPA requests that the Government implement a legislative amendment to restore the previous position which existed prior to the change in ATO administrative practice. Proposed amendment:

- would be relatively simple to draft, and therefore could be enacted relatively quickly;
- aligns the treatment of the present entitlement rules with the provisions requiring resolutions making beneficiaries specifically entitled to capital gains to be completed by 31 August;
- is consistent with the extension of time provided to private companies. This rule recognises, and accommodates, the practical difficulties faced by SME companies in finalising financial statements before 30 June; and
- a sensible mid-point between the date of 31 October at which individual beneficiaries are required to lodge their income tax returns and the 30 June income tax year end.



1.7 Tax discount for interest income

The IPA has frequently advocated the concessionary treatment of interest income; the current tax treatment of which compares unfavourably with other forms of savings such as property and shares. A tax discount for interest income was planned to come into operation on 1 July 2013 in the form of 50 per cent discount for interest income capped to \$500. This initiative was abandoned before its introduction.

It is noted that an uncapped 40 per cent savings income discount was recommended by the Henry Review in order to remove the inequitable treatment of interest income and to improve incentives for national savings.

Recommendation 1.7: That the Government revisits the introduction of a taxation discount for interest income.

1.8 Alienation of personal services income

The rules surrounding the 'alienation of personal services income' (PSI) were introduced in July 2000; primarily to enable taxpayers to self assess as to whether they operate as a personal services business. Taxpayers unable to satisfy PSI rules would have their income attributed back irrespective of whether they operated through an interposed entity.

The rules were aimed at ensuring that PSI taxation applied equally regardless of the arrangements under which income is earned and that business deductions, income splitting and tax deferral are not available to entities not genuinely conducting a business enterprise.

Whilst we are supportive of the policy intent of the legislation, we believe the existing framework needs to be reviewed to provide more certainty, ease compliance and reduce complexity. The PSI rules are relevant for small businesses and therefore need to be clear, understandable and conducive to the average taxpayer being able to discharge their obligations with certainty. There is too much uncertainty as to the interpretation of key elements of the law.

The use of interposed entities is often a legitimate commercial means by which contractual arrangements can be satisfied. It should not be viewed prima facie as an attempt to engage in income splitting and/or tax deferral.

The following aspects should be further considered:

- Simplify key elements of the law: Too much uncertainty with respect to interpretation of key
 elements of the law which make compliance difficult. Individuals who endeavour to comply
 with the existing rules face difficulties interpreting terms such as the 'results' test in order to
 determine compliance.
- Complex attribution rules and PAYG withholding obligations: Although the ATO has in place a Practice Statement containing simplified methods to address PAYG compliance, there is still room for streamlining. Reviews into the current system have shown low levels of compliance with existing PSI rules; indicating a systemic issue with legislation. The contractor reporting rules which came into operation last financial year will target the construction industry before wider application. This initiative will highlight deficiencies within the system; particularly the widespread non-reporting of income. Contractors generally report their ABN to clients. However, clients are currently under no obligation to report the fee income paid during a year to the ATO.
- Payments to associates for non-principal work for entities that cannot prove they are personal services businesses: This is a harsh outcome when essential services are performed by an associate and would be otherwise fully deductible if paid to a third party. There needs to be scope for deductibility of legitimate costs subject to integrity measures which ensure charges are at arms length.
- Provide more certainty: This is especially relevant for taxpayers who pass the existing test and whether they are able to income split and/or defer tax by allowing income to be retained within



- the entity. There appears to be a lack of understanding regarding the interaction between the PSI rules and the general anti-avoidance provisions (of Part IVA).
- In certain circumstances and for commercial practices the rules are inflexible.
- The distinction between PSI and income generated from a business structure is becoming increasingly unclear and the current framework hinders differentiation.

To promote economic growth, Australia requires a tax system which is consistent, cognisant of commercial reality and encourages productivity. Accordingly our taxation system should acknowledge the real benefits of contracting arrangements. The Henry Review has called for a revision of the rules and an extension of the PSI scope to cover all entities earning a significant proportion of business income from the personal services of their owner/managers.

Recommendation 1.8: That the alienation of personal services income rules be reviewed to take into account modern work arrangements, low levels of compliance and uncertainty.

1.9 Federal, state and territory tax reform

The Government should work with the states and territories to increase the efficiency and harmonisation of state and territory tax structures.

The IPA suggests the following key reform measures:

- Continued reassessment and realignment of the allocation of responsibilities between Federal
 and state bureaucracies with the aim of improving accountability, efficiency and reduction in
 public sector waste.
- The most inefficient taxes levied by federal, state, territory and local governments should be removed. The Henry Review has already identified a large number of inefficient taxes levied across taxing jurisdictions and proposed alternative funding arrangements to recover lost state-based revenues. The Henry Review considers other efficient broad-based taxes but its terms of reference excluded increasing the scope and rate of GST. The exclusion of the GST represented a missed opportunity to tackle the big issues confronting our tax system. The IPA and others have reiterated this position on a number of occasions. Any serious overhaul of inefficient and market-distorting state taxes (such as stamp duties or insurance taxes) brings with it a need to replace foregone revenue. Given GST revenues are already passed to state governments pursuant to the 1998 inter-governmental agreement, and the fact that the GST is an inherently more efficient tax, it would be preferable to closely review the option of expanding the existing base of goods and services currently subject to the GST and to review the GST rate. Consumption taxes such as the GST have the compelling advantage of improving productivity by eliminating duplication, cutting waste and allowing states to retire inefficient taxes such as stamp duties and the like.

