Creating a more dynamic and resilient economy inquiry

Questionnaire response 37

Name: SMSF Association

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1. Support business investment through corporate tax reform

1. What features of the Australian business environment have encouraged or restrained investment over the past 10 years?

The proposed Better Targeted Superannuation Concessions or Division 296 taxation of superannuation balances over $3 million is stifling business investment, innovation and access to capital by start up enterprises. Although this measure has not yet been legislated, the proposed model which taxes unrealised capital gains, is now acting as a significant barrier for new investment.

Start up enterprises rely upon essential foundation funding to commercialise their research and development. This includes the commercialisation of university research and intellectual property. The income and/or capital returns from these enterprises provide essential funding for the operation and international ranking of the university.

Due to their nature, these investments have long term investment time horizons, of 8 to 10 years on average. The investment cannot be sold until the enterprise lists, the company, intellectual property or technology itself is sold. Where the enterprise is listed, the ASX listing rules operate to prevent foundation investors from selling their shares for 6 months to 2 years.

Investors in these projects are acutely aware of the long-term investment required, and that the capital invested will be locked up over that period. This aligns with the long-term investment objectives of superannuation, which is why many investors choose to use their self managed superannuation fund (SMSF) to make that investment. The capital and investment objectives align.

Importantly, around 40% of venture capital investment is made by SMSFs.

These investments see wild swings in investment values, which are paper values only. Often those values are driven by staged capital raising, which sees the share price for later stage investments significantly higher than the foundation investors. This artificially inflates the perceived market value of the foundation shares. The true value of the shares is not truly ascertainable until the shares are acquired via a takeover or listing of the company.

The proposed taxation of unrealised capital gains in Division 296 does not refund tax paid on paper gains where a decline in value arises. In the following example is taken from an actual scenario, demonstrates the issue of taxing paper gains:

• The value of the SMSF is $2.5m at the time the investment is made

• Foundation investment: $150,000 @ 1c per share (15 million shares)

• Second stage capital raising @ 10c per share. This strikes the market value for the foundation shares which have increased to $1.5m in value

• Third stage capital raising @ 70c per share. This strikes the market value for the foundation shares acquired, which are now have a ‘market’ value of $10,500,000

• A restructure of capital and the project occurs, and the share value falls to 10c per share. The market value falls to $1.5m.

• The project collapses and now worth nil.

• No capital losses can be claimed.

• No value is realised, yet the paper gains will be taxed 15% on the way through.

• No refund of tax paid is made to the fund for the excess tax paid.
• The SMSF is unable to sell the shares to pay for the tax liability assessed and the member does not have the cash to pay the tax liability personally.

Failure to attract the capital investment needed over the term of these investments will see existing projects collapse, and new projects fail to get off the ground.

Venture capital plays a vital role in encouraging private investment to support projects that align with Government policy priorities including science and technology, medical research, green energy and innovations in environmental management systems, processes and technologies. It acts to fill the funding breach, as Government does not have the capacity to fully fund these initiatives. Appropriately, market forces drive which projects will succeed, allowing for a free-market economy and ensuring the efficient use of government investment.

2. What elements of the corporate tax system encourage and/or discourage investment and risk-taking?

When looking at the effects of taxation, to encourage or discourage investments, a focus on the corporate tax system alone is too narrow. It should not be examined in isolation. Investment, risk taking and innovation need to be considered in the broader environment. The sources of capital and investment and how the tax system treats (or will treat) directly impacts investment and access to capital.

As noted in our response to question 1, the proposed Division 296 superannuation tax (in its current form), is already having a significant impact on investment in venture capital, despite not yet being legislated. This is a serious concern, and a review of this tax policy setting is urgently needed.

Proposed tax reform without fulsome consultation on a range of potential models, that fully consider the benefits, operation and the unintended consequences, including the direct economic impact to investment and innovation, significantly stifles investment and opportunity to develop ideas in Australia.

3. Which parts of the corporate tax system do you find the hardest, or most time or cost-intensive to comply with? How could the compliance burden of the business/company tax system be reduced?

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2. Reduce the impact of regulation on business dynamism

1. What areas of regulation do you see as enhancing business dynamism and resilience? What are the reasons for your answer?

We are not aware of any such regulation.

2. How has your regulatory burden changed over time?

Our membership represents a cross section of the professionals who work in the SMSF sector. This includes accountants, administrators, auditors, actuaries, financial advisers and planners, lawyers and tax agents. Many of these operate as or are employed by small businesses.

The regulatory burden that applies to many of these professions continues are in perpetual motion, subject to continued change in their respective regulatory environments. The increased regulatory burden adds significant complexity and as a result cost to businesses and ultimately consumers.

