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Business Set-Up and Closure in Australia
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Dear Sir/ Madam

SUBJECT: BUSINESS SET-UP, TRANSFER AND CLOSURE ISSUES PAPER

CPA Australia represents the diverse interests of more than 150,000 members in 120 countries, including more than 25,000 members working in senior leadership positions. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders.

Against this background we provide this submission in response to the issues paper on business set-up, transfer and closure.

The growth of our economy, the strength of our public finances and the creation of new high paying jobs depends on the ability of Australian businesses to be more globally competitive. Accordingly, it is incumbent upon governments at all levels to create and build upon the policy foundations that will help to enable this happen.

Reducing the barriers and disincentives to business entry and making business transfer and closure easier is important to encouraging more Australians and foreign businesses to start a business in Australia. Increasing the number of businesses in Australia should have a long-term positive impact on the economy, jobs and innovation.

As an overarching comment, we believe that moving the tax system to a regime where business income is taxed on the same basis regardless of the legal entity through which the business is operated would do much to remove the taxation disincentives to establishing a business.

Alternatively, the Commission could explore the benefits of removing taxation disincentives to establishing and running a business in Australia. These include, but are not limited to, Australia's comparatively high corporate tax rate, uncertainty around the taxation treatment of trusts and the complexity in complying with Australia's tax laws especially under the private company loans rules and the tax consolidations regime. We make various recommendations on how these tax impediments can be ameliorated.

Regarding access to finance, CPA Australia's research shows that most Australian small businesses currently enjoy relatively easy access to finance. However, this is not to say there aren't some businesses experiencing difficulties accessing funds. For start-up businesses with limited histories, equity financing, whether from the personal resources of the business owners or investors, is often a more appropriate form of finance than debt financing. We therefore support current initiatives of the Government including reforms to allow easier access to crowd-sourced equity funding, proposed improvements to employee share schemes and removing unnecessary barriers to innovation in small business financing such as peer to peer lending.

We also suggest that improving access to the small business capital gains tax concessions through reforms to the \$6 million maximum net asset value test would reduce disincentives to business transfer and closure.

For insolvency arrangements, we believe that the fundamental principles of the current law ought to be preserved, however the punitive character of some aspects of corporate insolvency law warrant reconsideration and there is merit for exploring improved safe harbour arrangements in which more thorough regard can be applied to restructuring opportunities.

If you have any questions regarding this submission, please contact Gavan Ord, Manager, Business and Investment Policy

Yours faithfully

Paul Drum FCPA
Head of Policy

Encl.

Specific comments in response to the Issues Paper

Barriers to business set-up

Business structuring

When establishing a business, business owners need to consider whether they should run their business as a sole trader, through a partnership, a company, a discretionary trust, a unit trust, a hybrid trust or a mix of a number of these. The structure that best meets the needs of a business are determined by a wide range of factors including tax preferences, asset protection, the number of people involved in the business and the long-term objectives for the business. The importance of these factors varies depending on the particular circumstances of the taxpayer commencing business operations.

For many, the choice of which business structure best meets their needs can be bewildering and hence a possible disincentive to business set-up. For most, the best approach is to seek professional advice.

Our matrices in **Appendix A** show the main taxation treatments of different structures. The matrices clearly show that the choice of business structure can have significant tax consequences right from the point of establishment to the disposal of the business. Businesses can of course restructure if they so wish – however restructuring can be costly in terms of professional fees, disruption to the business and may trigger a capital gains tax event or a stamp duty liability.

As an overarching comment, we believe many taxation issues can be appropriately addressed by moving the tax system to a regime where business income is taxed on the same basis regardless of the legal entity through which the business is operated. Such an outcome should also provide trading entities with the option of accumulating after-tax profits which can be re-invested into working capital to improve their productivity and capacity to grow.

We appreciate that this and other suggestions may be more appropriately considered as part of the Government's Tax Reform White Paper process. However, what business really needs is action – and outcomes that will remove or reduce impediments to business growth and success.

Recommendation:

To help alleviate the tax issues associated with choice of business structure, the Productivity Commission consider the impacts of taxing business income on the same basis regardless of the legal entity through which the business is operated and that all such entities have the option of accumulating after-tax profits.

We acknowledge that such a change would require a paradigm shift in our collective view of the Australian income tax regime.

We therefore propose a range of alternate specific initiatives which in combination would alleviate much of the tax distortions associated with choice of business structure. Essentially, these changes seek to more closely align the income tax treatment of business income earned by the entity through which they operate.

Trusts

In recent years, our members and the broader community have faced substantial change and uncertainty concerning the taxation of trusts. The source of this change and uncertainty has come about from (among other things):

- judicial re-interpretation of the basic concepts of Division 6 of the Income Tax Assessment Act 1936 (e.g. the Bamford, Colonial First State and Greenhatch cases);
- hurriedly introduced legislative amendments (e.g. the 2011 trust streaming provisions); and
- the reversal of long-standing administrative practices (e.g. the revocation of Income Tax Rulings IT 328 and 329).

Given these landmark changes, CPA Australia proposed in its response to Treasury's options paper titled 'Modernising the taxation treatment of trust income' in February 2012 that a simplified taxation of trust regime could actually be achieved by developing separate rules for fixed trusts, non-fixed trusts carrying on investment and non-fixed trusts carrying on a business rather than trying to subject such differential trusts to a single set of rules.

Key features of such a regime would be as follows:

- the income of fixed trusts would be taxed on an attribution basis consistent with the re-designed rules applicable to managed investment trusts
- the default position would be that the taxable income of non-fixed trusts would be taxed to the beneficiaries of the trust provided it is distributed to them (including by being applied for their benefit or at their direction) before the date of lodgment of the trust's return for the relevant year. This model would apply a 'follow the money' principle which would tax the beneficiary to whom trust income is distributed. Where income is not distributed to beneficiaries by the required date it would be taxed to the trustee at the highest marginal rate. Under the flow through model, income would retain its character in the hands of the beneficiaries, including but not limited to capital gains and franked dividends. The benefit of the 50 per cent CGT discount and small business concessions would flow through to beneficiaries. This model would be most suitable and attractive for trusts that hold passive investments rather than carry on a business, and
- non-fixed trusts carrying on a business would be given the option of being treated as a company for all income tax purposes. Accordingly, the trustee of such a trading trust would only be assessed on taxable income at the company tax rate but income would not retain its character as is the case with non-fixed trading trusts who do not make such an election. Consequently, such a trust would also lose its ability to claim the 50 per cent CGT discount. This accumulations model will allow such business trusts to re-invest their after-tax profits into working capital thereby obviating the need for such trusts to make unpaid distributions to private company beneficiaries and the related Division 7A complexities.