The IPA is encouraged by the ACT's progressive approach to the removal of inefficient taxes such as stamp duty on property conveyances and the duties on general insurance. It is noted that, as recommended in the Henry Review, the ACT will increase property rates to offset the fall in revenues.

Recommendation 1.9: That the Government increase efforts to assist the states and territories in achieving reform, including harmonisation of state and territory taxes.

1.10 Goods and Services Tax

GST Adjustment provisions

The GST adjustment provisions are intended to deal with changes in intended use (that is, changes in creditable purpose). GST registered entities are entitled to claim an input tax credit to the extent that an acquisition is made for a creditable purpose. If an acquisition was partly used for private purposes or input taxed activities, the extent of creditable purpose would be limited to the part used to make taxable or GST-free supplies only.



The GST provisions which deal with adjustments are contained in Divisions 129, 130, 131,132, 135 and 138. Most taxpayers fail to strictly comply with these provisions due to their complexity and inflexibility and they represent one of the most misunderstood aspects of the GST system.

Accordingly, a simpler mechanism which achieves the broad policy aim should be considered. Whilst the IPA recognises that the current adjustment system is theoretically more accurate, its complexity creates compliance difficulties. A simpler and more flexible mechanism is likely to achieve higher compliance. We would be prepared to consult with Government to consider various options to improve the provisions.

GST and the margin scheme

Division 75 of the GST Act sets out special rules for real property that allow taxpayers an alternative means of calculating GST. The policy intent behind the margin scheme is to ensure that GST is payable only on the incremental value added to land by each registered entity in a series of transactions after the land enters the GST system.

The policy objective of the margin scheme is to achieve three outcomes:

- 1. to exclude pre 1 July 2000 value from the taxable value of land;
- 2. to exclude post 1 July 2000 value added other than through a GST-registered enterprise from the tax base; and
- 3. to ensure that each supplier pays GST only on the value added by that supplier.

Unfortunately, the margin scheme currently fails to achieve policy objectives due to shortcomings in design. We acknowledge the significant challenges in a GST context in trying to devise a system that achieves policy objectives. This is due in part to the complexity that is common in property transactions as well as having to deal with conceptual differences between the legal definition of real property and its tangible attributes. The current margin scheme provisions result in complexity, uncertain outcomes and significant compliance costs.

We acknowledge that the margin scheme represents a departure from the basic rules of GST law and therefore involves an additional level of complexity such as the need to obtain valuations of real property or to identify that the vendor is eligible to sell using the margin scheme.

Unfortunately, tinkering with the margin scheme legislation; designed to protect its integrity and system design, has resulted in unintended consequences which undermine the original policy objectives.

Examples of unintended consequences include:

- Application of GST to value added since 1 July 2000 that was not in the course of a GSTregistered enterprise.
- The application of GST on value added since the entity acquired the property and not on the value at the date of effect of its registration or the date on which the land was 'ventured' into an enterprise.
- Having to look back at the treatment of past transactions by external unrelated parties to
 determine eligibility to use the margin scheme can be extremely difficult to achieve. A system
 that requires tracing will inevitably create ongoing technical and practical application
 difficulties as well as costly compliance.

The retention of the current margin scheme design approach will not in our opinion alleviate the scheme's shortcomings.

The replacement of the margin scheme with a simpler, more efficient model better able to deal with many of the fundamental challenges is preferred.

There are alternative policy models for the GST treatment of property such as the notional input tax credit regime which warrants consideration.



We urge the Government to seriously consider reform in this area.

Recommendation 1.10: That the margin scheme provisions should be replaced with a simpler and more streamlined alternative policy model that achieves broad policy aims.

2.0 Superannuation and Financial Services

2.1 Increase in annual concessional contributions cap

The IPA believes the current concessional contributions cap of \$25,000 (or \$35,000 for certain members) requires increasing. Particularly for those aged 50 or older who have finished paying off mortgages and supporting children, and who are now nearing retirement, it is important for legislation to assist those in this age group to increase their superannuation balances.

Accordingly, superannuation policy for those aged over 50 years should be based on providing capacity for additional contributions, while protecting against any abuse. Higher concessional caps would allow this group to make more adequate preparations for retirement in the final years of employment. The IPA believes the annual concessional contribution cap for those aged between 50 and 60 years should be raised to \$50,000, and to \$75,000 per annum for those aged over 60 years.

