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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAX LAWS AMENDMENT (SMALL BUSINESS MEASURES No. 3) BILL 2015

EXPLANATORY MEMORANDUM

(Circulated by the authority of the
Minister for Small Business, the Bruce Billson MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
FBT	fringe benefits tax
FBTAA 1986	<i>Fringe Benefits Tax Assessment Act 1986</i>
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>

General outline and financial impact

Tax discount for unincorporated small businesses

Schedule 1 to this Bill amends the income tax laws to provide a tax offset (the small business income tax offset) to individuals who run small businesses (businesses with an aggregate annual turnover of less than \$2 million), or who pay income tax on a share of the income of a small business.

The amount of the tax offset is 5 per cent of the income tax payable on the portion of an individual's income that is small business income. In addition to calculating the offset in this way, the maximum amount of the tax offset available to an individual in an income year is capped at \$1,000.

Date of effect: This measure applies from the 2015-16 income year.

Proposal announced: This measure was announced by the Treasurer on 12 May 2015 as part of the 2015-16 Budget.

Financial impact: This measure has these revenue implications:

<i>2014-15</i>	<i>2015-16</i>	<i>2016-17</i>	<i>2017-18</i>	<i>2018-19</i>
0	0	– \$550m	– \$600m	– \$650m

Human rights implications: This Schedule does not raise any human rights issue. See *Statement of Compatibility with Human Rights* — Chapter 1, paragraphs 1.88 to 1.92.

Compliance cost impact: This measure has a small compliance cost impact of \$15.6 million each year. This cost has been fully offset within the portfolio.

Summary of regulation impact statement

Regulation impact on business

Impact: This measure has a small compliance cost impact of \$15.6 million each year. This cost has been fully offset within the portfolio.

Main points:

- Small businesses play a significant role in the Australian economy, they also face a unique set of operational challenges, and as a consequence typically have higher failure rates than those for larger companies.
- The Government committed to introducing a 1.5 percentage point small business tax cut from 1 July 2015 in the Coalition's Policy for Small Business. On 2 February the Prime Minister announced that a jobs and small business package would form part of the 2015-16 Budget with a cut in the company tax rate of 1.5 per cent for small business.
- 70 per cent of small businesses are not companies and would not benefit from a company tax cut.
- Providing a tax discount for unincorporated small businesses, which broadly mirrors the small company tax cut, will help to improve the cash flow of small businesses by reducing the amount of tax payable in the financial year, and help to alleviate the problem of higher regulatory costs.
- The tax discount will result in unincorporated small business owners having higher after-tax earnings which they can reinvest in their businesses. To the extent this occurs, it will tend to increase growth and productivity in the small business sector.
- Overall the proposal is assessed as having a low overall compliance cost impact, comprising a low implementation impact, and a low increase in ongoing compliance costs relative to the status quo.

Immediate deductibility for small business start-up expenses

Schedule 2 to this Bill amends the *Income Tax Assessment Act 1997* to allow small businesses and individuals to immediately deduct certain costs incurred when starting up a business, including government fees and charges as well as costs associated with raising capital, that are presently only deductible over five years.

Date of effect: These amendments will apply to expenditure incurred in the 2015-16 income year and later income years.

Proposal announced: This measure was announced on 12 May 2015 as part of the 2015-16 Budget.

Financial impact: These amendments will have a cost to the Budget of \$30m over the forward estimates period comprising:

2015-16	2016-17	2017-18	2018-19
–	– \$10m	– \$10m	– \$10m

Human rights implications: This Schedule does not raise any human rights issues. See *Statement of Compatibility with Human Rights* — paragraphs 2.34 to 2.39.

Compliance cost impact: This measure is expected to result in a small reduction in compliance costs as qualifying expenses are deducted in a single income year. In contrast, under the current taxation treatment these expenses need to be tracked and deducted over five income years.

Fringe benefits tax exemption — portable electronic devices for small businesses

Schedule 3 to this Bill extends the fringe benefits tax (FBT) exemption that applies to employers that provide employees with work-related portable electronic devices, such as mobile phones, laptops and tablets.

The amendments extend the exemption to small businesses that provide employees with more than one work-related portable electronic device, even where the devices have substantially identical functions.

Date of effect: The amendments apply for the 2016-17 FBT year and later FBT years.

Proposal announced: The amendments were announced on 12 May 2015 as part of the 2015-16 Budget.

Financial impact: The amendments are estimated to have a small but unquantifiable cost to revenue over the forward estimates period.

2014-15	2015-16	2016-17	2017-18	2018-19
–	–	*	*	*

Human rights implications: This Schedule does not raise any human rights issues. See *Statement of Compatibility with Human Rights* — Chapter 3, paragraphs 3.45 to 3.49.

Compliance cost impact: Low.

Summary of regulation impact statement

Regulation impact on business

Impact: This proposal will simplify FBT for small businesses by reducing complexity in complying with current rules and improving access for employers to work related benefit exemptions.

This proposal will allow FBT exemptions for more than one qualifying work related item in an FBT year where the items have substantially similar functions.

Main points:

- This proposal will provide a benefit to all taxpayers who incur FBT and qualify as a small business under the aggregated turnover test (currently \$2 million or less).
- Small businesses will be able to access the improved exemption from 1 April 2016.
- There have been many examples of business seeking clarification from the ATO regarding whether various items can both be exempt in the same FBT year. This proposal will remove this confusion and provide small business employers with greater flexibility.
- Small businesses tend to face proportionately higher regulatory costs than larger businesses, because of their inability to take advantage of economies of scale in understanding and complying with regulation.

Chapter 1

Tax discount for unincorporated small businesses

Outline of chapter

1.1 Schedule 1 to this Bill amends the income tax laws to provide a tax offset to individuals who run small businesses (businesses with an aggregate annual turnover of less than \$2 million), or who have a share of a small business' income included in their assessable income.

1.2 The tax offset is available to individuals who are small business entities, individuals who are a partner in a partnership that is a small business entity, and individuals who are a beneficiary of a trust that is a small business entity.

1.3 The amount of the tax offset is 5 per cent of the income tax payable on the portion of an individual's income that is small business income. In addition to calculating the offset in this way, the maximum amount of the tax offset available to an individual in an income year is capped at \$1,000.

1.4 All legislative references in this chapter are to the *Income Tax Assessment Act 1997*, unless otherwise stated.

Context of amendments

1.5 In the 2015-16 Budget, the Government announced a number of measures as part of a jobs and small business package, including providing a tax discount to unincorporated small businesses broadly equivalent to the small business company tax rate cut of 1.5 per cent.

Summary of new law

1.6 Schedule 1 to this Bill amends the income tax laws to provide a tax discount to individuals who are small business entities, or who have a share of a small business' income included in their assessable income, provided the small business is not a corporate tax entity. This tax discount

is provided through a non-refundable tax offset, which is referred to as the 'small business income tax offset'.

1.7 The amount of the small business income tax offset is equivalent to 5 per cent of the income tax payable on the portion of an individual's taxable income that is their 'total net small business income'. The maximum amount of the offset that an individual can claim for an income year is \$1,000.

1.8 An individual's 'total net small business income' is comprised of the 'net small business income' they make as a small business entity, together with any share of the 'net small business income' of a small business entity that is included in the individual's assessable income.

1.9 In general terms, the net small business income of a small business entity (including an individual) is the assessable income of the entity that relates to the entity carrying on a business, less any deductions to which the entity is entitled to the extent the deductions are attributable to the income. Where an individual has a share of the net small business income of another entity included in their assessable income, the individual also reduces the share by any deductions to which the individual is entitled, to the extent the deductions are attributable to the share of the entity's net small business income.

1.10 The small business income tax offset is available from the 2015-16 income year.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Application of the small business income tax offset	
Individuals are entitled to a non-refundable tax offset if they are small business entity, or they have a share of a small business' net income included in their assessable income, provided the small business is not a corporate tax entity. The tax offset is not available to individuals in their capacity as a trustee.	No equivalent.

<i>New law</i>	<i>Current law</i>
Calculation of the small business income tax offset	
<p>The amount of the tax offset is 5 per cent of the individual's basic income tax liability that relates to their 'total net small business income'.</p> <p>The 'total net small business income' of an individual is the sum of that individual's 'net small business income' (if they are a small business entity for that income year) and their share of a small business entity's net small business income for the income year that is included in their assessable income for that year. An individual's total net small business income does not include a share of the net small business income of a corporate tax entity.</p> <p>The 'net small business income' of a small business entity is calculated by working out the assessable income of the entity that relates to it carrying on a business, and subtracting from that assessable income the entity's deductions, to the extent its deductions are attributable to that income.</p> <p>Where an individual receives a share of an entity's net small business income, the individual's total net small business income is also reduced by the deductions to which the individual is entitled, to the extent their deductions are attributable to that share.</p> <p>An individual is able to claim one small business tax offset for an income year irrespective of the number of sources of small business income that an individual has.</p> <p>The maximum amount of the offset from all sources of income is \$1,000 for an income year.</p>	<p>No equivalent.</p>

Detailed explanation of new law

Entitlement to the small business income tax offset

1.11 The small business tax offset is available for an income year to an individual who is a small business entity for the income year, or who has a share of a small business' net income included in their assessable income during the income year, provided the small business is not a corporate tax entity. *[Schedule 1, item 1, subsection 328-355(1)]*

1.12 The small business tax offset is designed to provide a tax discount in relation to the income of unincorporated small businesses. The tax discount is not intended to apply in respect of the income of small business entities that pay company tax, as the tax payable on such income is reduced by the changes to the company tax rate for small business entities.

1.13 The term 'small business entity' is defined in section 328-110 and in general terms is an entity which carries on a business in an income year and has an aggregated annual turnover of less than \$2 million for that income year. The term 'corporate tax entity' is defined in section 960-115, and covers entities that are companies, corporate limited partnerships, corporate unit trusts, and public trading trusts.

1.14 Because income tax is generally paid by individuals or companies, limiting the small business tax offset to individuals who are small business entities, or whose assessable income includes a share of the net income of a small business entity, ensures that the tax offset is restricted to tax liabilities that relate to the income of unincorporated small business entities.