Whilst it appears counter-intuitive to have a multi-tiered trusts regime, we believe that the development of the above three discrete sets of rules will be more commercially aligned with how the bulk of trusts actually operate and has the capacity to provide greater certainty and ensure that business trusts can effectively reinvest their own after-tax profits into their business.

Recommendation:

Consideration be given to replacing the current taxation of trust regime with a regime which:

- ***recognises taxable income derived by fixed trusts be taxed on an attribution basis***
- ***non-fixed trusts carrying on investment activities be treated as a flow through vehicle with beneficiaries assessed on a 'follow the money' principle***
- ***non-fixed trusts carrying on a business activity be given the option to be taxed as a company at the corporate tax rate thereby allowing the trustee to accumulate after-tax profits***

The need for a new business entity?

In addition, there may be merit in exploring the concept of introducing a US 'S corp' style entity as a vehicle through which a small to medium sized enterprise (SME) can carry on a business in Australia.

This potential reform has been raised on a number of occasions. We acknowledge that like all major reform options it is not without its issues including its application in tax laws, corporations law, insolvency law and other business law.

Notwithstanding these comments, we believe that the concept of an additional entity being made available for Australian businesses with features of income streaming, income retention and limited liability should be considered as part of the proposed forthcoming Tax White Paper tax reform process.

See **Appendix B** for a more detailed discussion of an 'S corp' style entity.

Recommendation:

The Productivity Commission explore the possibility of introducing an entity with features of income streaming, income retention and limited liability as a vehicle through which a SME can carry on a business in Australia.

Complexity in complying with the tax system

The complexity of Australia's tax law is evident in all market segments including small to medium sized enterprises grappling with the onerous burden of complying with Division 7A and our outmoded taxation of trusts regime to larger organisations trying to comply with the tax consolidations regime many facets of which are still being amended 13 years after its inception. This complexity can become a disincentive to establishing a business especially given the advisory and valuation costs incurred in electing to be part of the consolidations regime as well as on-going compliance costs.

In relations to the tax consolidations regime, we suggest that the Commission consider the merits of introducing a revised and simplified tax consolidations regime for SMEs as privately held groups often carry on business through multiple structures and the complexity of the existing tax consolidations regime (especially on entry in the system) is prohibitive.

Recommendation:

The Board consider the value of a revised and simplified tax consolidations regime for SMEs being introduced.

Perhaps the most profoundly complicated provisions impacting the SME sector is anti-avoidance rules (Division 7A ITAA 1936) that relate to certain private company loans, which broadly treat certain payments, loans and debt forgiveness by a private company to a shareholder (or an associate) as a deemed dividend.

We understand that the Board of Taxation has presented the Government with its Final Report concerning the post implementation review of the private company loan rules.

From our perspective the Second Discussion Paper issued by the Board as part of the post implementation review contained a raft of measures which would considerably simplify compliance with Division 7A without placing the revenue at material risk, and that this may be fertile ground to make real inroads in reducing SME red tape in the short term.

In particular, CPA Australia supports the proposed design features of the single 10 year complying loan exemption as detailed in Chapter 6 of the Second Discussion Paper as it will remove much of the complexity associated with the current differential rules applying to secured and unsecured loans. This measure would also strike an appropriate balance between ensuring that shareholders or associates repay private company loans over a reasonable period (regardless of whether the loans are secured or not) at an appropriate arm's length interest rate whilst providing some flexibility for interest and principal repayments over the loan term.

We also strongly support the proposed introduction of an irrevocable 'tick the box' election which will allow a trading trust to exclude loans (including unpaid present entitlements) from the scope of Division 7A as set out in Chapter 6 of the Second Discussion Paper. This initiative will allow trading trusts to reinvest their after-tax profits into their working capital thereby improving their self-sufficiency and productivity. As a corollary it will also significantly reduce compliance costs, and ensure that trusts used to carry on a business are not faced with the prospect of having to sell assets to fund the repayment of loan principal at the end of a loan term as may be the case in respect of unpaid entitlements under Practice Statement PSLA 2010/4.

Recommendation:

We recommend that the Government focus particular attention on considering and implementing the recommendations set out in the Board of Taxation's Final Report concerning its post implementation review of Division 7A.

The corporate tax rate

A significant barrier to business set-up in Australia is Australia's headline company tax rate.. Reducing the company tax rate is crucial in a global marketplace where many competitor jurisdictions have reduced their corporate tax rate in order to both retain business activity and attract new investment. In short, Australia's current corporate tax rate of 30 per cent is increasingly uncompetitive.

We therefore support the Government's proposal to cut the company tax rate to 28.5 per cent from 30 per cent effective from 1 July 2015 for all companies, regardless of size. As a corollary we do not support the proposed simultaneous introduction of a 1.5 per cent levy for companies whose taxable income exceeds \$5 million annually.

We also strongly contend that the company tax rate be further reduced, to 25 per cent in the short to medium term and lower again in the longer term. This is essential if we want to facilitate further capital inflows into Australia, improve our international competitiveness and encourage greater number of business set-ups through corporate structures.

Recommendations:

The Government reduce the company tax rate to 28.5 per cent from 30 per cent from 1 July 2015 for all companies and not proceed with the proposed simultaneous introduction of a 1.5 per cent levy for companies whose taxable income exceeds \$5 million annually.

Australia's corporate tax rate should be progressively reduced to a more internationally competitive rate of 25 per cent over the short to medium term, and a lower rate again over the long term.

Disincentives to foreign businesses investing in or establishing a business in Australia

Australia's income tax regime deters overseas firms establishing and investing in new businesses in Australia in numerous ways.