It is acknowledged there will be an immediate cost to government of increasing the concessional cap, and in this fiscally constrained environment this may be a bold suggestion. However, the lost revenue will be offset in future years in the following manner:

(a) Reduced cost of government aged pensions

According to the Australian Bureau of Statistics (ABS), the median superannuation balances of Australians aged between 55 and 64 is \$90,000 for men and \$60,000 for women. The average retirement age for men and women is 63 and 59 years respectively and the average life expectancy is 79 for men and 84 years for women. Based on current figures, the average retired couple will need to fund their retirement for around 16 to 20 years on just \$11,500 per annum.

Moving forward, according to ABS statistics, the life expectancy for men and women in 2061 will be 92 and 97 respectively. Furthermore, whereas in 2012 approximately 15 per cent or 3.2 million Australians are aged 65 or over, in 2061 the ABS predicts this figure to be 31 per cent or 9 to 11 million Australians. Therefore, by 2061 not only will the number of Australians relying on the government pension triple, the number of years Australians will be reliant on government pensions will nearly double.

Policy designed to increase Australians' superannuation balances will therefore reduce the number of people reliant on government benefits in the future, thereby offsetting the short term loss in revenue that would result from increasing the concessional contributions caps.

(b) Stimulation of the economy

An additional benefit of increasing members' superannuation balances is the multiplier effect on the economy. That is, the more disposable income available to superannuants, the more they will spend in retirement, leading to more GST and tax revenue the government will collect.

(c) Replacing government spending on long term infrastructure with private funding

If more money is put into the superannuation system, the greater the possibility that large scale infrastructure projects can be funded by the private sector, thereby decreasing the amount of government spending. The increase in GST and taxation income generated from this increased spending, as mentioned previously, will offset the short term lost income arising from the increase in concessional contributions caps.



Recommendation 2.1: That the annual concessional contribution caps be amended as follows:

For those aged 50 to 60 years: \$50,000
For those aged over 60 years: \$75,000

2.2 Introduction of the Low Income Superannuation Contributions payment (LISC)

A result of recent taxation changes ensures that those earning less than the tax free threshold of \$18,200 will now pay more tax inside super than outside. Furthermore, those earning between the tax free threshold and \$37,000 will be taxed at just 19 per cent, only marginally better than the tax payable by their super fund. The incentive for this group to contribute extra into super is therefore diminished. Considering there are approximately 3.6 million Australians who fall into this income category, if policy is not developed to incentivise this group to contribute more superannuation, the number of Australians reliant on government assistance in retirement is likely to increase in future years.

Whilst increasing the concessional contributions caps will assist those in the middle to upper income categories, it is Australians in the lower to middle income groups that need assistance in providing for their retirement.

There are two particular government initiatives that currently exist, or are proposed, to provide assistance to this group of Australians. Firstly, there is the government co-contributions scheme which until the 2008-09 financial year provided up to \$1,500 in assistance to low income earners making additional superannuation contributions. This amount has since been reduced to \$500. The second initiative is the proposed low income superannuation contribution (LISC) payment of \$500 which was linked to the MRRT, which the Government intends to repeal.

Whilst the IPA understands that from a policy perspective, the LISC is likely to be abandoned, from a fairness and equity point of view this policy should still be considered with alternative funding mechanisms, such as those contained within this submission, to be considered. In addition to, or as an alternative to the LISC, the IPA would like to see the Government consider increasing the co-contribution amount to the former level of \$1,500. It is estimated that an additional contribution of \$500 per year for someone currently aged 25 years is likely to lead to an increased superannuation balance at age 65 of approximately \$140,000, hence the reason the IPA believes in the importance of such a policy.

Recommendation 2.2: Introduce the Low Income Superannuation Contributions (LISC) payment or increase the government co-contribution to past levels.

2.3 Remove the 10 per cent work test requirement for making concessional contributions

The IPA does not believe there to be any valid reason for the restriction on members making personal concessional contributions if the member earns more than 10 per cent of his or her income from employment services or any of the services listed in subdivision 290-C of the ITAA 1997.

It is felt this prohibition is inequitable for a number of Australians. For example, those who may have investments that provide passive income and also work part-time to supplement the passive income will be limited to the superannuation contributions made by their employer. To put this inequity into perspective, the maximum concessional superannuation contribution a part-time worker earning \$15,000 from employment services who also owns an investment property valued at \$350,000 producing a net return of \$10,000 will be \$15,000 if he or she salary sacrifices their entire employment income. However a worker earning \$25,000 from employment services could make \$25,000 worth of concessional contributions into his or her superannuation fund.



The IPA believes the source of the concessional contribution should not matter and that this particular item of legislation should be repealed. It is felt that Australians should be subject to a concessional contributions cap that does not discriminate against the source of the contribution.

Recommendation 2.3: Repeal legislation that prohibits a personal concessional member contribution where the member earns more than 10 per cent of their income from employment services.

2.4 Remove the work test for making contributions for those aged 65 or over

If the Government is serious about encouraging Australians to increase their superannuation balances, it seems counter productive to have legislation that prohibits anyone from making superannuation contributions after they turn 65 if they are no longer gainfully employed on at least a part-time basis.