1.15 The small business tax offset is available to individuals who are themselves small business entities (for example, individuals who operate as a sole trader), and to individuals who are not a small business entity, but who are assessed on the income of a small business entity (for example, a partner in a partnership that is a small business entity or a beneficiary of a trust that is a small business entity).

1.16 The small business tax offset is not restricted to individuals who are Australian residents. To the extent that the Australian sourced income of a foreign resident satisfies the requirements for obtaining the offset, the offset will be available to the foreign resident. Similarly, the small business tax offset can apply to the foreign business income of an Australian resident.

1.17 Because the tax offset is available to individuals, it cannot be claimed by trustees who are liable to pay income tax on the income of a

small business entity that is a trust. Even though a trustee may in fact be an individual, the tax law regards them in their capacity as a trustee as a separate entity that is liable for income tax on the income of the trust as a trustee and not as an individual.

1.18 The small business tax offset is designed to apply to trusts that actively carry on a business as a small business entity. Such trusts are unlikely to have beneficiaries under a legal disability that relates to a physical or mental disability. However, in the event that a trustee is assessed on the income of a beneficiary under a legal disability, the offset could be obtained by the beneficiary if they lodged a tax return, or a return was lodged on their behalf. However, where a trust has a beneficiary who is under a legal disability because they are a minor, that minor will not have access to the tax discount (the application of the tax offset to minors is explained in further detail at paragraphs 1.71 to 1.85 below).

Calculating the amount of the small business tax offset

1.19 The small business tax offset for an income year is calculated by first determining the percentage of an individual's taxable income for the income year that is 'total net small business income'. This percentage is then applied to the individual's basic income tax liability for the income year, with the amount of the tax offset being equal to 5 per cent of the result of that calculation, up to a maximum amount of \$1,000. [*Schedule 1, item 1, subsections 328-360(1) and (2)*]

1.20 The small business tax offset provides a tax discount to individuals that is broadly equivalent to the small business company tax rate cut of 1.5 per cent. Because individuals are subject to progressive rates of tax, the tax offset is applied as a percentage discount of the individual's tax liability related to their small business income. In working out the amount of the small business tax offset for an income year, an individual is required to identify their taxable income, basic income tax liability, and 'total net small business income' for the income year.

1.21 Taxable income and basic income tax liability are determined in accordance with the core provisions of the Act, and are amounts that an individual must identify in working out how much income tax they are required to pay in an income year. Taxable income is worked out in accordance with the method statement in subsection 4-15(1), and basic income tax liability is worked out in accordance with the method statement in subsection 4-10(3). The proportions of these amounts that relate to an individual's total net small business income are used to calculate the amount of the small business income tax offset.

1.22 The amendments introduce the concepts of 'total net small business income' and 'net small business income'. These concepts are

used in working out the proportion of an individual's taxable income and basic income tax liability that are from income generated through the business activities of a small business entity. For most individuals, total net small business income is worked out by reference to their own net small business income, and their share of the net small business income of another entity. However, special rules apply for working out the total net small business income of minors who are a 'prescribed person' under Division 6AA of Part III of the *Income Tax Assessment Act 1936*.

1.23 An individual is able to claim one small business tax offset for an income year irrespective of the number of sources of small business income that the individual has. The maximum amount of the offset from all sources of income is \$1,000 for an income year.

Example 1.1

Adrian is a small business entity. For the 2015-16 income year, Adrian's taxable income is \$100,000, his basic income tax liability is \$25,000, and his total net small business income is \$50,000.

To work out the amount of his small business income tax offset for the 2015-16 income year, Adrian first divides his total net small business income by his taxable income ($\$50,000/\$100,000 = 0.5$). The result of this calculation shows that half of Adrian's taxable income relates to his total net small business income.

Adrian then multiplies the result of the first calculation by his basic income tax liability ($0.5 \times \$25,000 = \$12,500$). The result of this second calculation shows that \$12,500 of Adrian's basic income tax liability is from his total net small business income.

Adrian's small business tax offset is equal to 5 per cent of the result of this second calculation ($0.05 \times \$12,500 = \625). The full amount of Adrian's small business tax offset is therefore \$625.

Adrian can claim the full amount of the small business tax offset for the 2015-16 income year because it is less than \$1,000.

Net small business income

1.24 The starting point for working out an individual's total net small business income for an income year is the related concept of 'net small business income'. Subject to specific modifications, a small business entity's 'net small business income' for an income year is the sum of the entity's assessable income minus its deductions for the income year, to the extent that the assessable income relates to the entity carrying on a business, and its deductions are attributable to that assessable income.
[Schedule 1, item 1, paragraphs 328-365(1)(a) and (b)]

1.25 A small business entity's net small business income is broadly equivalent to the entity's taxable income that relates to its small business activities.

1.26 Where a small business entity's assessable income that is taken into account in working out its net small business income is less than the deductions that are attributable to that income, the entity's net small business income for the income year is zero. [*Schedule 1, item 1, subsection 328-365(2)*]

1.27 Assigning a nil amount to net small business income in these circumstances prevents net small business income from being a negative amount. This approach ensures that in working out the amount of the offset, various amounts of net small business income that make up an individual's total net small business income do not offset one another, and the amount of an individual's total net small business income (which is divided by the entity's taxable income in calculating the amount of the offset) cannot be a negative amount.

1.28 The definition of small business entity requires that a small business entity carries on a business. The requirement in net small business income that assessable income relates to the business that is carried on by a small business entity ensures that net small business income reflects amounts earned through the business activities undertaken by the entity that make it a small business entity. The term 'business' is defined in section 995-1 and includes any 'profession, trade, employment, vocation or calling, but does not include occupation as an employee'.

1.29 In many cases, small business entities will receive income from a variety of sources. Income that does not relate to a small business entity carrying on a business (for example, employment income), will not form part of its net small business income.

Example 1.2

Warren is an individual who runs a small business (Wazza's Green Books) as a sole trader.

Warren earns ordinary income from carrying on the business through Wazza's Green Books throughout the 2015-16 income year. As a result of carrying on this business, Warren is a small business entity for the 2015-16 income year.

Throughout the 2015-16 income year, Warren also has a full time job working as a green keeper at a golf course.

The income that Warren makes through Wazza's Green Books relates to the business that Warren carries on as a small business entity,

whereas the employment income that Warren receives from his work at the golf course does not relate to a business that Warren carries on.

As such, in calculating his net small business income for the 2015-16 income year, Warren has regard to the income he earns from carrying on a business through Wazza's Green Books, but does not take into account the income he earns from his employment at the golf course.

1.30 The assessable income of an entity includes its ordinary income and statutory income. Whether or not an amount of assessable income relates to the business activities of a small business entity will be a question of fact.

1.31 An amount of assessable income that relates to ordinary income derived in the ordinary course of an entity carrying on a business would be taken into account in working out the entity's net small business income.

1.32 Amounts of statutory income will be included in a small business entity's assessable income for different reasons. To the extent that an amount of statutory income relates to the business that a small business entity carries on, the amount will be taken into account in working out the entity's net small business income. To establish that a particular amount of statutory income relates to a business that is carried on by a small business entity, it must be able to be objectively concluded that there is an association or connection between the income and the business activities of the entity.

1.33 An example of an amount of statutory income that would relate to the business carried on by a small business entity is a repayment of a farm management deposit under section 393-10. Where the owner of a farm management deposit withdraws a farm management deposit, the amount of the deduction that was claimed when the deposit was made is included in the owner's assessable income in the income year in which the withdrawal is made (for an explanation about the way deductions for farm management deposits are treated in working out net small business income, see paragraph 1.44 below). Because the deposit was made from income derived from the primary producer carrying on a primary production business, and the repayment of the deposit represents the primary producer realising those amounts in a later income year, the amount of statutory income that is referable to the repayment of the deposit would be assessable income related to the primary producer carrying on a business.

Example 1.3

Karen is both a primary producer and a small business entity.

In the 2011-12 income year, Karen makes a farm management deposit of \$100,000.

During the 2015-16 income year, Karen earns \$50,000 of ordinary income from carrying on a business as a primary producer, and also makes a \$50,000 withdrawal from the farm management deposit that she made in the 2011-12 income year.

Both the ordinary income and the withdrawal of the farm management deposit relate to the primary production business that Karen carries on.

As such, in working out her net small business income for the 2015-16 income year, Karen has regard to the \$50,000 of ordinary income that she earned from carrying on her primary production business, as well as the \$50,000 of statutory income included in her assessable income from the repayment of her farm management deposit.

Net capital gains and personal services income are disregarded in working out net small business income

1.34 The net small business income of a small business entity does not include assessable income that is a net capital gain or personal services income, unless the personal services income is produced from conducting a personal services business. [*Schedule 1, item 1, subparagraphs 328-365(1)(a)(i) and (ii)*]

1.35 A small business entity's net capital gain is excluded from its net small business income because net capital gains are aggregate amounts comprised of an entity's capital gains and capital losses. Identifying the extent to which a net capital gain relates to a small business entity's business activities would require a disaggregation of the net capital gain and reconsideration of the order in which gains are offset by losses. Although disregarding net capital gains will have the effect of reducing the amount of a small business entity's net small business income, it is consistent with the way prior year losses (which are also aggregated amounts) are disregarded in determining the deductions that are attributable to the assessable income of a small business entity (the treatment of prior year losses is explained further at paragraph 1.47 below).

1.36 Part 2-42 contains rules which limit the deductions that individuals can claim against their personal services income (see Division 85), and treat income of an entity (such as a partnership, trust or company) as the income of an individual where the income is made from the personal services of the individual (see Division 86). The rules in

Divisions 85 and 86 are intended to align the treatment of personal services income with employment income and do not apply to personal services income that is income from a personal services business.

1.37 Excluding amounts of income that are personal services income from net small business income ensures that the offset does not apply to income that is treated as employment income. In the context of net small business income, employment income is not earned in the course of carrying on a business and therefore cannot form part of a small business entity's net small business income.