Further, the regulation of the advice sector attracts industry funded levies to finance regulator activities and a compensation scheme of last resort (CSLR). Both have a role of vital importance on the regulation of the sector and protection of consumers. However, the way these levies are structured disproportionately impacts small businesses who bear the significant cost burdens. Costs associated with the regulatory activities of ASIC on matters involving ASX listed companies or their subsidiaries, flow through the whole sector, resulting in advisers in small businesses incurring the costs of such actions. Similarly, where the matter then moves to the CSLR, the levies on advisers to fund consumer compensation payments are again substantially funded by advisers from small businesses.

Regulatory burden and resulting costs, and the costs imposed on the sector through levies act as significant barriers to entry and risk the long-term sustainability of the sector. These pressures are significantly increasing year on year with no sign of abatement.

Costs are an increasing barrier for consumers accessing professional advice from qualified professionals, at time when the need for these services are arguably at their greatest. Regulatory burden imposed on the premise to protect consumers has instead acted as a barrier for consumers accessing essential advice and services.

3. What regulations do you find time-consuming, overly complex or otherwise constraining business dynamism and resilience? What are the reasons for your answer?

The Australian Law Reform Commission (ALRC) review of Chapter 7 of the Corporations Act 2001 (Cth) made a number of recommendations that would alleviate regulatory complexity and cost. We encourage the Productivity Commission to consider the ALRC reports and recommendations as part of this review.

These reforms would provide welcome relief and alleviate significant complexity for the financial advice sector and benefit consumers.

In particular, some specific recommendations that could be considered for implementation include:

• Recommendation 10 The Office of Parliamentary Counsel (Cth) should develop drafting guidance to draw attention to defined terms each time they are used in corporations and financial services legislation.

• Recommendation 29 In order to support best practice legislative design, the Office of Parliamentary Counsel (Cth) should establish and support a Community of Practice for those involved in preparing legislative drafting instructions, drafting legislative and notifiable instruments, and associated roles.

• Recommendation 30 The Department of Treasury (Cth), in consultation with the Office of Parliamentary Counsel (Cth), should review existing guidance relating to the design and drafting of legislation, with a view to producing and maintaining a consolidated guide to legislative design for corporations and financial services legislation.

4. Can you share any specific examples of where you think a regulator has done a good or bad job of understanding and reducing regulatory burden on businesses and why?

Recent AFCA determinations on the application of the wholesale investor rules for SMSFs have created significant uncertainty on the operation of the law and resulted in dual regulatory positions for different market participants.

As an example, refer to AFCA determination 12-00-923475 (https://my.afca.org.au/searchpublisheddecisions/kb-article/?id=ca242507-4576-ef11-a670-0022489466fb) which sets out AFCAs views in some detail.

These determinations have enlivened a previous view held by ASIC. In 2004 to 2014, ASIC web content (QFS 150) stated that the $2.5 million asset test and the $500,000 product value test would not apply to SMSFs. The application of the wholesale investors rules was (in ASICs view at that time) to be limited to the $10 million fund value test only. Previously, the application of the wholesale investor rules operated such that where the trustees - or in the case of a corporate trustee, a controlling individual who was a director of the trustee company met the $2.5m asset test, supported by a qualified accountant's certificate – the SMSF would satisfy the wholesale investor tests.

In 2014, ASIC withdrew its web content and revised its approach (ASIC MR 14-191MR; 8 August 2014). Where an SMSF trustee satisfied either the $2.5 million asset test or the $500,000 product value test could be used by SMSF investors.

AFCA is not a law-making body and is regulated by ASIC. However, the determinations by AFCA have become precedential in nature. The position now taken by AFCA has created significant uncertainty for firms who hold both retail and wholesale authorisations under their Australian Financial Services Licenses. Due to the inclusion of retail clients in their authorisation, they are required to hold membership with AFCA.

AFCA's remit does not extend to wholesale clients and wholesale AFS Licensees. However, they have accepted cases where they have determined that a client classed as wholesale should be treated as a retail client, and where the AFSL holds both wholesale and retail authorisations. This has in turn lead to these determinations.

We are not aware of any regulatory action been taken by ASIC against wholesale only AFSLs, nor have they issued regulatory guidance on the operation of these rules in the context of SMSFs.

The result is two different regulatory environments on the operation of the same provisions, due to the nature of the AFSL held. As a result, there is a significant litigation risk present for professionals and firms operating in this segment of the market. Firms who are members AFCA now have unquantifiable contingent liabilities for SMSF clients who have invested or received financial services as wholesale clients.

In the absence of regulator guidance or case law, the AFCA determinations are an example of regulatory overreach, on the interpretation and application of the law. That application does not align with ASICs public facing material, nor the legal interpretation and application of these provision by the sector.

To rectify this situation, legislative amendments are now urgently required, as the Corporations Act 2001 (Cth) does not provide for a regulations or legislative instrument making power to provide a remedy.