The IPA sees no valid reason for such legislation and believes the legislation should be amended to allow Australians to contribute to their superannuation fund irrespective of whether they are gainfully employed and irrespective of their age. Changes to existing legislation should be considered that would allow Australians aged 65 or over and not working to contribute to super in situations that they are currently unable to do so. Some situations whereby those not gainfully employed may find themselves with money or assets to contribute to their fund include:

- (a) when those aged over 65 sell their homes in the course of downsizing and may have additional money that could be contributed to superannuation;
- (b) many aged 65 or over with assets such as property or other assets that provide insufficient income may liquidate such assets to invest in more liquid assets that produce a greater income stream needed for retirement:
- (c) those aged 65 or over receiving passive income from investments may be in a position to contribute to superannuation; and
- (d) where a widow or widower inherits money from his or her spouse's estate upon his or her death.

Note the above is not an exhaustive list of examples whereby a member currently aged 65 or over and not working would benefit from a change in legislation.

Recommendation 2.4: Repeal the relevant legislation that prohibits contributions to a superannuation fund by Australians aged 65 or over if not gainfully employed on at least a part- time basis.

2.5 Introduction of a life-time concessional contributions cap

The IPA believes the current 'flat' contributions caps provide an inefficient mechanism for making contributions to a member's superannuation fund and may lead to years of wasted opportunity to contribute to superannuation.

For instance, there will be times in a person's life when they are better placed financially to make larger contributions to super than other times. For example, when it comes to parents that have taken a number of years out of the work force to give birth to and raise children, these parents may not be able to take advantage of the concessional contributions cap of \$25,000 for the years they are not working.

Another example is found in the fact that a concessional contribution cap of \$25,000 for a 21 year old, or most parents baring the cost of raising a family, is not likely to be taken advantage of. In most



instances, it is not until Australians have paid off their mortgages and their children have left home that they are in a position to contribute up to their concessional contributions caps.

Policy should therefore be considered that will address this inefficiency with regard to superannuation contributions.

One option may be the provision of credit for those lost years which could then be applied against the concessional caps when there is a return to employment by parents taking time out of work to raise children, or others are better placed to take advantage of their contributions cap. In this way, lost "entitlements" could be retrieved. The adoption of a lifetime cap would assist in this regard.

Another option may be to allow a working spouse/ partner to nominate an amount of their own superannuation for transfer into the superannuation account of the non-earning partner.

Recommendation 2.5: The development of superannuation policy which provides a 'life-time concessional contributions cap' to make the contributions regime more efficient.

Recommendation 2.5.1: The development of superannuation policy which provides for a spouse to make concessional contributions on behalf of the member.

2.6 Encourage members to take benefits as a pension rather than lump sum

Whilst extensive legislation exists to regulate how much, and the manner in which Australians contribute to superannuation, limited legislation exists relating to how Australians withdraw their superannuation once they have retired or reached 65 years of age. Accordingly, Australians are free to do as they please with their superannuation upon meeting certain conditions of release. ABS data from 2007 shows around 60 per cent of retirees take either a partial or total lump sum. Of this group only 40 per cent invested in a pension product (an annuity or life pension) or an income earning product (bank account). Around a third of all retirees used the lump sum to pay off a mortgage, while 16 per cent of males purchased a new car.

It is the Institute's view that the use of retirement funds in this manner is not always appropriate and does little to diminish the future pension burden faced by a shrinking workforce and aging population.

The IPA supports choice in superannuation decision making, but also believes there needs to be suitable incentives which encourage retirees to invest in pension and annuity products. Annuities will generally better provide for the longer term needs of retirees and protect against cost of living risks. Annuities are also clearly more closely aligned with the policy intentions of the superannuation system.

Consistent with the findings and reform proposals of the Henry Review, the IPA recommends amendments to taxation and superannuation laws to encourage the development and uptake of annuity products, but not to make it compulsory.

The IPA also recommends the age threshold of 60, whereby any lump sum withdrawn by those aged less than 60 is tax free up to a cap, which is currently \$180,000, be removed. In other words, any lump sum in excess of a member's life time low rate cap, irrespective of their age, will be taxed at the same rate as anyone under age 60 which is currently 16.5 per cent.

As those taking a transition to retirement income stream (TRIS) are subject to maximum draw down amounts, the IPA believes legislation should be introduced to apply a maximum draw down amount to all pensions, with any excess withdrawals taxed at 16.5 per cent. As there is currently no limit on how much can be withdrawn by those receiving a pension, in the absence of a maximum pension



drawdown, any legislation to tax lump sums in excess of a low rate cap could be circumvented with members withdrawing the entire superannuation balance as a pension.

Recommendation 2.6: That the recommendations in the Henry Review in relation to annuity and deferred annuity products be adopted to encourage the use of annuity and other life pension products upon retirement.

Recommendation 2.6.1: That retirees be permitted to take a tax free lump sum up to their low rate cap, irrespective of their age.

Recommendation 2.6.2: That hardship provisions permit qualifying retirees to draw a larger tax free lump sum where hardship can be demonstrated.