1.38 However, limiting the restriction on personal services income to income that is not from a personal services business is consistent with the limitations under Divisions 85 and 86, as income from a personal services business is not treated as employment income.

General treatment of deductions in working out net small business income

1.39 Net small business income is a net amount that represents the part of a small business entity's taxable income that is from its business activities. As such, a small business entity's net small business income is reduced by any of the small business entity's deductions, to the extent the deductions are attributable to the income included in its net small business income. *[Schedule 1, item 1, paragraph 328-365(1)(b)]*

1.40 A small business entity may have deductions that relate to types of income that are not relevant in working out its net small business income. The inclusion of the words 'to the extent' allow for deductions to be apportioned where they relate to more than one source of income, some of which are included in net small business income and some of which are not.

1.41 The only deductions that are relevant in working out a small business entity's net small business income are those that are 'attributable' to the assessable income of the entity that is taken into consideration in working out its net small business income. This requirement ensures that a small business entity's net small business income is not reduced by deductions that are unrelated to the income included in its net small business income.

1.42 In the case of general deductions that are claimed under section 8-1, it is necessary to establish that a loss or outgoing was incurred in gaining or producing income. Because there will be a causal connection between income and a general deduction, it would generally be expected that a general deduction from a loss or outgoing incurred in gaining or producing a particular amount of income would also be attributable to that

amount of income for the purposes of calculating net small business income.

1.43 However, a deduction can also be attributable to an amount of income where it is not directly incurred in the course of gaining or producing the income. Specific deductions of the kind allowed under section 8-5 may also be attributable to a particular amount of income where there is a sufficient nexus between the income and the deduction, or where the relationship between an amount of income, or the business that generated the income, and the deduction is specifically provided for under the income tax laws.

1.44 An example of a specific deduction that is attributable to an amount of income is a deduction for a farm management deposit under Division 393. Under subsection 393-5(1), an individual can deduct the amount of a farm management deposit if they are the owner of a farm management deposit and they carry on a primary production business. Deductions of this kind are attributable to amounts of the primary producer's income because of the connection between the deduction allowed under subsection 393-5(1), and the income of the primary producer from carrying on their primary production business to which the deduction is applied.

1.45 Another example of a specific deduction which would be taken into account in calculating net small business income is a deferred deduction from non-commercial business activities under Division 35. Where Division 35 applies, an individual who has a deduction from non-commercial business activities can apply the deduction only to the extent they have assessable income that is generated from the same business activities that gave rise to the deduction. Any remaining amounts of the deduction are quarantined, and the individual can claim a deduction in later income years equal to the quarantined amount against assessable income that is generated from the same business activity that gave rise to the quarantined deduction. In applying the deduction to such income in a later year, paragraph 35-10(2)(b) specifically attributes the deduction to the business activity that generated the income. Because the deduction is applied to the income from that activity, the deduction would also be attributable to the income. Given that such amounts of income are from a particular business activity of an entity, it would be expected that both income and the deductions of this kind would be taken into account in working out a small business entity's net small business income.

1.46 Similarly, deductions under section 40-880 apply in respect of costs incurred in relation to the business of an entity, including a proposed business. Although such deductions might not relate to amounts directly incurred in producing amounts of income that are earned in the course of carrying on the business, they would nevertheless be attributable to

income earned in the ordinary course of carrying on the business because of the relationship between the deduction and the business that gave rise to the income. In cases where a small business entity does not have any income to apply a deduction against (for example, in the case of expenditure related to a business that is proposed to be carried on), the entity would not have any net small business income in relation to that business activity. However, if Division 35 also applied to a deduction for business related costs (for example, to expenditure in relation to a proposed business), and as a result the availability of the deduction was deferred to a later income year, the deduction in relation to the business related costs would be attributable to income related to the business activity in the later income year.

1.47 In contrast to deductions for non-commercial business activities, deductions in an income year for Division 36 losses would not be attributable to the income earned in the income year. Rather, prior year losses under Division 36 are attributable to the income earned in the year or years in which the loss was incurred. The requirement that deductions are attributable to income is only satisfied where there is a clear connection between the deduction and a particular amount of income, or the underlying business activities that gave rise to the income, in the income year in which the deduction applied. This connection can be the result of either the type of deduction (for example, a general deduction under section 8-1), or because of a relationship that is specifically provided (for example, a deduction for non-commercial business activities that is attributed to the business activities in a later income year).

1.48 Although a prior year loss under Division 36 may be entirely composed of deductions that related to income in a previous income year that would have been included in net small business income, it may also be the case that a prior year loss is comprised of deductions that were attributable to other types of income. It is not intended that taxpayers deconstruct their prior year losses to determine which components were attributable to different types of income in a previous income year. However, where an individual is liable to pay tax on the share of the net small business income of a trust, Division 36 losses (and other deductions not taken into account in working out net small business income) may be relevant in determining the amount of the share that is included in the individual's total net small business income (see paragraphs 1.62 below).

1.49 Although there will be cases where another entity is able to claim a deduction in relation to income that is included in the net small business income of a small business entity, deductions of this kind are not taken into account in working out the small business entity's net small business income. For example, a partner may have a deduction in relation to their share of the net small business income of a partnership, but that deduction will not be taken into consideration in working out the net small

business income of the partnership. However, deductions that can be claimed by an individual in relation to their share of a small business entity's net small business income will be relevant in working out the individual's total net small business income (see paragraphs 1.63 to 1.67 below).

Deductions that are disregarded in working out net small business income and total net small business income

1.50 For the purposes of working out a small business entity's net small business income, and an individual's total net small business income (explained further below), certain deductions are disregarded. The deductions that are disregarded are deductions for tax-related expenses under section 25-5, deductions for gifts or contributions under Division 30, and deductions for personal superannuation contributions under Subdivision 290-C. [*Schedule 1, item 1, section 328-370*]

1.51 In some cases it may be arguable that deductions for tax-related expenses, deductions for gifts or contributions, or deductions for personal superannuation contributions are associated with particular amounts of income. However, to avoid having to establish whether expenses of this kind are attributable to particular amounts of income, or to apportion such deductions between different types of income, deductions related to these expenses are not considered in working out the net small business income of a small business entity, or the total net small business income of an individual.

1.52 Disregarding deductions in this way increases the amount of a small business entity's net small business income, and increases the amount of an individual's total net small business income. Increasing these amounts has the effect of increasing the maximum amount of the tax offset that can be claimed by an individual, subject to the \$1,000 limit.

Total net small business income

1.53 An individual's 'total net small business income' for an income year is comprised of the net small business income they make as a small business entity during the income year, together with any share of the net small business income of another entity that is a small business entity (other than a corporate tax entity), which is included in the individual's assessable income. [*Schedule 1, item 1, subsection 328-360(1)*]

1.54 In conjunction with taxable income, an individual's total net small business income is used to determine the proportion of the individual's basic income tax liability that relates to small business activities. To work out this proportion, the individual's total net small business income is divided by their taxable income.

1.55 The total amount of net small business income is capped at the amount of their taxable income to ensure that this proportion does not exceed 100 per cent. *[Schedule 1, item 1, subsection 328-360(1)]*

1.56 Applying a proportion of more than 100 per cent would inflate the amount of the individual's basic income tax liability in working out the amount of the small business tax offset.

1.57 Total net small business income aggregates the various amounts of net small business income that an individual is liable to pay income tax on. Although individuals will have to work out the various amounts of net small business income, combining these amounts allows individuals to claim a single small business income tax offset, and do one calculation for working out the amount of the tax offset.

1.58 Individuals work out the net small business income that they earn in their capacity as a small business entity in the same way as other small business entities. However, where an individual is liable to pay income tax on the share of the net small business income of another entity, there are a number of additional considerations relevant to the individual that must be taken into account.

1.59 The first of these considerations is that the individual only includes in their total net small business income, their share of the net small business income of a small business entity that is also included in their assessable income. *[Schedule 1, item 1, paragraph 328-360(1)(b)]*

1.60 Where an individual receives a share of a small business entity's net small business income, but that amount is not included in the individual's assessable income, the share does not form part of the individual's total net small business income. Amounts that are not included in the individual's assessable income are not taxed in the hands of the individual. Because total net small business income determines the amount of an individual's small business tax offset, it is appropriate to restrict the individual's total net small business income to amounts that the individual actually pays income tax on.

1.61 The requirement that an individual's share of the net small business income of a small business entity is included in the individual's assessable income may mean that deductions available to the small business entity that are not considered in working out its net small business income are relevant in working out an individual's total net small business income.

1.62 Using the example of prior year losses that are retained in a trust that is a small business entity, if the trust had prior year losses that exceeded its assessable income in an income year, it would be possible for

a beneficiary of the trust to have a share of the trust's net small business income but not have any assessable income in relation to that share. In such cases the basic calculation of the trust's net small business income would be unaffected by the prior year loss (as the net small business income of the trust does not take account of the prior year loss), but the individual's total net small business income would not include their share of the trust's net small business income because it was not included in their assessable income.

1.63 In working out an individual's total net small business income, the individual is also required to reduce their share of a small business entity's net small business income by any deductions that the individual has, to the extent the deductions are attributable to their share of the net small business income. [*Schedule 1, item 1, paragraph 328-360(1)(b)*]

1.64 In some cases an individual will be able to claim deductions in relation to their share of a small business entity's net small business income that are not available to the small business entity. Deductions of this kind are not taken into consideration in calculating the net small business income of the small business entity. This approach to calculating the net small business income of a small business entity reflects the fact that a deduction available to the individual will not be available to other entities who also have a share of the net small business income (although other individuals may have to apply their own deductions that are attributable to their respective shares).

1.65 Applying the deduction that an individual has in relation to a share of the net small business income of a small business entity ensures that their total net small business income represents the part of the individual's taxable income that is from small business activities. In working out whether an individual must apply a particular deduction to their share of the net small business income of a small business entity, the same considerations that are relevant in determining whether a small business entity's deduction is attributable to a particular amount of its assessable income apply. Similarly, the considerations about the extent to which a deduction is attributable to a particular amount of income that are relevant in working out a small business entity's net small business income also apply to an individual in respect of their share of the entity's net small business income.