Some of these key factors include:

- Australia currently has an internationally uncompetitive 30 per cent company tax rate which from a purely income tax perspective makes Australia less attractive as a location to carry on a business or invest when compared to our major trading partners especially in the Asian region
- As a corollary Australia has a greater overall reliance on direct taxes (especially company tax) than our overseas competitors who have gradually increased reliance on consumption taxes. As a by-product this has led to increasingly complex income tax legislation which has added uncertainty, risk and cost particularly when compared to competitor jurisdictions in our region. That is, to plug growing revenue needs, the design and administration of the Australian income tax law has been made more complicated and less comprehensible which does not make Australia a user friendly place in which to do business
- Like most jurisdictions Australia is continuing to grapple with the impact of the digital economy and the erosion of the corporate tax base especially as our concept of permanent establishment is still based principally on physical locality. This has created uncertainty as to whether Australia should pursue further unilateral solutions such as the United Kingdom's proposed diverted profits tax or continue to mainly rely on the proposed multilateral solutions being progressed by the OECD
- The complexity of the tax laws and the plethora of related guidance products issued by the Australian Taxation Office
- Australia's dividend imputation system may be perceived as being an impediment in that a payment of 30 per cent company tax by an overseas resident in Australia only results in a 15 per cent dividend withholding tax exemption when fully franked dividends are repatriated by the locally owned affiliate to the foreign parent
- Australia does not typically offer the same level of tax incentives as many other competitor jurisdictions such as Singapore and the United Kingdom
- Varying commercial and taxation drivers may affect the choice of entity which a foreign resident may choose when investing or carrying on business in Australia. In particular, the differential treatment of business income derived by trading trusts and companies may result in some non-residents choosing trusts as a preferred vehicle in carrying on a business when in essence it would be more appropriate to use a company for those purposes. This is particularly important as a non-fixed trust is typically entitled to apply the 50 per cent capital gains tax discount in certain circumstances, potentially stream capital gains and franked dividends in certain situations and allow for some limited income splitting. By contrast a company does not offer any of these tax advantages but is also typically subject to a broader range of anti-avoidance provisions such as Division 7A, the debt and equity provisions under Division 974 and a raft of complex rules associated with dividend imputation. Conversely, companies offer some tax advantages which are not available using a trust such as access to the R&D tax incentive and a less convoluted loss recoupment regime including the availability of the same business test.

Recommendation

The Productivity Commission explore whether the competing tax preferences of particular entity types can be rationalised where practicable to make the choice of entity for foreign business less driven by tax issues.

Acquiring a business – earnout arrangements

As the ATO says on its web site ‘Earnout arrangements are often employed as a way of structuring the sale of a business to deal with uncertainty about its value. In an earnout arrangement, the proceeds for the sale of the business (or assets of the business) generally include a lump sum payment. However, the terms of the sale contract require either the buyer or the seller to make more payments that are contingent on the performance of the business.’

While earnout arrangements are fairly common, the taxation treatment of such arrangements has become increasingly complicated and uncertain. Greater clarity through more comprehensible information on the tax treatment of earnouts would remove a potential disincentive to disposal and acquisition of a business.

Recommendation:

The Productivity Commission recommend to the Australian Taxation Office that they significantly simplify the taxation treatment of earnout arrangements

Access to finance

CPA Australia is of the view that financing conditions for the SME sector have improved substantially in recent years. This is evidenced both in the responses to our annual survey of small business, as well as through our ongoing engagement with members working in and advising the sector.

Our 2014 small business survey found that of those businesses that required funds in the past 12 months, actual financing conditions were easier than expected. Nearly half of respondents stated that their experience accessing finance was easy or very easy and only 23 per cent stated that the experience was difficult or very difficult. In comparison to other markets in the region, Australian small businesses are enjoying some of the easiest financing conditions.

Ease or difficulty accessing finance

	Australia	Hong Kong	Singapore	Indonesia	Malaysia	New Zealand	Vietnam	China
Easy/very easy	48%	30%	31%	55%	32%	54%	40%	35%
Neither easy nor difficult	26%	28%	28%	25%	21%	21%	17%	15%
Difficult/very difficult	24%	41%	39%	20%	44%	25%	42%	50%
Don't know	2%	1%	2%	0%	2%	0%	0%	0%

The 2014 survey also showed that the 12 months to September 2014 was the easiest period for Australian small business to access finance since the survey began in 2009.

Interestingly, the age and the size of the small business had little impact on the experiences in accessing finance. That is, businesses that had been established less than five years had typically similar positive experiences accessing finances as more established businesses.

The relatively easy financing conditions have however not translated through to any significant increase in the demand for external finance by Australian small business with only 31 per cent of businesses requiring external funds in the 12 months to September 2014. The percentage of Australian small businesses seeking external finance has remained relatively constant over the past six years despite shifts in economic confidence, business conditions and significantly easier financing conditions.

The age of the business had little impact on demand for finance with businesses established less than five years only slightly less likely to have demanded finance over the past 12 months than more established businesses. However, the size of the business in terms of turnover and number of employees had a significant impact on demand for finance, with larger small businesses significantly more likely to demand finance than those with less than five staff or an annual turnover of less than \$200,000.

In terms of where Australian small businesses source their external finance, it should come as no surprise that banks are by far the most popular source of finance, followed by the personal resources of the small business owner. The popularity of banks as a source of finance significantly increases as the businesses become more established and as they take on employees. However regardless of the age of the business, banks are the most popular source of finance.

It is interesting to note that it is highly unlikely for Australian small businesses to source funding from a venture capital fund or angel financing, particularly in comparison to small businesses from Asia. It is also interesting that government grants are an insignificant source of finance for Australian small businesses, particularly in comparison to Singapore and Malaysia.