Recommendation 2.6.3: That the minimum draw down factors for those receiving a superannuation pension be reduced. Since the requirement to withdraw a minimum pension amount was introduced in 2007, in the majority of these years drawdown relief has been afforded to pensioners, thereby reducing the minimum amount a pensioner must withdraw.

These recommendations expose the government to minimal incremental costs which would be needed to implement reforms and provide public education around the changes.

However savings could be substantial. With reference to 2007 aggregates; around 70 per cent of fund members were in a default super fund. Of this group, half had drawn more than 25 per cent of their balance as a lump sum. In so doing, this group were more likely to move to a government pension early in retirement. Measures which encourage default fund (such as MySuper) account holders into annuity and life pension products are, we believe, likely to lead to significant pension savings.

2.7 Removal of the requirement for a bare trust for acquisitions using a limited recourse borrowing arrangement (LRBA)

One of the key considerations when a superannuation fund borrows to acquire a single acquirable asset (SAA) under a LRBA is that the lender does not have recourse to the other assets of the superannuation fund. This, along with the desire to be in line with instalment warrant arrangements that the larger superannuation funds traditionally invested in was the reason for borrowing legislation to include the requirement to hold the SAA in a bare trust.

Not only does the IPA believe a bare trust to be unnecessary, it also believes that the requirement for a bare trust under these arrangements creates complexity and significant costs and therefore legislation should be amended to remove this requirement. Provided the loan documentation prohibits recourse of the lender to the SAA acquired under a LRBA, the objective of protecting the fund's other assets can still be achieved with significantly less complexity and cost.

Support for this recommendation can be found in the fact that since legislation was passed to allow such borrowing arrangements, the ATO has been required to issue a number of publications and pronouncements to clarify the Commissioner's position on the application of the LRBA legislation. Additionally, one only needs to speak with a variety of SMSF lawyers who will all highlight how technically complex this legislation is with many providing a different opinion on the application of the LRBA legislation.

Recommendation 2.7: That legislation relating to LRBAs be amended to remove the requirement for the single acquirable asset to be held on trust so the superannuation fund trustee obtains a beneficial interest.



2.8 Small business superannuation compliance

Small business, as with large business, has a plethora of reporting obligations. However, unlike large business which is usually better resourced to deal with the multitude of reporting requirements, the cost of compliance for small business is disproportionately higher.

The IPA therefore welcomes the Government's commitment to reduce the compliance burden on small business. As it relates to superannuation payments on behalf of employees, the IPA believes that small business compliance costs will be reduced if they no longer administer superannuation payments on behalf of employees. And whilst it commends the introduction of the small business superannuation clearing house, the IPA believes this could be further enhanced to benefit small business through the following recommendations.

Firstly, whilst acknowledging the efforts of the Department of Human Services, the IPA believes the ATO is the more logical department to handle superannuation payments made via the small business superannuation clearing house as superannuation payments align more closely with the ATO.

Secondly, we feel the threshold of 19 staff to be eligible to use the clearing house should be increased to 100 staff to help more businesses reduce their compliance costs.

And finally, the IPA contends that a single payment to the ATO on behalf of employees, comprising income tax and the superannuation contribution would ensure that employee's Superannuation Guarantee (SG) is paid in a timely manner. We believe one option to achieve this objective would be to have the SG payment made with and attached to the quarterly Business Activity Statement.

Recommendation 2.8: The small business superannuation clearing house should be brought under the jurisdiction of the ATO.

Recommendation 2.8.1: The threshold with regard to staff numbers eligible to use the small business superannuation clearing house should be increased from 19 to 100.

Recommendation 2.8.2: Another reporting option should be incorporated into the quarterly BAS to allow superannuation payments to be made to the ATO so it can pay into members' superannuation funds.

3.0 Access to Small Business Finance in Australia

The IPA has partnered with Deakin University to form the SME IPA-Deakin Research Centre. The Centre has been undertaking research into "SME finance – funding growth and impediments to growth". As the first part of this research, the Centre has been examining the sources of financing for small business. We have been provided with a brief excerpt of some of the preliminary findings of an extensive literature search on the sources of small business finance reported in the practitioner and academic journals undertaken by the Centre. A synthesis of the literature is currently being undertaken and a report is being compiled for the IPA and will be submitted at the end of April 2014.

Table 1 Actual Sources of External finance 2013

	2005	2009	2010	2011	2012	2013
Bank	85%	54%	50%	55%	54%	65%
Personal resources	-	38	41	45	53	28
Non-Bank financial institutions	30%	7	4	13	9	10
Friends or family	8%	25	18	27	24	13
An investor	6%	-	-	-	-	13
Others	4%	7	7	3	2	4
A sale of assets	-	13	13	20	22	-
Don't know	-	7	7	0	1	-

Source: Compiled from CPA Australia Asia Pacific Small Business Survey (2012) and ABS longitudinal database



Table 2 Most likely Sources of External finance to be targeted in the following year

	2009	2010	2011	2012	2013	2014
Bank	61%	64%	60%	60%	64%	61%
Personal resources	34	32	35	35	45	12
Non-Bank financial institutions	16	-	19	19	17	7
Friends or family	18	15	18	18	16	4
An investor	-	-	-	-	-	10
Others	4	14	2	2	9	3
A sale of assets	19	6	22	22	14	•
Don't know	3	4	4	4		3