1.66 A deduction will be attributable to an individual's share of the net small business income of a small business entity if it is a deduction for an expense incurred by a small business entity that is not applied by the entity, but is instead applied (in whole or part) by an individual to their share of the small business entity's income. An example of a deduction of this kind is a deduction under section 40-570 in relation to capital expenditure on depreciating assets that are water facilities or horticultural

plants. Where a partnership incurs an expense in relation to these types of assets, section 40-570 specifically allocates a share of the expense to individual partners. As such, even if the expense satisfies the requirements about being attributable to ordinary income of the partnership that forms part of its net small business income, the expense will not be a deduction that can be applied to the partnership's net small business income. However, to the extent an individual partner can claim a deduction for the expenditure, and the deduction is attributable to the partner's share of the net small business income of the partnership, the partner's share of the net small business income of the partnership will be reduced by the amount of the deduction in working out the partner's total net small business income.

1.67 Deductions that do not relate to expenditure by the small business entity can still be attributable to an individual's share of the net small business income of the entity if there is a sufficient nexus between the deduction and the individual's share. An example of a deduction of this kind is an interest expense incurred by an individual in relation to money that they borrow to buy into a partnership. Assuming that the individual has a share of the net small business income of the partnership included in their assessable income, the deduction that is also available to the individual for those interest expenses should be applied to reduce their total net small business income for the income year. Applying deductions of this kind ensures that individual partners are in the same position they would have been in had they been a sole trader undertaking the same sorts of business activities and incurring the same sorts of expenses as the partnership.

1.68 Consistent with the approach for working out a small business entity's net small business income, individuals are not required to apply deductions for tax-related expenses under section 25-5, deductions for gifts or contributions under Division 30, and deductions for personal superannuation contributions under Subdivision 290-C (see paragraphs 1.50 to 1.52 above). [*Schedule 1, item 1, paragraph 328-360(1)(b)*]

1.69 In the event that an individual is liable to pay income tax on a share of the net small business income of a corporate tax entity, such shares are not taken into account in working out the individual's total net small business income. [*Schedule 1, item 1, subsection 328-360(1)*]

1.70 An individual who pays income tax on the income of a corporate tax entity cannot claim the small business tax offset in relation to that income, but can continue to claim the offset in relation to other net small business income. To ensure that the small business tax offset only applies to the net small business income of unincorporated small business, an individual's share of the net small business income of a corporate tax entity is disregarded in working out the individual's total net small business income.

Example 1.4

Zoe is an individual who runs a small business as a sole trader. Zoe has \$80,000 of net small business income in her capacity as a small business entity for the 2015-16 income year.

Zoe is also a partner in a partnership that is a small business entity. For the 2015-16 income year, the partnership has a net small business income of \$50,000, and \$25,000 of this net small business income is included in Zoe's assessable income. Zoe is able to claim a deduction of \$5,000 in relation to the share of the partnership's net small business income included in her assessable income.

Zoe is also a beneficiary of a trust that is a small business entity. For the 2015-16 income year, the trust has assessable income of \$30,000 and has net small business income of \$25,000. However, the trust has prior year losses of \$50,000. As a result of those losses the trust has no net income for the 2015-16 income year, and none of the trust's net small business income is included in Zoe's assessable income for that year.

Zoe's total net small business income for the 2015-16 income year is \$100,000.

This \$100,000 is comprised of the \$80,000 of net small business income Zoe has in her capacity as a sole trader, and \$20,000 from her share of the partnership's net small business income (being Zoe's \$25,000 share of the net small business income, minus \$5,000 for the deductions to which she is entitled). Zoe does not include any amount of her share of the trust's net small business income in her total net small business income for the income year.

Working out the total net small business income of certain minors

1.71 Division 6AA of Part III of the ITAA 1936 sets out special rules which apply to the income of minors. A minor to which Division 6AA applies is referred to as a 'prescribed person'. Subject to some exceptions, the income of a prescribed person is taxed at higher rates than those generally applicable to individuals. These rules were introduced to remove incentives for adults to split their income by diverting it to their children.

1.72 The general rules for working out total net small business income do not apply to individuals who are a 'prescribed person' within the meaning of section 102AC of the ITAA 1936. [*Schedule 1, item 1, subsection 328-375(1)*]

1.73 Instead, the total net small business income of a prescribed person is the total amount of 'business income' (within the meaning of subsection 102AE(5) of the ITAA 1936) that the prescribed person

derives from carrying on a business as a small business entity, and from carrying on a business in a partnership that is a small business entity, less any deductions that the prescribed person or the partnership has, to the extent the deductions are attributable to the prescribed person's business income. [Schedule 1, item 1, subsection 328-375(2)]

1.74 This approach restricts the income included in the total net small business income of a prescribed person to their business income. As a result of this different approach to calculating total net small business income, the amount of the small business tax offset for a prescribed person may be different than the amount of the tax offset that would be available to another individual in the same circumstances.

1.75 Restricting the total net small business income of a prescribed person in this way is a targeted way of ensuring the small business tax offset applies only to the income of a minor that is genuinely related to the minor's own business activities. This restriction will not apply to a minor who is not a prescribed person because they are an excepted person under Division 6AA of Part III of the ITAA 1936.

1.76 While there is no issue with the small business tax offset applying to a minor in relation to income they earn from activities they genuinely undertake, applying the offset to amounts of a minor's income that are subject to Division 6AA of Part III of the ITAA 1936 would undermine the application of that Division because it would wind back the increased rates of tax that apply to the minor in respect of that income under section 13 of the *Income Tax Rates Act 1986*.

1.77 The concepts about a prescribed person 'deriving the income from carrying on a business', and the business being carried on by the prescribed person either 'alone or in the partnership' are consistent with the way 102AE(5) envisages that such amounts are made by the minor.

1.78 The term 'business income' is explained further at subsection 102AE(5) of the ITAA 1936 as income derived by a minor from carrying on a business, either alone or in partnership. In broad terms, the business income of a minor is the income derived by a minor through business activities that they genuinely carry on. In determining the amount of a minor's business income, regard is had to things like the extent to which the minor had real control over the business and the disposal of its income and the extent to which the capital of the business consisted of capital contributed by the minor. Business income is the only type of a prescribed person's income excluded from Division 6AA that is consistent with the type of income (being assessable income to the extent it relates to carrying on a business) to which the small business tax offset is intended to apply.

1.79 Where a prescribed person carries on a business as a small business entity, determining their business income will be very similar to identifying the income that is relevant to working out the net small business income of another individual that is a small business entity. In both cases, the relevant income must be assessable income that relates to the individual carrying on a business. The key difference for the prescribed person is that the income must also satisfy the additional business income requirements set out in subsection 102AE(5).

1.80 Where a prescribed person has a share of the income of a small business entity included in their assessable income, the general approach to working out their total net small business income does not apply. Instead, the prescribed person can only include in their total net small business income, amounts of business income that they derive as a partner of a partnership that is a small business entity. Although the income of the partnership will be earned by the partnership, targeting the business income of the prescribed person derived through the partnership is consistent with the way such income is identified under Division 6AA.

1.81 Because of the direct focus on the business income of the prescribed person, other amounts of the partnership's income (for example, other amounts of partnership income that the prescribed person derives, or that are derived by other partners in the partnership) are not relevant in working out the prescribed person's total net small business income. This approach means that a prescribed person cannot apply the small business tax offset to other amounts included in their assessable income that would qualify under the general approach to working out total net small business income. This approach means that any distributions from a trust that are included in the assessable income of a prescribed person will not be eligible for the tax offset. This restriction reflects the fact that under Division 6AA, there is no scope for a prescribed person to derive business income from a trust.

1.82 In addition to identifying amounts of business income, a prescribed person must reduce their business income by any deductions that they have, to the extent the deductions are attributable to their business income. Further, if the prescribed person has business income from carrying on a business through a partnership, any deductions available to the partnership, to the extent the deductions are attributable to that business income, are also applied in working out the prescribed person's total net small business income. *[Schedule 1, item 1, paragraph 328-375(2)(b)]*

1.83 The general approach outlined above in relation to determining whether deductions are attributable to particular amounts of assessable income, as well as the extent to which such deductions are attributable, applies equally in working out whether deductions are attributable to the

business income of a prescribed person. Because the total net small business income of a prescribed person looks directly at the business income they derive from carrying on a business through a partnership, the deductions of the partnership that are attributable to that business income are applied directly to the business income (rather than being applied in the course of identifying the net small business income of the partnership). However, although the mechanism for applying deductions to income earned through a partnership is different, the principles for determining whether the deductions available to the partnership are attributable to the income are the same.

1.84 Consistent with the general approach to calculating net small business income, if the total business income of a prescribed person is less than the deductions attributable to that income, the total net small business income of a prescribed person is zero. Similarly, and consistent with the general approach to calculating total net small business income, the total net small business income of a prescribed person cannot exceed their taxable income for the income year. *[Schedule 1, item 1, subsection 328-375(3)]*

1.85 These modifications to working out a prescribed person's total net small business income ensure that a prescribed person cannot have a negative amount of total net small business income, and that the amount of the prescribed person's basic income tax liability is not inflated in working out the amount of the small business tax offset.

Consequential amendments

1.86 These amendments make consequential amendments to add the small business tax offset to the list of tax offsets in the table to section 13-1, to include material about the small business tax offset in the Guide to Division 328, and to add the small business tax offset to the list of concessions available to small business entities in the table to section 328-10. Consequential amendments are also made to subsection 995-1(1) to insert the definition of 'net small business income'. *[Schedule 1, items 2 to 5, table in section 13-1, section 328-5, table in subsection 328-10(1) and subsection 995-1(1)]*

Application and transitional provisions

1.87 The amendments apply to assessments for the 2015-16 income year and later income years.

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Tax discount for unincorporated small businesses

1.88 Schedule 1 to this Bill is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

1.89 Schedule 1 to this Bill amends the income tax laws to provide a tax offset (the small business income tax offset) to individuals who run small businesses (businesses with an aggregate annual turnover of less than \$2 million), or who pay income tax on a share of the income of a small business.