Sources of external funds – comparison across markets

	Australia	Hong Kong	Singapore	Indonesia	Malaysia	New Zealand	Vietnam	China
Bank	62%	61%	59%	64%	62%	68%	73%	60%
Friends or family	13%	16%	14%	11%	35%	12%	30%	40%
Your personal resources	29%	27%	25%	21%	36%	28%	18%	40%
Non-bank financial institution	8%	17%	15%	41%	21%	6%	14%	41%
An investor	13%	51%	29%	38%	41%	4%	45%	39%
Government grant	10%	20%	27%	6%	21%	8%	9%	9%
Venture capital fund/angel financing	3%	22%	23%	13%	29%	1%	13%	28%
Other (please specify)	1%	1%	3%	1%	0%	7%	0%	0%
Don't know	1%	0%	1%	0%	0%	0%	0%	0%

In short, most Australian small businesses are currently not experiencing any difficulty accessing finance if they are seeking finance. However, this is not to say that there aren't any businesses experiencing difficulties accessing finance.

For start-up businesses with limited histories, equity financing, whether from the personal resources of the business owners or investors is often a more appropriate form of finance than debt financing. We therefore support current initiatives of the government including reforms to allow easier access to crowd-sourced equity funding, proposed improvements to employee share schemes, and removing unnecessary barriers to innovation in small business financing such as peer to peer lending.

While funding conditions are relatively easy at the moment, the global financial crisis demonstrates that this can change very quickly. Also recent experiences with crowd-sourced equity funding show that financial innovation can be stifled as regulatory systems play catch-up, often to the detriment of small business. It would therefore be beneficial if Australia's financial regulators generated more usable data on business financing conditions (for example through periodic senior loan officer opinion surveys) and are more pro-active in identifying and acting on unnecessary regulatory barriers to financial innovation.

Recommendations:

The Productivity Commission recommend that one member of the Council of Financial Regulators conduct a regular senior loan officer opinion survey to gain a more detailed understanding of business financing conditions, and

The Productivity Commission consider if changes to Australia's financial regulatory system are necessary to improve the timeliness of regulatory responses to unnecessary barriers to financial innovation.

Crowd-sourced equity funding

CPA Australia strongly supports legislative change to encourage greater access to crowd-sourced equity funding by a significantly wider range of Australian businesses. Such a regime must however strike an appropriate balance between the financing needs of business and investor protections.

Of the two reform models being considered, we favour the New Zealand model with some variations to align the model with the Australian financial services licensing regime and to reduce the risks of conflicts of interest. We believe the New Zealand model with such adjustments strikes the best balance between the funding needs of innovative businesses, investor protection for what will be highly speculative investments and better encouraging the development of a liquid secondary market.

Recommendation

The government adopts legislative changes to encourage greater access to crowd-sourced equity funding by a significantly wider range of Australian businesses. The changes should draw upon the New Zealand model.

Access to reliable high speed internet at an affordable price

In the global economy, real-time access to information and the ability to deal directly with markets – both domestically and internationally at your place of work, including the home is essential to the competitiveness of businesses, large and small. Improvements in communications infrastructure that allows more Australians to have better access to digital technology and a reduction in mobile phone ‘black spots’ should be an incentive to more Australians to establish a business, particularly in rural areas. We therefore support the government’s policy that Australians should have access to the National Broadband Network as soon as possible.

Recommendation:

The Government remain committed to completing the national broadband network as soon as possible.

Barriers to business transfer and closure

Taxation

Small business CGT concessions

The current small business capital gains tax (CGT) concessions are designed to reduce some of the tax disincentives to disposing of a business and business assets. While the concessions appropriately reward small business for engaging in entrepreneurial risk the numerous eligibility tests to access the concessions are very complex and often counter-intuitive in nature. This could act as a disincentive to some business transfers and deter foreign investment because of the related uncertainty.

In our view the most disputed and litigated aspect of the small business CGT concessions is the ability of a taxpayer to satisfy the \$6 million maximum net asset value test where the requirements of the \$2 million aggregated turnover test are not otherwise met in satisfying the basic eligibility conditions in claiming the concessions .

This is partly due to the complex eligibility criteria to meet the maximum net asset value test as set out under sections 152-15 and 152-20 of the Income Tax Assessment Act 1997 (the ITAA 1997).

In practice, many small business taxpayers whose eligibility is contingent on meeting the \$6 million maximum net asset value test fail to include the net value of CGT assets of connected entities or affiliates, or incorrectly exclude pre CGT acquired assets or post CGT acquired assets such as depreciating assets or trading stock which do not generate capital gains but must nonetheless be included in that calculation.

However, the most problematic aspect of the maximum net asset value test is the inherently subjective nature of determining the market value of the taxpayer's CGT assets which can lead to disputation between the ATO and taxpayers where they have different competing market valuations of assets.

Accordingly, we believe that it may be prudent to replace the current subjective maximum net asset value test with some alternate objective test for small business taxpayers which is easier to comprehend and apply with certainty. This may take the form of fully exempting a gain where the aggregated turnover is less than \$2 million and tapering entitlement to the concessions for those whose aggregated turnover is between \$2 million to \$6 million.

Recommendation:

We recommend that the subjective \$6 million maximum net asset value test be replaced with some alternate objective eligibility test. This could take the form of a revised aggregated turnover test, which could include the concession being gradually reduced above a certain threshold.

Increase the small business entity turnover threshold

CPA Australia's supports the Board of Taxation's recommendation that the small business entity turnover threshold be increased from \$2 million to \$3 million (see recommendation 5.1 of the Board of Taxation's report titled *Review of Tax Impediments Facing Small Business* from August 2014). Further, we support the Tax Reform white paper process investigating the feasibility of increasing the threshold to \$5 million.

Recommendation:

The Government increase the small business entity turnover threshold to \$3 million, in line with recommendation 5.1 of the Board of Taxation's Review of the Tax Impediments facing Small Business.

Improving insolvency arrangements

To what extent do the existing insolvency arrangements facilitate or hinder business closure?

Since the current voluntary administration (VA) regime (Part 5.3A of the Corporations Act 2001) has been in operation it has been observed that there has been a tendency to hasten closure of a company what might, under a modified or different treatment, have been turned around, or salvaged in part. However, it is difficult to draw conclusions about the economic efficiency of a scheme which applies across the full range of corporate size and complexity, and is neutral in its sectoral application.