Source: Compiled from CPA Australia Asia Pacific Small Business Survey (2012) and ABS longitudinal database

Table 3 Forms of Financing

	2009	2010	2011	2012	2013
Credit cards	61.8%	62.6%	66%	73%	71%
Bank Loan (secured)	-	33.1	41	41	-
Overdrafts	33.3	29.5	34	40	28%
Leasing	30	22.5	28	36	35%
Loan or equity injection from family or friend	-	17.6	24	23	ı
Hire purchase	21.6	17.1	19	24	ı
Bank loan (unsecured)	-	12.2	17	17	ı
Chattel mortgage	-	8.1	12	20	ı
Vendor financing	8.2	4.7	6	8	ı
Debtor financing	3.7	3.3	7	3	ı
Inventory financing	1.4	2.7	6	1	ı
International trade financing	2.9	1.6	5	2	ı
Other	5.9	2.5	2	2	
None	23.3	20.5	18	13	-

Source: Compiled from CPA Australia Asia Pacific Small Business Survey (2012)

Table 4 Sources of External Equity Finance by Firm Age in 2005

Table 4 Sources of External Equity i			1 1116	IIICC I	<i>J</i> y 1 11	III Ay	C 111 4	2003		
	0	to	5	5	to	10	10	to	20	20+ years
	yea	ars		yea	ars		year	S		
Existing owner	389	%		96	%		95%)		76%
Friends and family	60			13			9			20
Other individuals	23			9			5			4
Other business venture/private	18			11	<u> </u>		2			5
equity										

Source: ABS longitudinal database

Table 5 Expected Demand for Finance in 2014

	2009	2010	2011	2013	2014	
Yes, definitely	5%	7%	9%	9%	8%	
Yes, possibly	27	26	36	32	33	
No	60	57	42	49	49	
Don't know	8	10	12	10	10	

Source: Compiled from CPA Australia Small Business Survey (2012)



Table 6 Sources of advice on Business financing

	2010	2011	2012	2013
Bank	50%	43	34%	38%
Friends/Family	15	21	15	15
Financial adviser/broker	28	33	29	25
External accountant	47	39	54	38
A mentor	9	12	12	11
Non-bank financial institute	10	16	11	8
None	9	8	9	7
Others	4	1	6	2

Source: Compiled from CPA Australia Asia Pacific Small Business Survey (2012)

Summary of Tables 1-6: Trend in sources of small business finance in Australia

- Banks are the key stable sources of finance. Both secured and unsecured bank loans are one of the key stable sources (Table 1, 2 and 3). Senate Economics Committee Inquiry into Access of Small Business to Finance's Report 2011 suggests that external financing sources (both personal and business lending products) for smaller loans (under \$500,000) have declined since GFC for agricultural, manufacturing and financial sectors. Also, the lending conditions have become stricter than prior to the GFC. Moreover, lending is predominately secured lending against a tangible asset accompanied with personal guarantees and for an existing loan, banks require additional security (CPA, SME access to finance: recent experiences of SMEs in accessing finance, May 2012).
- Table 3 indicates that although a number of business lending products are available for SMEs, small businesses (an estimated two million small businesses in Australia) mainly use credit cards followed by secured bank loans and overdrafts (Council of Small Business Associations of Australia COSBOA, 2013). An increasing trend for hire purchase and leasing (Table 3) is also observed. A lender may be able to provide a borrower with relatively cheap funding through a lease if the lender is better able to use the tax deductions allowed for depreciation of the collateral asset, and if bankruptcy costs are high. The ABS Business Longitudinal Database shows that larger businesses tend to make more use of leases than smaller businesses (Mati, Gorajek and Stewart 2012).
- Personal and friends/family as sources of finance are a declining trend (Table 1 and 2), however friends and family contribute more for start-up companies (Table 4) than mature companies.
- Investors (ie business angels) are setting a new trend.
- Table 5 refers to the CPA Australia Small Business Survey in which businesses were asked whether they will seek external funds in the next 12 months. Almost 50 percent of respondents replied in the negative, while 10 percent of the respondents do not have any idea about their financing demand.
- There is a declining trend in taking advice from banks and relying on other sources of finance. Businesses access banks and finance companies via finance brokers (Table 6), however intervention by brokers in such processes significantly increase the cost of borrowing (Mati, Gorajek and Stewart 2012).

Other relevant information on funding of small businesses

Forty nine per cent of the small businesses (there are around two million small businesses in Australia) in Australia have a business lending product other than a credit card. If credit cards are *included* as a source of lending for small businesses, the proportion of small businesses who have a business lending product (which may include a credit card) rises to 71 per cent or 1.42 million small businesses. If credit cards are excluded then 51 per cent of small businesses have *no lending product*.



If credit cards are included as a lending product then 29 per cent (about 585,000 small businesses) of small businesses do not have a lending product.