1.90 The amount of the tax offset is 5 per cent of the income tax payable on the portion of an individual's income that is small business income. In addition to calculating the offset in this way, the maximum amount of the tax offset available to an individual in an income year is capped at \$1,000.

Human rights implications

1.91 Schedule 1 to this Bill does not engage any of the applicable rights or freedoms.

Conclusion

1.92 Schedule 1 to this Bill is compatible with human rights as it does not raise any human rights issues.

REGULATION IMPACT STATEMENT

Tax discount for unincorporated small businesses

Background

1.93 The Australian economy is in transition and faces significant structural challenges due to both domestic and international factors. Mining investment is now detracting from GDP growth. The switch to broader-based growth driven by activity in non-resource sectors is occurring, but perhaps more slowly than is desirable.

1.94 Below trend economic growth is leading to spare capacity in the labour market and increasing unemployment, particularly youth unemployment. Economic growth has been below its long run average in 5 of the past 6 financial years, weighing on job creation and contributing to a gradual upward drift in unemployment.

1.95 Low interest rates, a falling Australian dollar and real wage adjustment over time are expected to support employment and encourage business growth over the longer term.

1.96 There have been some positive signs the required adjustment is underway, including job advertisements showing a slight upward trend in recent months.

1.97 However there is a risk of the adjustment being a protracted one, particularly given businesses remain reluctant to invest and take on new workers in the absence of stronger sustainable consumer demand. Investment in the non-mining sectors continues to be subdued, and small businesses have responded by scaling back the level of their capital spending. Treasury anticipates that longer-term capital expenditure will be lower than previously anticipated in the non-mining sector, notwithstanding solid growth this year.

1.98 In the 2015-16 Budget, the Treasurer announced unincorporated small businesses will be able to claim a non-refundable tax offset (otherwise known as a tax credit or a rebate) calculated at 5 per cent of the tax payable on business income, limited to \$1,000 per taxpayer. This tax discount was announced along with a 1.5 percentage point tax cut for incorporated small businesses.

The problem

1.99 Small businesses make an important contribution to the Australian economy. They account for the vast majority of the active private businesses in the country and represent large shares of its employment and value added.

1.100 There are currently around 2.3 million small businesses in Australia (defined as having less than \$2 million turnover). According to the Australian Bureau of Statistics, small businesses provide around 43 per cent of non-financial private sector jobs in Australia and around one third of non-financial output in 2012-13. The small business sector has the potential to contribute strongly to national growth and competitiveness, including providing greater employment opportunities. Small businesses have the advantage of being adaptable and flexible and the ability to respond profitably to changing circumstances. Studies indicate that it is small businesses that are often the entities that test and pioneer innovative ideas and business practices which are critical to future economic growth, job prospects and improved living standards.

1.101 However, while small businesses play a significant role in the Australian economy, they also face a unique set of operational challenges, and as a consequence typically have higher failure rates than those for larger companies. A comparison of the outcomes of the National Australia Bank survey of large companies, with the Sensis survey of small businesses undertaken by the Reserve Bank suggests that conditions for small businesses have been weaker than for larger businesses since the global financial crisis in 2008-09.

1.102 A further challenge for small companies is access to finance. Funding for small businesses is essential to facilitate productivity growth and job creation. Improving small business's access to finance was a Government election commitment.

Case for government action / Objective of reform

1.103 There is a clear role for Government to address impediments and create the right conditions for Australian small businesses to grow and become more productive, creating more jobs. With the economy facing below-trend growth, the Government's objective is to stimulate small business investment, growth and employment.

1.104 The Australian economy is in transition. The declining terms of trade and the ageing of the population are placing downward pressure on income growth. Small businesses are a key driver of Australia's economy,

underpinning growth and innovation and providing jobs for millions of Australians.

1.105 Small businesses are typically more vulnerable to shocks and changes in economic conditions than larger businesses. This makes it particularly important that, during this period of economic transition, policy settings support small business growth and innovation. This proposal will reduce the tax burden on many unincorporated small businesses.

1.106 The Government committed to introducing a 1.5 percentage point small business tax cut from 1 July 2015 in the Coalition's Policy for Small Business. On 2 February the Prime Minister announced a small business and jobs package would be announced in the 2015-16 Budget.

1.107 Reducing the rate of company tax for incorporated small businesses without offering a tax cut for unincorporated entities might have inadvertently encouraged small business owners to structure their business differently from how they would prefer in order to gain a tax advantage. Business owners may choose not to incorporate because the reporting requirements are less onerous or because they desire more flexibility in how operate their business. These decisions are not always about tax, but rather what structure best suits the business and its owners.

1.108 For businesses that are operated by a sole trader, through a partnership or through a trust, the business income is usually taxed in the hands of the business owner/s at their marginal rate of personal income tax. That is, unincorporated businesses are not taxed like a company; the income from the business flows through to individual owner/s according to the tax rules applying to that structure type and then taxed at the individual level along with any other income the individual earns.

1.109 Providing a tax discount for unincorporated small businesses, which broadly mirrors the small company tax cut, will help to improve the cash flow of small businesses by reducing the amount of tax payable in the financial year, and help to alleviate the problem of higher regulatory costs.

1.110 The tax discount, and the increase in business cash flow, may also help some small businesses to secure finance. Providing unincorporated small businesses with a tax discount may encourage extra business activity as previously marginal activities become more profitable. Businesses can re-invest in their business with the cash-flow from the discount in the way they consider best for their business. This increased investment is expected to lead to higher employment and wages over time.

Policy options

Option 1: No change

1.111 Under this option, no new actions would be taken by the Government and existing policy settings would be relied upon.

1.112 Unincorporated business income is added to an individual's other income and taxed at their marginal personal income tax rates.

Option 2: 5 per cent unincorporated tax discount for small business, capped at \$1,000

1.113 This proposal would provide individual taxpayers with business income from an unincorporated small business with aggregated annual turnover less than \$2 million with a 5 per cent discount on the tax payable on their taxable income from that source. The discount would be capped at \$1,000 per individual in an income year, delivered as a tax offset. The proposal would apply to income years beginning on or after 1 July 2015.

1.114 The tax discount would be calculated by summing all net small business income (net business income from businesses which pass the small business entity test), multiplied by the individuals average tax rate, multiplied by 5 per cent. This formula ensures that the discount is only available for small business income and not the entire income of an individual who has small business income. The \$1,000 cap applies at the individual taxpayer level. An individual can receive income from any number of small business entities, but the offset cannot exceed the cap. If a small business has multiple owners, each of those owners may receive the offset, up to the \$1,000 cap.

1.115 There is no requirement for individuals to calculate this offset as the ATO will do this in E-Tax software and other IT systems. There will be some minor reporting requirements at the business entity level to inform individual taxpayers of the net small business income from that entity.

1.116 This proposal would directly affect the owners of small unincorporated business entities (those with aggregated turnover less than \$2 million). The costs and benefits of this proposal should be considered alongside the small company tax rate cut of 1.5 percentage points.

Option 3: 5 per cent unincorporated tax discount for small business, uncapped

1.117 This option would operate in the same way as option 2, above. However, instead of being capped at \$1,000 this option would only be

bound by the \$2 million turnover threshold. For example, a business with an aggregated turnover less than \$2 million and a taxable income of \$1 million would be able to claim a tax discount of over \$20,000. Not many businesses would fit this scenario, but it highlights the value of the tax discount for more profitable small businesses, if the discount is uncapped.

1.118 This option may require extra integrity measures which limit the tax advantage which businesses receive from restructuring for the sole purpose of benefitting from this discount.

Cost benefit analysis of each option / Impact analysis

Option 1: No policy change.

1.119 This option involves no new actions by the Government and relies on existing policy settings. Consequently, it would introduce no new impacts on businesses, community organisations or individuals. At the same time, it would not address the issues identified in the problem section.

1.120 In addition, this option would mean that most small businesses would not receive a tax cut. The 1.5 percentage point small business tax cut for companies will not flow through to unincorporated entities and may cause a distortion in the decisions of small business in how they choose to structure.

Options 2 and 3: A 5 per cent tax discount for small business

Benefits

1.121 In Australia, most (around 70 per cent) small businesses tend to operate as a sole trader, partnership or trust, rather than a company, so these businesses would not be eligible for a cut in the company tax rate. A 5 per cent discount on the tax payable on their taxable income would reduce the tax rate on income from an unincorporated business in the hands of its owner/s and so broadly mirror the tax cut proposed for small companies.

1.122 Unlike a tax cut for companies that satisfy the small business test, this proposal would give a tax cut to *unincorporated* businesses with turnover below \$2 million – around 1.5 million businesses.

Levi and Darcy own a small greengrocer business run as a partnership. Their turnover is \$600,000 and the taxable income of the partnership is \$120,000. Levi and Darcy each receive \$60,000 and would ordinarily pay tax of approximately \$11,000 each. To calculate the offset, they would each multiply their net small business income (\$60,000) by their

average tax rate ($11,000/60,000 = 18.3\%$) and then multiplied by 5 per cent. (Note that they do not include any income any than the net small business income in the tax offset calculation.) The offset is approximately \$550. Levi and Darcy would each end up with a tax liability of approximately \$10,450 ($\$11,000 - \550).

1.123 This proposal will result in unincorporated small business owners having higher after-tax earnings which they will be free to reinvest in their businesses. While the average proportion of the additional cash-in-hand that owners would reinvest is unknown, on average, this is expected to increase growth and productivity in the small business sector.

1.124 The design of options 2 and 3 prevents individuals from applying for an ABN to get a discount on their other income. It does this using the existing rules for a small business entity: that the entity must be carrying on a business, not just having an ABN. Another aspect of the design that prevents manipulation is that measure only calculates the tax discount on income from a small business, not the entire income of a small business owner.