CPA Australia is of the view that the one-size-fits-all application of Australia's key statutory-based corporate business recovery system no longer fully serves business and wider economic expectations and needs. In making this observation, CPA Australia acknowledges the conclusions drawn by CAMAC in its 2004 report 'Rehabilitating large and complex enterprises in financial difficulties' that the VA procedure was fundamentally sound for Australian circumstances and that there was no justification in a shift towards United States-style Chapter 11 debtor-in-possession arrangements. The fundamentals of VA ought be preserved, with targeted reforms, some of which might draw on Chapter 11 noting that the American Bankruptcy Institute (ABI) has only recently completed a comprehensive review of Chapter 11.

Recommendation:

The fundamentals of current voluntary administration (VA) regime ought be preserved, with targeted reforms, some of which might draw on Chapter 11 noting the American Bankruptcy Institute (ABI) recently completed comprehensive review of Chapter 11.

Structural issues within corporate insolvency law

As stated above, we believe the fundamentals of the VA regime should be preserved, though consideration needs to be given to a differential scale-based application along with targeted reform in a limited number of specific areas of application and interaction. Considering the question of thresholds at which a stronger business recovery orientation should be applied, current VA statutory arrangements, would need to provide greater flexibility to allow evaluation of the prospects, and to put into effect a recovery or turnaround strategy. This would, in CPA Australia's view, likely necessitate modification of the statutory moratorium rules (sections 440B, 440D and 440F of the Corporations Act 2001) so as to provide greater scope to evaluate recovery options.

Additionally, it may be necessary to modify the statutory rules which create a clear demarcation between administrator powers and those of directors once the company enters voluntary administration (sections 437A, 437B, 437C and 437D). Repeating our earlier observations, such flexibility would need to be specifically targeted and we believe this should be at larger corporations. It is amongst this demographic that there is more likely to be assets and a viable business model that might, in time, be worked through and where liability issues (see below discussion) impinge upon director personal risk and reputation assessments, and thus, their appetite for engaging in a long term recovery, restructuring or turnaround strategy.

An alternative approach which might provide a degree of size/ complexity-based differentiation with increased flexibility to assess turnaround options, could be through modification of Part 5.1 of the Corporations Act 2001. The use of creditors' schemes and compromises have declined since the introduction of Part 5.3A and it may be that Part 5.1 might be adapted towards enabling more flexibility for directors, members, creditors and the courts to collaborate towards reaching more economically beneficial outcomes.

At the very small micro-end, the possible drawing out of the procedure is unlikely to generate economic gains as these will often be asset-less administrations and could also likely be detrimental to the individual debtor/ director concerned. Frequently these individuals will have granted security over the principal family home and it seems incumbent on policymakers to limit, where they can, a continuance of wishful recklessness.

In addition, further protraction in resolving matters potentially draws into consideration the special equity of 'surety wives' to be relieved from liability in respect of a guarantee, which though regarded by many commentators as an anachronism, still attracts legal controversy. To reiterate, amongst this type of corporate failure, the swifter and more streamlined the procedure, the better. We note that the ABI - in its Chapter 11 review -has also identified the need for more streamlined procedures for SME bankruptcies.

We also make the following observations and suggestions that are, in the main, restricted to reform within the existing VA procedure:

- We acknowledge some debate and interest in a turnaround process commonly described as pre-packaged insolvency sales. Given the uncertainty of these arrangements, operating as they would in

the 'twilight' between solvency and insolvency, and the possible challenges concerning practitioner independence, possible law reform in Australia, in the first instance, should focus on targeted improving of the existing VA regime.

- There should be sufficient supervisory oversight to draw matters to an expeditious conclusion, and where possible, should have minimum need for court intervention consistent with the way in which the current s 447A has evolved in its operation. It is noted also that the specialised and significant bankruptcy court involvement in the United States acts, we believe, against some form of wholesale transplanting of Chapter 11 into Australia. Nonetheless, some of the underlying philosophy and orientation of Chapter 11 certainly has merit to any Australian law reform.
- It is not a straight-forward matter to identify particular attributes of size, let alone complexity, to which particular parts of a differentiated external administration scheme should apply. These are complex matters of policy judgment and we caution against any reforms that might inadvertently encourage phoenix company activity.
- A further matter on which there has been significant and sustained focus as a source of hastening to liquidation an otherwise salvageable business, is the use of supplier contractual terms that specify capacity to withdraw supply or services upon the counterparty's entry into voluntary administration (*ipso facto* clauses). In the Australian bankruptcy context such clauses are void (s 301 of the Bankruptcy Act 1966) and are likewise void under the US Bankruptcy Code. An outright statutory voiding of *ipso facto* clauses may not be warranted, however CPA Australia would strongly support either capacity for an administrator to seek court orders that the party to such a contract may not terminate (the view expressed in PJC's 2004 *Stocktake of Corporate Insolvency Law*) or, by some other means, brought within moratorium arrangements.
- Laws such as corporate insolvency which function in an economic context have incentive impacts affecting the behaviours of participants. CPA Australia has acknowledged the need for serious reconsideration of those parts of the VA procedure which influence attitudes toward business recovery and rescue. A 'root and branch' review of the type being conducted by the Commission needs to be necessarily wide to include consideration of where reform in one area may give cause for adjustment elsewhere. Currently, s556 of the Corporations Act 2001 (ordering of priority payments upon liquidation) treats all unsecured creditors equally regardless of whether they are consensual (predominantly contract-based) or non-consensual (often claims based upon debtor negligence). Promoting through legislative reform a stronger business recovery orientation, whilst sound, should not result in a perverse incentive to avoid or defer the meeting of compensation claims. On this basis, CPA Australia encourages consideration being given to priority treatment of industrial and other product liability claims to address those rare, though grave, circumstances of accumulating liability being delayed or subject to uncertainty.