The CPA Australia survey (2012) shows that there is a shift from using funding for *survival* to using funding for *growth* as well as decrease in loan demand. Only 25 per cent of small business owners reported needing additional funding to support their businesses. The main reasons for requiring additional funding are to *cover increasing expenses*, to *fund business growth* and for *business survival*. The CPA survey also indicates that of those businesses requiring additional funding, 50 per cent obtained all or part of their additional funding from a bank in 2010, compared with 54 per cent in 2009, and 68 per cent in 2007-08.

Bank and non-bank sources of SME financing

Of the two million small businesses in Australia:

- 1. 1.3 million or 63.4 per cent use a bank only for their business lending products (including credit cards);
- 2. 46,000 or 2.3 per cent use a non-bank only:
- 3. 96,850 or 4.9 per cent use both a bank and non-bank; and
- 4. 584,000 or 29.4 per cent do not have any business lending products.

For those small businesses that have a business loan product (including a credit card), 90 per cent are with a *bank only*, accounting for 89 per cent of loans outstanding. For the 3 per cent of small businesses who use a non-bank only, these account for 1 per cent of loans outstanding.

Use of personal lending products for business purposes

The survey by COSBOA (Small Businesses-Access to Finance, 2013) suggests that only 7 per cent of small businesses use a personal lending product for their business (excluding credit cards). If credit cards are included, this increases to 20 per cent.

In terms of the estimated number of small businesses who use a personal lending product for business purposes, this is 387,200 if credit cards are included or 137,000 if credit cards are excluded.

Below are the top five personal lending products used by small businesses excluding credit cards:

Personal lending products used	Number (Estimated)
Line of credit	67,515
Property mortgage	29,644
Overdraft	27,800
Other long-term loan (12motnsh or longer)	15,886
Short-term loan (less than 12 months)	1,986

Source: COSBOA (2013)

The full report will be released by the IPA Deakin Research Centre at the end of April 2014.

Recommendation 3.1: That small business financing be reviewed with policy developed to remove impediments.



4.0 Standard Business Reporting

The IPA is a strong supporter of the Government's initiative to streamline reporting and lodgement using Standard Business Reporting (SBR). SBR and its integrated approach to the lodgement of information with government departments, regulators and government agencies are gradually being adopted by accountants and their clients.

Greater awareness is still required and despite efforts by Treasury, government and stakeholders such as the IPA, it is obvious that much more needs to be done to raise awareness among businesses, accountants and the public.

The IPA continues to encourage members to be proactive and use SBR enabled software and SBR technology. We also encourage awareness raising with clients of the benefits of SBR.

IPA members have indicated they are prepared to move to SBR if their chosen software vendor provides SBR enabled software. We believe the lack of SBR enabled software, to date, has hindered the rate of adoption. This is expected to change as more SBR enabled software is released by the major providers.

Internationally, more countries are adopting SBR/XBRL including the adoption of a SBR/XBRL taxonomy in International Financial Reporting Standards. The International Federation of Accountants is a strong supporter of SBR/XBRL and has released a joint report: *Leveraging XBRL for Value in Organizations* which promotes the benefits of SBR/XBRL.

The IPA continues to strongly urge successive governments to maintain adequate funding for the SBR initiative in order to realize its significant benefits to the economy including small business.

We believe that technology enabled efficiencies will allow small business and consumers to deal with financial regulation and to better understand and implement financial system reforms.

Recommendation 4.1: That the Government be encouraged to maintain funding for the SBR program to ensure benefits are realised; and more be done to promote its benefits.



APPENDIX TO RECOMMENDATION 2.6

Rationale and discussion paper: Soft compulsion for purchase of annuity and pension products by retirees

The IPA believes MySuper account holders should be encouraged to invest the majority of their retirement benefits into an annuity or another similar pension product.

The IPA believes that:

- this better reflects the underlying intention of a robust superannuation scheme; being the promotion of financial independence for retirees and reduced reliance on the State;
- this is consistent with compulsion which currently underpins the MySuper system; and
- Soft-compulsion will ultimately promote better member outcomes and is, therefore, better public policy.

Superannuation system rationale

The primary purpose of any superannuation system is not the accumulation of funds but the provision of retirement incomes and long term reduced retiree reliance on government financial support.

This purpose was formally acknowledged in the Super System Review – Final Report "...the retirement phase of a person's participation in the superannuation system **is the key purpose** [emphasis added] for the accumulation of superannuation savings."

It is accordingly incongruous that the current superannuation system is largely focused on the accumulation phase with very little policy addressing the retirement or benefit phase.

A key driver behind the establishment of the superannuation system was recognition that an ageing population would place significant financial stress on Federal governments in the near future.

The *Intergenerational Report* of 2010 forecasted that by 2030 the costs of the government age pension and health care for the elderly would push governments into fiscal deficit. As a proportion of Australian GDP; health care, aged care and pensions will increase from 8 per cent in 2010 to 13 per cent in 2030. The government share of GDP was expected to rise from 22.4 per cent in fiscal 2016 to 27.1 per cent in 2049/50.