Costs

1.125 Revenue loss for government in the short term is estimated to be \$1.8 billion over the forward estimates for option 2, which is capped at \$1,000 per individual. Considering the cost to revenue of option 2, the uncapped option (3) has not been costed. The high cost to government revenue of option 3 is not considered appropriate in the current fiscal circumstances.

1.126 The proposed cap in option 2 will limit the cost to revenue of this proposal, but means that the proportional tax cut for those with higher business incomes will be less. This will retain an incentive for business owners to consider incorporation when their business earnings are larger and take them into higher personal income tax brackets.

1.127 There will be some transitional compliance costs for around 1.5 million unincorporated small business entities, as well as the estimated 785,000 individuals who receive distributions from trusts and partnerships. These implementation costs relate to understanding and adjusting to the new arrangements and have been assessed at around \$14.8 million per year. The assessed regulatory costs assume that the majority (around 90 per cent) of both unincorporated businesses and individuals receiving distributions use a tax agent or accountant.

1.128 Option 3 has the same regulatory costs. Although there would be some reduction in complexity from not having a \$1,000 cap, any compliance savings are expected to be offset by the increased integrity measures required for option 3. These integrity measures would be

required to prevent larger businesses from artificially structuring into multiple entities to qualify as small businesses and gain access to this proposal and other concessions. While not directed at small business, integrity rules may impose a compliance burden on a large number of small business taxpayers.

1.129 Ongoing compliance costs are expected to be minor. Partnerships and trusts will need to determine and advise individuals receiving distributions of the amount of the income distributed which will be eligible for the tax discount. Individuals receiving the tax discount, or their tax agent, will also be required to complete a new label on their tax return reflecting this information.

Net Benefit

1.130 Options 2 and 3 would potentially benefit around 1.5 million small unincorporated businesses including sole traders, partnerships and trusts. Like the tax cut proposed for incorporated small businesses, because the proposal is a tax-based assistance measure, the benefit will be proportional to the amount of tax the business pays up until the \$1000 cap 'binds', for option 2. At what business income level the \$1000 cap binds will be dependent on the average tax rate of the individual, but would be around \$80,000 of business income per individual assuming they have no other income sources.

1.131 The tax discount will result in unincorporated small business owners having higher after-tax earnings which they can reinvest in their businesses. To the extent this occurs, it will tend to increase growth and productivity in the small business sector.

1.132 Overall the proposal is assessed as having a low overall compliance cost impact, comprising a low implementation impact, and a low increase in ongoing compliance costs relative to the status quo. Average annual compliance costs are detailed in the table below.

Table 1.1: Regulatory burden and cost offset estimate table for options 2 and 3

<i>Average annual regulatory costs (from business as usual)</i>				
Change in costs (\$ million)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	\$12.0 m	\$	\$3.6m	\$15.6 m
Cost offset (\$ million)	Business	Community organisations	Individuals	Total, by source
Agency	\$15.6 m	\$	\$	\$15.6m
Are all new costs offset?				
<input type="checkbox"/> Yes, costs are offset <input type="checkbox"/> No, costs are not offset <input type="checkbox"/> Deregulatory—no offsets required				
Total (Change in costs – Cost offset) (\$ million) = \$0				

1.133 The regulatory costs associated with this measure are offset by the regulatory cost reduction associated with a measure to simplify transfer pricing records.

Consultation

1.134 The tax proposals have been informed by targeted consultation with tax specialists outside government, including the Board of Taxation (the Board), on a confidential basis. Options were discussed with the Board on a couple of occasions, to give particular Board members an opportunity to provide feedback and to ask follow-up questions. This included the incorporated tax cuts and accelerated depreciation options. The Board's positive feedback was a factor in deciding on particular parameters in the final policy design.

1.135 The Treasury also consulted with the Australian Tax Office in order to identify any implementation issues, integrity concerns with the proposals, as well as any potential flow-on impacts they might have within the broader tax framework.

1.136 The limited consultation on the proposals reflects the cabinet-in-confidence nature of the decision making process. However, this proposal needs to be considered alongside the incorporated tax cuts for small business, which was an election commitment. One of the benefits of this proposal is that it complements the incorporated tax cuts by providing a tax cut to unincorporated small businesses. Without this proposal there would be a disincentive to structure as an unincorporated entity.

1.137 The legislative change requires careful consideration and targeted consultation to determine an approach for implementation will occur between the drafting process and introduction to parliament.

1.138 As the implementing legislation is to be introduced as a 2015 Winter A Bill, it is not possible for public consultation to occur on exposure draft legislation. Feedback provided in the public domain by businesses and industry organisations, including the Council of Small Business Australia, on the Budget announcement has indicated broad support for the measure.

Option selection / Conclusion

1.139 The preferred option is to provide a tax discount capped at \$1,000 to individuals with small business income, which would broadly mirror the small company tax cut. This option will provide increased cash flow to unincorporated small businesses allowing them to re-invest in their businesses. The greater re-investment from this and other announced measures of the Government are likely to lead to increased productivity and employment.

1.140 The high cost to government revenue of option 3 is not considered appropriate in the current fiscal circumstances.

1.141 This option strikes a balance between encouraging investment and economic growth and ongoing budget repair.

Implementation and evaluation / Review

1.142 Legislation is required to implement the proposal. As the Government has set the start date as the 2015-16 income year, a 5 per cent tax discount for small business, capped at \$1,000, is scheduled to be introduced to the Parliament during the Winter sittings.

1.143 The design of the legislation is expected to be relatively straightforward largely relying on current models in the tax system.

1.144 The ATO would be responsible for administering the tax rules applying to small businesses. The ATO and Treasury are experienced in implementing this type of reform.

1.145 Evaluation of this proposal would be on-going. It is expected that the ATO's normal compliance and data analysis activities would identify tax avoidance activities occurring as a result of this proposal.

1.146 The benefit of this proposal should not be assessed in isolation, but considered as part of the small business package.

Chapter 2

Immediate deductibility for small business start-up expenses

Outline of chapter

Schedule 2 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to allow small businesses and individuals to immediately deduct costs incurred when starting up a business, including government fees and charges as well as costs associated with raising capital, that are presently only deductible over five years.

Context of amendments

Current law on deductions for capital expenditure

The tax law draws a distinction between income and capital, both for the purposes of determining whether amounts are ordinary income and in determining whether a loss or outgoing gives rise to a general deduction.

Taxpayers carrying on a business can generally deduct from their assessable income any losses or outgoings which are necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. However, they cannot deduct any losses or outgoings of capital or of a capital nature: see subsection 8-1(2) of the ITAA 1997.

However, the cost of acquiring capital assets is generally recognised for tax purposes elsewhere in the tax law.

In particular, Division 40 of the ITAA 1997 generally allows a deduction for capital assets acquired by taxpayers equal to the amount by which assets decline in value over each income year. However, a deduction is allowed only to the extent assets are held for a taxable purpose, such as the purpose of producing assessable income. Division 40 also provides special rules that allow deductions for certain other capital expenditure.

To avoid expenditure incurred by a business for the purpose of producing assessable income not being recognised anywhere in the tax law (referred to as black hole expenditure), section 40-880 of the ITAA 1997 allows entities to deduct over a five-year period capital expenditure they incur for the purposes of a business that the entity carries on, or a business proposed to be carried on, or that used to be carried on.

Deductions under section 40-880 are only available if:

- the business is, was previously, or is proposed to be carried on for a taxable purpose;
- the expenditure relates to the business or the entity deriving assessable income from the business; and
- the expenditure does not fall within one of the categories of excluded expenditure listed under subsection 40-880(5).

For example, expenditure is excluded under subsection 40-880(5) if it:

- forms part of the cost of a depreciating asset;
- can be deducted under another section of the tax law;
- is incurred in relation to a lease or other legal or equitable right;
- is expenditure which is of a private or domestic nature; or
- is incurred in producing exempt income or non-assessable non-exempt income.

Expenses incurred in starting up a business

Among the types of expenditure that are generally deductible under section 40-880 are expenses relating to establishing a proposed business.

Normally most expenses related to carrying on a business are:

- deductible (generally under the general deduction provisions in section 8-1 or the trading stock rules in Division 70 of the ITAA 1997); or
- included in the cost base of assets for the purposes of the capital gains tax rules in Part 3-1 of the ITAA 1997 or the capital allowance rules in Division 40 of the ITAA 1997.

However, expenditure incurred in relation to a proposed business before the business is carried on is generally not deductible under these general provisions. As the business is not yet operating, most of the provisions relevant to deductions for carrying on a business do not apply. Further, in some cases the entity incurring the expenditure will not be the entity carrying on the business; rather, it will be incurred by another entity involved in establishing the business that expects to profit from it.

For these pre-establishment expenses, it is often only section 40-880 that will allow the expenditure to be deducted. Consistent with other deductions under section 40-880, such expenditure is presently deductible over five years.

On 12 May 2015, in the 2015-16 Budget, the Treasurer announced that from the 2015-16 income year, businesses would be able to immediately deduct a range of expenses associated with starting a new business, including professional, accounting and legal advice, that can only presently be deducted over a five year period.

Summary of new law

Schedule 2 to this Bill amends the ITAA 1997 to allow taxpayers who are not in business or are a small business entity to immediately deduct certain expenses relating to the proposed structure or operation of a business. The expenses must relate to a business that is proposed to be carried on, including certain government fees and charges and costs associated with raising capital, where these expenses would otherwise be deductible over five years under section 40-880 of the ITAA 1997.

For expenses to be immediately deductible, the entity claiming the deduction must be:

- a small business entity; or
- not carrying on a business and not connected with, or an affiliate of, an entity that carries on a business that is not a small business entity;
- for the income year in which the deduction is claimed.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Deductibility of start-up expenses	
Certain start-up expenses, including costs associated with raising capital, that would otherwise be deductible over five years are immediately deductible where they are incurred by a small business entity or an entity that is not in business.	Business capital expenditure, including start-up expenses, is deductible over five years for all businesses.