Recommendations:

- ***The one-size-fits-all legislative arrangement for corporate insolvency requires serious reconsideration. Acknowledging the subjective nature of size thresholds, greater flexibility is warranted for larger companies whilst the emphasis with micro insolvency should be on an expeditious closure.***
- ***The current structure of moratorium arrangements has scope for improved flexibility and scope, with the current inability for capacity to void ipso facto clauses a particular concern.***
- ***Any substantive move to a stronger US Chapter 11 style debtor-in-possession approach for large and complex insolvencies should, as an anti-abuse measure, be accompanied with reform of current statutory priorities to give greater standing to non-adjusting involuntary creditors.***

Liability issues within corporate insolvency and wider corporate law and revenue law

Central to much of the debate about the current law's assumed shortcomings in promoting a positive attitude toward corporate restructuring in the face of financial difficulty, is the disincentive created by the insolvent trading regime (Part 5.3B – Div. 3). Application of these rules can result in personal liability by way of court orders to pay compensation to the company (Div. 4) thus augmenting the pool of funds available to unsecured creditors. Personal concern of directors is compounded by possible 'duality of liability' under the duty of care and diligence (s 180), the operation of declarations of contravention (s 1317E), the application of penalties (s 1311 and Schedule 3) and the disqualification provisions (Part 2D.6). Both the liability concern and the incentive to seek the 'safe haven' of voluntary administration, or more likely liquidation, are further exacerbated by the operation of provisions such as s 18-130 of the Taxation Administration Act concerning PAYG withholding obligations and the relief from, or reduction in, non-compliance tax where the director took action to appoint an administrator or liquidator.

CPA Australia is aware of the debate in the business community about the negative economic consequences of the existing narrow-based business judgment rule relief (s 180(2)). The need for a general extension of this relief beyond the duty of care and diligence is uncertain. CPA Australia is nevertheless supportive of reform either by way of insertion of a specific business judgment referenced defence, or through the modest redrafting of the wording which, in relation to the duty, uses the wording "suspected that the company was or would become insolvent" (s 588G(3)(c)) and, in relation to the defence, is expressed in terms of "expect[ed] that the company was solvent ... or would remain solvent" (s 588H(2)). The present wording, in our view, makes the availing of any defence which does exist, very difficult.

Recommendation:

The current insolvent trading regime acts as an unwarranted incentive to hasten what might otherwise be salvageable businesses to liquidation. There should be developed a stronger safe harbour within what is overwhelmingly a punitive set of arrangements.

Do existing insolvency arrangements act as a disincentive to business set-up?

We urge that the question of incentive to set up a business is driven by a wide range of factors. As will be elaborated below, development of corporate insolvency law, as distinct from wider corporate law, should be treated in relatively narrow terms in which wider economic growth or restructuring considerations should play one part amongst a range of considerations, some of which are not economic in character.

How do existing insolvency arrangements affect the choice of business structure?

Choices of business structure are driven by a range of factors, not least of which in the corporate context is the benefits of limited liability. Both the law and business practice, including secured lending arrangements, have evolved to redress abuse and adverse consequences. The particulars of bankruptcy and insolvency law are unlikely to be in any way determinative. An individual's asset protection considerations are of relevance, though again the particularity of bankruptcy and insolvency rules are unlikely to be relevant to the extent of raising concerns, either economic or justice-based.

Is the underlying incentive structure within the corporate and personal insolvency arrangements able to effectively facilitate business closure without discouraging new business set-ups?

Professor Roy Goode in his highly regarded text on corporate insolvency law identifies four overriding objectives of the law of corporate insolvency:

1. to restore the debtor company to profitable trading where this is practicable;
2. to maximise the return to creditors as a whole where the company itself cannot be saved;
3. to establish a fair and equitable system for ranking claims and the distribution of assets among creditors; and
4. to identify a mechanism by which the cause of a failure can be identified and those responsible of mismanagement brought to book.

These objectives are achieved through a series of predominately statutory based instruments which include:

- substitution of collective action for individual rights of pursuit
- a scheme of predetermined distribution, and,
- avoidance of transactions and recovery of misplaced assets.

Viewed in these terms, corporate insolvency law though highly evolved still, in its essence, aims to resolve competing claims to private law entitlements within a public law framework where an insufficiency of assets prevents enforcement of all claims. Within an overarching statutory corporate insolvency scheme, and at particular points in time, some balancing between objectives will occur.

Necessarily, the specifics of the corporate failure or financial stress event places primary focus on the immediacy of business restoration or closure, evaluated against the demands of a maximised and timely return to unsecured creditors. In these terms, the statutory corporate insolvency scheme can at best have neutral impact on encouraging business set-ups and is an inappropriate mechanism for wider policy consideration of economic or sectoral/ industry transformation. Its economic facilitating efficiency as such, should be gauged in terms of how it enables existing assets to be returned to, or reorganised towards, value creation, though in coherence with its other objectives.

Where should the balance lie between creditors and debtors in the arrangements? Are there feasible alternatives to the existing corporate insolvency arrangements? Is the use of safe harbour provisions for firms seeking to restructure a feasible alternative?

As observed above, an essential function of bankruptcy and insolvency law is the expeditious treatment of collectivised private law entitlements. Matters of balance between creditors and debtors given effect to in the law involve a range of considerations. The fact that English and Australian insolvency law has an assumed orientation towards creditor interests draws upon a strong preference to the legal significance of rights. Particularly given the friction between secured and unsecured creditors and the inevitability that any further recognition of a basis for taking security is detrimental to the body of unsecured creditors, CPA Australia urges preservation of this emphasis in any law reform proposal. Voluntary contractual-based creditors have an absolutely reasonable expectation of the fulfilment of obligations and involuntary creditors with claims in civil wrongs should on the basis of law's morality be provided compensation.

The above said should in no way preclude regard being given to particular elements of the law's treatment of debtors which might be warranted. As remarked elsewhere, the punitive character of some aspects of corporate insolvency law warrant reconsideration and there is merit for exploring improved safe harbour arrangements in which more thorough regard can be applied to restructuring opportunities. CPA Australia suggests two aspects of corporate insolvency law, adjustment to which might offer avenues for encouraging

a stronger business rehabilitation culture and ameliorating some of the current perceived harshness in the law without risking erosion of creditors' interests.