Furthermore, the number of people employed to those not working is expected to fall from around 5 to 1 today to 2.7 to 1 by 2050. These figures at their most basic point to increased reliance on welfare; funded by a proportionately declining working age population shrinking workface and relative falling taxation base.

If we accept that the principal policy intent of superannuation is to reduce the future costs of government funded pensions, it must also be accepted that current governments must develop policies which will ensure that when retirement is reached; monies have been wisely invested to ensure that adequate funds are available to at the very least defer demands on the public purse. We do not believe that current policy does this.

We believe the current tax free status of superannuation benefits and the ability of retirees to draw down the full amount as a lump sum and without restriction as to use; severely undermine the underlying policy intent of superannuation.

The IPA therefore argues that policies need to be adopted that encourage retirees to take annuity or pension products upon retirement.

The fiscal gap caused by an ageing population can be ameliorated by appropriate government policy. This can be shown by changes in the projected fiscal gap between the 2007 *Intergenerational Report* and those projected in the 2010 *Intergenerational Report*. In the 2007 report the fiscal deficit was



projected to commence in 2025, five years earlier than the 2010 report. The major reason for this change was changes to superannuation policies between 2007 and 2010.

We are of the view that the fiscal impact of an ageing population can be further ameliorated by ensuring that a large cohort of the retiring population are encouraged or incentivised to draw an annuity or other pension product.

Soft-compulsion

Compulsion is a fundamental facet of Australia's superannuation system. It is recognised that while people accept the need for retirement savings, many would not do so voluntarily without compulsion. Without compulsion people would likely under-invest in their retirement futures.

The Australian government recognised this earlier than many other jurisdictions. Accordingly, since 1992 contributions towards superannuation have been compulsory. Since that time, minimum required contributions have risen from 4 per cent to 9 per cent and will eventually reach 12 per cent from 1 July 2019.

The government has also determined that there needs to be greater compulsion for those it has designated as the disengaged; being those who place their superannuation into a default superannuation option. The government has recognised that those in the default system tend to be disengaged from superannuation and often have little financial literacy. These people would rather leave things to "the experts".

To further protect those who make no choice in superannuation and who find themselves in so called "default funds", the government limited these default funds to those that have low fees and without commission. These are the MySuper funds.

Many commentators have consistently questioned why compulsion is required in the accumulation phase but not in the more important retirement or benefit phase.

The arguments in favour of compulsion in the accumulation phase are principally that the majority of people are not sufficiently financially literate to make informed choices and that compulsion protects their interests; apply equally in the retirement or benefits phases.

The IPA though prefers adopting 'soft compulsion' over strict compulsion. The reason for this is that while it encourages particular behaviour it allows for freedom of choice by those with the capacity to make their own decisions.

By soft-compulsion in this context we are talking about adopting measures that promote particular behaviour and discourage other activities without being strictly compulsory.

Soft-compulsion will ensure that people make appropriate investment decisions. The IPA strongly believes this is necessary in relation to retirement planning for MySuper account holders. Their lower level of financial literacy and disengagement from superannuation (and investment generally) indicates they would benefit from limiting their choices when it comes to investing for their best retirement outcomes. Accordingly, the IPA believes that MySuper account holders must be encouraged to put a majority of balances in retirement into an annuity or other pension product.

Best interests of account holders

The IPA argues that the best interest for MySuper account holders is for them to invest in annuity and pension products that will provide financial security in their retirement.

While most economic theories contend that people act in their own best interest, this is often not the case. The notion of best interest must also be considered in relation to time frames; meaning that whilst the immediate drawing of a lump sum may be in the short term best interest of a retiree (a holiday or home payments); in the medium to longer term this may not be the best outcome. It is not



clear that the vast majority of MySuper account holder retirees will make decisions which are cognizant of these longer term issues.

The Australian Bureau of Statistics "Survey of Employment Arrangements, Retirement and Superannuation" indicate that many retirees are not putting their money to the best long term use. Almost 60 per cent of those who had access to superannuation in retirement had taken either all or part of their superannuation as a lump sum. Of these, just over 20 per cent invested some or all of this lump sum into a bank account, personal savings or other investment, while just fewer than 20 per cent invested in an annuity, approved deposit scheme or other superannuation product.

Further, 34 per cent of men and 27 per cent of women used money from a lump some payment to either pay off a mortgage or invest in a new home. Sixteen per cent of men used part or all of the lump sum to buy a new car and 13 per cent of both men and women used the lump sum to pay off debts (other than a mortgage).

Around 40 per cent of those who took a lump sum re-invested part or all of that money. More than 60 per cent had spent their lump sum on other than the intended purpose.

Conclusion

The superannuation system was designed to reduce reliance on government pensions and to encourage self-sufficiency in retirement. While compulsory contributions have increased the funds people have on retirement, the absence of compulsion in the retirement phase may result in suboptimal choices about how benefits should be used.

We suggest that the disengaged contributor and those in MySuper products should be encouraged through soft-compulsion to invest an appropriate minimum amount of their benefits into an annuity or other pension product.

This will result in better outcomes for those members and is in accord with the underlying intent of superannuation policy.



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