Detailed explanation of new law

Certain start-up expenses immediately deductible

Expenditure that would be deductible over five years under section 40-880 of the ITAA 1997 is fully deductible in the income year in which the expenditure is incurred if the expenditure:

- relates to a business that is proposed to be carried on; and
- is either:
 - incurred in obtaining advice or services relating to the proposed structure or the proposed operation of the business; or
 - is a payment to an Australian government agency of a fee, tax or charge incurred in relation to setting up the business or establishing its operating structure; and
- the entity that incurred the expenditure is either:
 - a small business entity for that income year; or
 - does not carry on a business and does not control and is not controlled by an entity carrying on a business in the relevant income year that is not a small business entity in that income year.

[Schedule 2, item 3, subsection 40-880(2A)]

The purpose of the amendments is to make pre-establishment expenditure by small business entities and entities not carrying on a business that is currently deductible over a five-year period immediately deductible.

Scope and availability of immediately deductible expenditure

The amendments do not extend the scope of what is currently deductible as they only apply to amounts that would otherwise give rise to a deduction under section 40-880 of the ITAA 1997. Instead the amendments bring forward the time at which certain deductible expenditure can be recognised. [*Schedule 2, item 3, subsection 40-880(2A)*]

To the extent an amount is not deductible under section 40-880, including because the amount is deductible under some other provision of the tax law or because the deduction is subject to the rules concerning non-commercial losses, immediate deductibility does not apply.

Similarly, immediate deductibility under these amendments is only available for a subset of expenditure that is deductible under section 40-880 — expenditure incurred in relation to a business that is proposed to be carried on. The amendments do not apply to expenditure incurred in relation to an ongoing business or a business that has ceased to operate (including expenditure relating to the liquidation or winding up of an entity). [*Schedule 2, item 3, paragraph 40-880(2A)(a)*]

The amendments also further limit immediate deductibility to two categories of expenditure:

- expenditure on advice or services relating to the structure or the operation of the proposed business; and
- the payment to an Australian government agency of fees, taxes or charges relating to establishing the business or its operating structure.

[*Schedule 2, item 3, paragraph 40-880(2A)(b)*]

Advice or services relating to the structure or the operations of the proposed business

Advice or services relating to the structure of a business encompasses, for example, advice from a lawyer or accountant on how the business may be best structured as well as services such individuals or firms may provide in setting up legal arrangements or business systems for such structures. It does not include the cost of acquiring assets that may be used by the business.

Similarly, advice and services obtained in relation to the operation of the proposed business includes professional advice on the viability of the proposed business (including due diligence where an existing business is being purchased) and

the development of a business plan. It also covers the costs associated with raising capital (whether debt or equity) for the operation of the proposed business including, for example, costs incurred in accessing crowd-sourced equity funding, but not the direct costs of the capital itself such as interest, dividends or capital repayments.

Deductibility for advice and services does not include other expenses an entity itself may incur in relation to the operation of a proposed business (such as the cost of travelling to a particular location as part of assessing locations for a business).

Payments to Australian government agencies

The other category of expenditure to which the measure applies is payments of taxes, fees or charges relating to establishing the business or its structure that is made to an Australian government agency.

As defined in the ITAA 1997, **Australian government agency** means the Commonwealth, a State or Territory or an authority thereof. As local governments are created under state or territory legislation, they are included in this definition as an authority of the relevant state or territory government.

Broadly, this category of expenditure includes regulatory costs incurred in setting up the new business. Examples of the types of expenditure within this second category would be the costs associated with creating the entity that may operate the business (such as the fee for creating a company) and costs associated with transferring assets to the entity which is intended to carry on the proposed business (for example, the payment of stamp duty). It does not include expenditure relating to taxes of general application such as income tax. The payment of these general taxes does not relate to establishing a business or its structure but instead to the operation and activities of the businesses. Such general taxes are also not normally deductible under section 40-880.

Eligible taxpayers

Immediate deductibility is also limited to expenditure by certain entities, with the effect of excluding expenditure incurred by larger businesses.

If the claimant entity carries on a business in the income year, it must itself be a small business entity. Broadly speaking, the tax law defines a small business entity as an entity with an aggregate annual turnover of less than \$2 million: see Subdivision 328-C of the ITAA 1997 for more information. [*Schedule 2, item 3, paragraph 40-880(2A)(c)*]

Alternatively, if this entity does not carry on a business in the income year it must not be connected with or be an affiliate of (within the meaning of Subdivision 328-C of the ITAA 1997) an entity that carries on a business in the income year that is not a small business entity. [*Schedule 2, item 3, paragraph 40-880(2A)(c)*]

Example 2.1: Start-up expense which can be immediately deducted

Winston Co is a company that is a small business entity and is in the process of setting up a florist business, to be operated by a separate entity. Winston Co is uncertain as to the best location for the proposed business. Winston Co obtains advice from a consultant in order to assist in determining a suitable location. These amendments will apply to the cost of obtaining this advice, allowing it to be fully deducted in the income year in which it is incurred.

Example 2.2: Capital expenditure which cannot be immediately deducted

Percy already carries on an established small landscaping business. As part of plans to expand and improve his business Percy obtains financial advice about financing the expansion. As Percy's business is already established the amendments will not apply.

Consequential amendments

The amendments insert a reference to the immediate deductibility for small business start-up expenses into the list of small business concessions in section 328-10 of the ITAA 1997 to alert taxpayers to the existence of the new concession. [*Schedule 2, item 4, table item 1A of the table in subsection 328-10(1)*]

The Bill also makes a number of minor consequential amendments to guide material. [*Schedule 2, items 1 and 2, section 40-825 and subsection 40-880(1)*]

Application and transitional provisions

The amendments apply to expenditure incurred in the 2015-16 income year and later income years. [*Schedule 2, item 5*]

The amendments have retrospective application to a small group of taxpayers with substituted accounting periods for the 2015-16 income year that commence before 1 July 2015. The only consequence of the retrospective application is to allow these affected taxpayers to access an earlier deduction for relevant expenditure, which is wholly beneficial to affected taxpayers.

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Immediate deductibility for small business start-up expenses

This Schedule is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

2.35 Schedule 2 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to allow certain taxpayers to immediately deduct certain expenses relating to the proposed structure or operation of a business that is proposed to be carried on, including certain government fees and charges, where these expenses would otherwise be deductible over five years under section 40-880 of the ITAA 1997.

2.36 For expenses to be immediately deductible, the entity claiming the deduction must either be a small business entity (if it already carries on a business), or an entity which does not carry on a business.

Human rights implications

This Schedule does not engage any of the applicable rights or freedoms.

The amendments made by the Schedule only affect the period over which certain business expenditure can be deducted.

Conclusion

This Schedule is compatible with human rights as it does not raise any human rights issues.

Chapter 3

Fringe benefits tax exemption — portable electronic devices for small businesses

Outline of chapter

- 3.1 Schedule 3 to this Bill extends the fringe benefits tax (FBT) exemption that applies to employers that provide employees with work-related portable electronic devices, such as mobile phones, laptops and tablets.
- 3.2 The amendments extend the exemption to small businesses that provide employees with more than one work-related portable electronic device, even where the devices have substantially identical functions.
- 3.3 Currently, where a device has substantially identical functions to a device provided to the employee earlier in the FBT year, the later device does not get the FBT exemption, unless it is a replacement item.

Context of amendments

- 3.4 FBT is a tax employers pay on certain benefits they provide to their employees, including to their employees' family or other associates. The benefit may be in addition to, or part of, the employee's salary or wages package. Benefits provided to some other persons that are not employees may also be subject to FBT, such as directors of a company or statutory officeholders.
- 3.5 FBT is calculated under the *Fringe Benefits Tax Assessment Act 1986* (FBTAA 1986).
- 3.6 FBT is separate to income tax and is calculated on the grossed up taxable value of the fringe benefits provided. The FBT year runs from 1 April to 31 March.
- 3.7 A benefit that is exempt is not a fringe benefit. This means that it is not included in calculating an employer's FBT liability.
- 3.8 Section 58X of the FBTAA 1986 allows an FBT exemption for the following work-related items:

- a portable electronic device;
- an item of computer software;
- an item of protective clothing;
- a briefcase; and
- a tool of trade.

3.9 The FBT exemption in section 58X applies to these items provided by way of an expense payment benefit, a property benefit or as a residual benefit (these terms are defined in section 136 of the FBTAA 1986).

3.10 Even if an employer provides an employee with a work-related item that is subject to an FBT exemption, they still need to consider the limitations on the exemption.

3.11 The meaning of the specified work-related items, and the limitations on the exemption, are explained in the Australian Taxation Office Publication, *Fringe benefits tax — a guide for employers*, Chapter 20: *Fringe benefits tax exempt benefits* (1 July 2014).

Portable electronic device

3.12 A portable electronic device is a device that is:

- easily portable and designed for use away from an office environment;
- small and light;
- can operate without an external power supply; and
- designed as a complete unit.

3.13 Examples of portable electronic devices include a mobile phone, calculator, personal digital assistant, laptop, portable printer, and portable global positioning system (GPS) navigation receiver.

Limitations on exemption

3.14 The exemption is currently limited to:

- items primarily for use in an employee's employment — that is, for work-related use (subsection 58X(2) of the FBTAA 1986); and
- one item per FBT year for items that have a substantially identical function, unless the item is a replacement item (subsections 58X(3) and (4) of the FBTAA 1986).

Work-related use test

3.15 An item is primarily for use in an employee's employment if it is provided principally to enable the employee to do their job. This is referred to as the 'work-related use test'.

3.16 When determining whether or not an item is primarily for use in an employee's employment, the decision is based on the employee's intended use at the time the benefit is provided to them. An employer does not have to look at the employee's actual usage over the FBT year to determine whether the item is used primarily in the employee's employment.

3.17 However, an employer must use a reasonable basis to determine whether an item is primarily for use in an employee's employment — for example, the employee's job description, duty statement or employment contract.