1. The Corporations Act 2001 definitions of solvency and insolvency (s 95A) are drawn directly from personal bankruptcy law and are judicially interpreted as consistently applying a cash flow test. The United States adopts a balance sheet test, whilst other jurisdictions apply a blend of considerations. The well entrenched Australian approach may warrant reconsideration towards something more practically-based which allows judgments to be made, and assessments applied, which examine insolvency risk on a more enduring basis.
2. Addressing some matters of balance within the VA provisions, s 439A does foremost emphasis the business rescue and continuity objective, and failing this through the use of words "if it is not possible", the achieving of a better return to creditors. Moreover, the further reference in subsection 435A(b) should act against an overly hasty winding up of the company. That the power to decide vests with creditors (s 439C) based upon the reports and opinion of the administrator (subsection 439A(4)), is consistent with a creditor orientation without necessarily disregarding debtor interests. Where this procedure may have opportunity for procedural improvement, particularly in relation to larger and complex insolvencies, is in relation to the timeframes (subsection 439A(5)) for reporting and decision.

Recommendation:

- ***The statutory definitions of solvency and insolvency should be expressed in contemporary terms allowing some reference to balance sheet position.***
- ***The timeframe of creditor meeting convening and decision within voluntary administration should be made more flexible to accommodate the complex nature of large corporation in financial difficulty.***

How should the sanctions in personal insolvency or bankruptcy apply to individuals? For how long should these sanctions around bankruptcy apply? Are these sanctions a disincentive for entrepreneurial activity? Is there adequate enforcement of the existing sanctions? Are there feasible alternatives to the current bankruptcy process?

CPA Australia's view is that the three-year duration for discharge from bankruptcy (subsection 149(2) of the Bankruptcy Act 1966) is appropriate and reiterate our earlier observations that entrepreneurial activity is driven by a wide range of factors and aptitudes to which personal bankruptcy and corporate insolvency law can play only a minor part. Also, given personal bankruptcy law's often interaction with family law and the inevitability of situations of co-existence of family law disputes and bankruptcy, bankruptcy law is an uncertain, and perhaps indeed an inappropriate, vehicle for economic consideration outside of safeguarding the welfare of the parties immediately, and often profoundly, impacted.

Are the insolvency arrangements able to transfer assets and capital effectively? Are insolvency procedures timely to ensure that assets do not become 'stranded' and unable to be used elsewhere?
Refer our comments above.

Is the insolvency process unnecessarily costly and lengthy? How might this additional cost be measured? Is it simply a transfer between participants in the process or does it represent a loss in the overall efficiency of the economy?

As mentioned earlier, economic efficiency, though a critical element, is not the only basis for evaluating the efficacy of bankruptcy and insolvency law. Given that it deals with one party's inability to meet the collective private law claims of multiple creditors, a component in the purpose of these laws relates to meeting the reasonable expectations of creditors to be treated fairly and expeditiously, whilst at the same time avoiding unilateral action by one party, or group of creditors, detrimental to the whole. These utilities within an insolvency regime may be at odds with a stronger business recovery orientation, the indeterminacy of which is a matter of sound policy judgment balancing both justice and economic considerations.

With respect to overall efficiency of the economy, it may be that the insolvency process and its accompanying costs should perhaps not be treated in isolation discrete from the overall corporate regulatory scheme. The establishment of a limited liability company is now a comparatively streamlined process and the Corporations Act is largely permissive and principle-based when it comes to matters of a company's internal affairs and management.

APPENDIX A Matrix comparing main income tax treatments of different structures

Please note that beneficiaries are taxed on their taxable income at their marginal tax rates and trustees are generally taxed on income to which no beneficiary is presently entitled at 49 per cent from 1 July 2014.

	Individual	Partnership	Company	Discretionary trust	Unit trust	Hybrid trust	Superannuation fund
Can accumulate income	Yes	No	Yes	No	No	No	Yes
Can use FBT salary packaging	No	No	Yes	Yes	Yes	Yes	No
Superannuation contributions fully deductible?	Yes	Yes	Yes	Yes	Yes	Yes	N/A
Limits on contributions to the structure	No	No	No	No	No	No	Yes
Tax rates (applying 2014 tax rates – note that the effective highest marginal tax rate excluding the Medicare levy increased from 46.5% to 49% for the year ended 30 June 2015)	Individual marginal rates	Individual marginal rates (or corporate rate if company)	30%	Beneficiary marginal rates or 46.5%	Beneficiary marginal rates or 46.5%	Beneficiary marginal rates or 46.5%	15% or highest marginal rate excluding Medicare levy if non-complying or non-arm's length
Distribution of losses	Can use	Can use	Trapped in structure	Trapped in structure	Trapped in structure	Trapped in structure	Trapped in structure
Can transfer losses	N/A	N/A	If consolidated	No	No	No	No
Streaming of income	No	No	Depends on rights of shares issued	Yes (but limits after 1 July 2010)	No	Yes (but limits after 1 July 2010)	Yes
Interest deduction on return of capital	No	Yes	Yes	Yes	Yes	Yes	Borrowing restricted
Return of capital tax-free?	Yes	Yes	Unfranked dividend or capital proceeds	Yes	CGT event E4 may apply	Yes or CGT event E4 applies	Payments taxable to members
Receipt of franked dividends	Can claim credits – 45 day rule	Can claim credits – 45 day rule	Can claim credits – 45 day rule	Beneficiary may not get credits – 45 day rule	Should pass through – 45 day rule	Beneficiary may not get credits – 45 day rule	Can claim credits – 45 day rule
Loans to associates	Allowed	Allowed	Division 7A applies	UPEs may be deemed dividends post 16 Dec 2009	UPEs may be deemed dividends post 16 Dec 2009	UPEs may be deemed dividends post 16 Dec 2009	Cannot lend to members or relatives
Non-commercial loss rules apply	Yes	Yes	No	No	No	No	No

Matrix comparing CGT treatments of different structures

	Individual			Trusts			Company			Superannuation fund		
	Selling a business	Selling a share in a company	Selling an interest in a trust	Selling a business	Selling a share in a company	Selling an interest in a trust	Selling a business	Selling a share in a company	Selling an interest in a trust	Selling a business	Selling a share in a company	Selling an interest in a trust
CGT discount	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Active asset reduction	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Active asset retirement	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Active asset rollover	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Active asset 15 year exemption	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓

1. Partnership CGT assets are treated the same as if the individuals held the assets themselves.
2. In order for a trust to access the small business CGT concessions there must be a beneficiary of the trust that is a significant individual in the company or trust in which the investment is held (directly or indirectly) and that significant individual and other CGT concession stakeholders must have a combined participation percentage of at least 90% where the trust sells an interest in any entity in the year in which the CGT event happens.
3. In order for a company to access the small business CGT concessions there must be a shareholder of the company that is a significant individual in the company or trust in which the investment is held (directly or indirectly) and that significant individual and other CGT concession stakeholders must have a combined participation percentage of at least 90% in the company selling the interests in any entity in the year in which the CGT event happens.
4. In order to get the portion of a capital gain sheltered by the active asset reduction out of a company without attracting tax, it must be paid out on liquidation of the company.
5. In order for the portion of the capital gain sheltered by the retirement exemption from a company or trust to be exempt, it will be necessary to pay funds to the significant individual or their spouse that also holds an interest in the company or the trust.
6. A superannuation fund cannot claim the CGT small business concessions as it does not carry on a business. Refer to the chapter on superannuation funds for further details.

APPENDIX B Initial comments concerning the introduction of a new entity for small businesses.

Please find below some initial thoughts concerning the possible introduction of a new entity for small businesses in Australia. Such an entity would have features similar to the USA's 'S corp' model, but with the additional feature of the entity being able to retain income within the entity taxed at the prevailing corporate rate.

Positive aspects

- Cuts accounting, audit and tax regulation and thus aids reducing compliance costs
- Division 7A on the Income Tax Assessment Act 1936 would *prima facie* not apply if all the tax liability vests with the members and there are no timing disadvantages, (which would be further enhanced if members of the company were limited to natural persons)
- Would appear to eliminate the mismatch between trust income and net taxable income and thereby both reduce complexity and tax avoidance involving the re-characterisation of trust income as capital
- Would appear to reduce unpaid present entitlement (UPE) amounts owed by trusts to default corporate beneficiaries (which would be further enhanced if members of the company were limited to natural persons)
- Provides an alternate structure for SMEs compared to trusts where there is great uncertainty especially from a taxation perspective and 'traditional' corporations which are subject to significant corporations law, accounting and tax regulation
- It would be limited to resident trading businesses and not those merely holding passive investments
- Could provide a more definitive form of limited liability than that available in respect of trustees where such protection is only available where a corporate trustee is used and/or the trust deed expressly limits the liability of the trustee to the net assets of the trust
- Could possibly simplify access to the small business concessions where the members in the company are natural persons as it is the member and not the entity making the capital gain
- An additional critical feature of this proposal is that the entity is permitted to retained funds, whereas the trustee of the family trust structure commonly used by SMEs is typically compelled to distribute income to ensure that any undistributed amount is not to be assessed to the trustee at the highest marginal rate (currently 49 per cent).

Negative aspects

- Reduced regulation (and unaudited accounts) may lead to less reliable information (and less reliable income tax returns which are based on such reduced information). This could lead to short term savings but long term costs which may be detrimental from a governance perspective
- Pierces the corporate veil between companies and shareholders in terms of exposure to tax liabilities where members are natural persons (thereby leading to the use of trusts with corporate trustees as the member)
- Shares would be regarded as property in a matrimonial dispute where right to future distribution from a family discretionary trust is generally not caught
- If trustees can be shareholders have we significantly reduced complexity as we will still have issues of interposed entity(s) to address and the related complexity of the taxation of trusts at the ownership rather than the operational level?
- How is capital gains on exit treated? Would the member get the CGT discount not available to companies under the current CGT regime?
- Treasury maintain that the current company tax system has been designed on the premise that there will be wastage of franking credits which would not appear to arise where members are natural persons
- Unclear how restrictions will apply to the utilisation of losses where the member is a natural person (as the recoupment of an individual's tax losses is only typically limited to the non-commercial loss rules). That is, will the utilisation of tax losses increase vis a vis the current regime as company and trust tax losses are subject to stringent recoupment tests especially where there is a change in majority beneficial ownership
- Given the above CGT, dividend imputation and tax loss concerns it may be challenging to make such a reform revenue neutral. This may be exacerbated where the member of the company is a trustee of a family trust and may be able to stream capital gains and split income over family members especially where the ultimate owner is already subject to tax at the highest marginal rate of 49 per cent

Uncertainty

- What will happen to the existing 770,000 trusts? Will they be transitioned or treated under such a proposed entity especially given the bulk of these trusts are 'garden variety' family discretionary trusts? Presumably this could involve some form of capital gains tax rollover relief but there would still be associated commercial and stamp duty issues to consider
- Whether membership of the company is restricted to natural persons
- Whether the member(s) in the S Corp entity would have access to the CGT discount which is a pivotal consideration as the choice of structure can be heavily influenced by the perceived benefits of the exit strategy

Corporations law, insolvency law and other business law issues

- There are possible concerns with the "moderate level of regulation to ensure adequate governance" and the process of "flow-through of income and losses" in the context of creditor protection and the shifts that have occurred in the notion of maintaining capital intact.
- How will the flow-through sit in comparison with statutory rules of capital reduction and share buybacks which are subject to a solvency test?
- It will be essential to determine how the flow-through might be treated within the scheme of voidable transactions which form the key plank of recovery procedures for the benefit of creditors of insolvent companies.
- Ease of flow-through may act against rules of tracing where downstream recipients may claim innocent change of position or where knowledge of receipt in breach of a duty may be less easily construed.
- The insolvent trading regime applies strict rules of when debts are incurred – one of which is paying a dividend. These form a vital mechanism which enable an objective test of when a director ought suspect insolvency thus triggering director's personal liability for unsecured debts. How the flow-through functions in these terms would need to be determined.
- Australia has yet to develop a coherent approach to corporate veil piercing. Recent English development point to two main themes in it being invoked – cases dealing with concealment and those dealing with evasion. Possibility of blurring between ownership and the separate entity principle might attract unwanted attention being given to veil piercing development.