3.18 Alternatively, if an employer is aware that there may be private use of an item, they can document factors such as those listed below to determine whether the item is primarily for use in the employee's employment:

- the reason or reasons the item was provided to the employee;
- the type of work the employee will be performing;
- how the use of the item relates to the employee's employment duties; and
- the employer's policy and any conditions relating to the use of the item.

Substantially identical functions

3.19 An eligible work related item will not be exempt from FBT if earlier in the same FBT year the employer has provided the employee, by way of an expense payment or property benefit, with an item that has

substantially identical functions. This is referred to as the ‘substantially identical functions test’.

3.20 It is the features or design specifications that are examined when determining whether items have substantially identical functions, not the intended use of the items.

3.21 Items have substantially identical functions where the functions of two items are the same in most respects. However, items may be different in a number of ways which do not impact on an item’s function. For example, colour, shape, brand and design would not generally be relevant considerations when determining whether two items have substantially identical functions.

3.22 Where a tablet computer can perform the functions of a laptop computer, even in a reduced capacity, it would be considered to have substantially identical functions to the laptop computer. However, where a tablet computer is designed primarily as a means of digital media consumption, rather than creation, it would not have substantially identical functions to a laptop.

Replacement items

3.23 The substantially identical functions limitation does not apply if the later item is a replacement item for the earlier item (subsection 58X(4) of the FBTA 1986). An item is a replacement item if the previous item is lost or destroyed, or needed replacing because of developments in technology.

3.24 The distinction between replacement items and other substantially identical items, and the operation of the ‘substantially identical functions test’ impose significant compliance costs on small businesses. The distinctions are difficult to apply and result in uncertainty for employers. This reduces the utility of the exemption to small business.

Summary of new law

3.25 Schedule 3 to the Bill removes, for small businesses, the substantially identical functions limitation on the FBT exemption for work-related portable electronic devices.

3.26 The amendments ensure small business employers that provide multiple portable electronic devices to an employee in an FBT year can claim an FBT exemption for all of those devices.

3.27 The requirement that devices are primarily for use in the employee's employment (the work-related use test) will remain.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>The substantially identical functions test no longer applies for small businesses.</p> <p>This means that a small business can provide a portable electronic device to an employee that has substantially identical functions to a device already provided to that employee in the same FBT year, and all of the devices will be exempt from FBT.</p>	<p>The substantially identical functions test limits the FBT exemption for portable electronic devices.</p> <p>Under the test, a portable electronic device will not be exempt from FBT if, earlier in the same FBT year, the employer provided the employee with an item that has substantially identical functions.</p>

Detailed explanation of new law

Extended operation of the exemption

3.28 Currently, a portable electronic device is not exempt from FBT if, earlier in the same FBT year, the employer has provided the employee, by way of an expense payment or property benefit, with an item that has substantially identical functions (see paragraphs 3.19 to 3.24).

3.29 For small businesses, this limitation will be removed with respect to portable electronic devices. Small business employers will be allowed an FBT exemption for multiple portable electronic devices provided to the same employee in the same FBT year, notwithstanding that those devices have substantially identical functions. *[Schedule 3, item 2, paragraph 58X(4)(b) of the FBTA 1986]*

3.30 These amendments will provide certainty and reduce compliance costs for small businesses. Employers will no longer need to apply the substantially identical functions test to determine whether or not the later device provided is subject to FBT. As long as the later device is primarily for use in the employee's employment, it will be exempt from FBT.

Example 3.1: Small business entity providing multiple devices

Lindy owns a marketing firm that meets the definition of a small business entity for the relevant FBT year. A new employee commences, and Lindy's business provides them with both a laptop and a tablet.

The laptop is provided for the employee to use when travelling for work and so that they can work from home. The tablet is provided for the regular meetings that the employee has with clients of Lindy's business. Both devices are primarily for use in the employee's employment.

Lindy's business no longer needs to consider whether or not the tablet has substantially identical functions to the laptop.

Even if the devices do have substantially identical functions, Lindy's business will be allowed an FBT exemption for both the tablet and the laptop.

Neither the laptop nor the tablet will be included in calculating Lindy's business's FBT liability.

3.31 The substantially identical functions test in subsection 58X(3) of the FBTAA 1986 will still apply with respect to the other eligible work related items in section 58X of the FBTAA 1986. These items are an item of computer software, an item of protective clothing, a briefcase and a tool of trade (subsection 58X(2) of the FBTAA 1986).

3.32 These amendments do not affect the work-related use test, which must still be satisfied if a personal electronic device provided to an employee is to be exempt from FBT (subsection 58X(2) of the FBTAA 1986).

Small businesses entitled to the extended exemption

Definition of small business entity

3.33 A small business entity is defined in section 328-110 of the *Income Tax Assessment Act 1997* (ITAA 1997). Broadly, an entity is a small business entity for an income year if it:

- carries on a business in the income year; and
- satisfies the \$2 million aggregated turnover test for the income year.

3.34 An entity will satisfy the \$2 million aggregated turnover test for an income year if one or both of the following apply:

- the entity's aggregated turnover for the previous income year was less than \$2 million (subparagraph 328-110(1)(b)(i) of the ITAA 1997);
- the entity's aggregated turnover for the income year, worked out as at the first day of the income year or as at the day the entity starts to carry on the business, is likely to be less than \$2 million (subparagraph 328-110(1)(b)(ii) of the ITAA 1997).

3.35 An entity will also satisfy the \$2 million aggregated turnover test for an income year if the entity's aggregated turnover for the income year, worked out as at the end of the income year, is less than \$2 million (subsection 328-110(4) of the ITAA 1997).

3.36 An entity's 'aggregated annual turnover' for an income year includes its annual turnover for an income year and the annual turnovers of its connected entities and affiliates (subsection 328-115(2) of the ITAA 1997).

Being a small business entity for an FBT year

3.37 To be entitled to the extended exemption, an employer must be a small business entity for the purposes of the relevant FBT year in which they provide the portable electronic device.

3.38 The FBT year starts on 1 April and ends on 31 March. In contrast, the definition of small business looks at whether a business is a small business entity for an income year (generally 1 July to 30 June).

3.39 To address this, the amendments apply to an employer for an FBT year, if the employer was a small business entity for either or both of:

- the year of income starting most recently after the start of the FBT year; or
- the year of income ending most recently after the start of the FBT year.

[Schedule 3, item 2, paragraph 58X(4)(b) of the FBTAA 1986]

3.40 If the employer was a small business entity for either or both of these income years, then they will be eligible for the extended FBT exemption for the relevant FBT year.

3.41 If the later relevant income year ends before the employer must lodge their annual FBT return, they are able to use the two tests described in paragraph 3.34, above to work out whether they are a small business entity for the relevant income year.

Example 3.2: Is an employer a small business entity for an FBT year?

Darren wants to know if his surveying business can access the extended FBT exemption under the new law for portable electronic devices provided during the 2016-17 FBT year, which runs from 1 April 2016 to 31 March 2017.

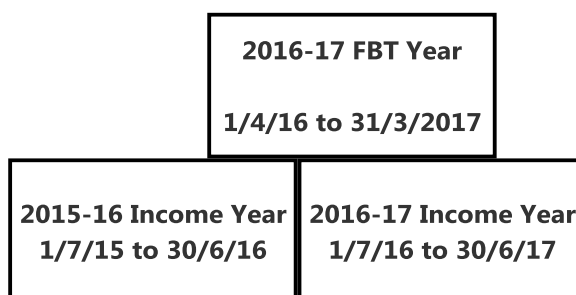
To determine this, Darren's business looks at whether it met the 'small business entity test' for either or both of:

- the income year starting most recently after the start of the FBT year (for Darren's business, this is the 2016-17 income year, which started on 1 July 2016);
- the income year ending most recently after the start of the FBT year (for Darren's business, this is the 2015-16 income year, which ended on 30 June 2016) .

Darren's business does not meet the 'small business entity test' in section 328-110 of the ITAA 1997 for the 2016-17 income year.

However, Darren's business does meet the 'small business entity test' for the 2015-16 income year. This is on the basis that his business's aggregated turnover for the previous income year, the 2014-15 income year was less than \$2 million (subparagraph 328-110(1)(b)(i) of the ITAA 1997).

This exemption is allowed regardless of when in the 2016-17 FBT year the devices are provided.



New employers that start part of the way through the income year

3.42 Under the existing law, a special rule applies to entities that start carrying out business operations part of the way through one of the relevant income years. The entity's turnover for that year is worked out using a reasonable estimate of what the turnover would have been if the entity had carried on a business for the whole of the income year (subsection 328-120(5) of the ITAA 1997).

Consequential amendments

3.43 The definition of 'small business entity' is moved from section 58GA of the FBTAA 1986 to the dictionary in section 136 of the Act. As this definition is now used in two sections of the FBTAA 1986, it is included in the FBTAA 1986's dictionary. *[Schedule 3, items 1 and 3, subsection 58GA(3) and 136(1) of the FBTAA]*

Application and transitional provisions

3.44 The amendments apply in relation to the 2016-17 FBT year and later FBT years. *[Schedule 3, item 4]*

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Fringe benefits tax exemption — portable electronic devices for small businesses

3.45 This Schedule is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

3.46 Schedule 3 to this Bill extends the fringe benefits tax exemption that applies to employers that provide employees with work-related portable electronic devices, such as mobile phones, laptops and tablets.

3.47 The amendments extend the exemption to small businesses that provide employees with more than one work-related portable electronic device, even where the devices have substantially identical functions.

Human rights implications

3.48 This Schedule does not engage any of the applicable rights or freedoms.

Conclusion

3.49 This Schedule is compatible with human rights as it does not raise any human rights issues.

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Item 1, subsections 328-360(1) and (2)	1.19
Item 1, paragraphs 328-365(1)(a) and (b)	1.24
Item 1, subparagraphs 328-365(1)(a)(i) and (ii)	1.34
Item 1, paragraph 328-365(1)(b)	1.39
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Schedule 2: Immediate deductibility for small business start-up expenses

<i>Bill reference</i>	<i>Paragraph number</i>
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Schedule 3: FBT and portable electronic devices

<i>Bill reference</i>	<i>Paragraph number</i>
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