PITCHER PARTNERS

Pitcher Partners Advisors Proprietary Limited
ACN 052 920 206

Level 13, 664 Collins Street
Docklands, Victoria 3008

Postal Address
GPO Box 5193
Melbourne, Victoria 3001

Level 1, 80 Monash Drive
Dandenong South, Victoria 3175

Tel +61 3 8610 5000
Fax +61 3 8610 5999
www.pitcher.com.au

Ref: AMK

13 February 2019

The Treasury
Langton Crescent
PARKES ACT 2600

By Email: *prebudgetsubs@treasury.gov.au*

Dear Sir / Madam

2019-20 PRE-BUDGET SUBMISSIONS

A. INTRODUCTION

1. We refer to the media release issued by the Senator the Hon. Zed Seselja on 19 December 2018 ("**Media Release**") requesting submissions to be made to the Government on priorities for the 2019-20 Budget. We thank you for this opportunity to provide our pre-budget submission.

2. Pitcher Partners specialises in advising clients in what is commonly referred to as the middle market. The middle market is a diverse group of taxpayers comprising of privately-owned entities and their owners, regardless of their size. Accordingly, the middle market covers a broad spectrum of entities and individuals, ranging from closely held listed companies to family operated businesses.

B. GENERAL POLICY STATEMENTS

3. As outlined in the Media Release, the Government has indicated that the budget is expected to return to surplus in 2019-20. Furthermore, the Government has indicated that the budget is likely to reflect a plan to keep the economy strong and to also guarantee the essential services on which Australians rely. We support this overall objective, which is consistent with our pre-budget submission.

4. While the budget may return to surplus in 2019-20, we are concerned with the potential of a slowing Australian economy. Given that this is an election year, we are also concerned with non-systemic and non-coherent policies that would simply seek to provide incentives to voters, leading to a spike in future consumption without a long-term national return. In our view, such an approach is unlikely to systemically meet the Government's overall objective outlined in the Media Release above (as

such policies could simply result in reductions in personal debt or the consumption of imported goods).

5. We believe that the expected budget surplus places the Government in a unique position, such that policies can be packaged together with the aim of encouraging longer term economic growth in Australia. As such, we believe that there are three important areas that the Government could focus on being: (1) longer term infrastructure projects; (2) programs to skill or increase competitive capacity of local business; and (3) targeted tax specific measures for the middle market.

C. SPECIFIC POLICY STATEMENTS

(a). Critical Infrastructure projects

6. There are a number of key current infrastructure related concerns in Australia. The first is that most States are suffering from the effects of an energy crisis. We believe that it is now opportune for the Government to create policies and increase expenditure with respect to energy infrastructure to deal with growing population, energy shortages and rising energy prices.

7. The second is that a number of our capital cities are also struggling with transport related infrastructure issues. Our major cities have struggled to keep up with population growth, as congestion becomes a significant political issue. We believe it is opportune for the Government to commit to working with the States to deliver larger transport infrastructure projects that will seek to address these issues. Long term projects could include the airport rail link in Melbourne, the Sydney to Melbourne rail link, the East / West freeway link, etc. It is also opportune to fast track a number of current transport related projects.

8. Finally, as a supportive measure, the Government could also consider committing to the significant development of regional centres of each of the States, linked to an appropriate infrastructure program, with the aim of reducing congestion, coupled with encouraging investment and job creation.

9. In addition to Government spending measures, we have also outlined a number of specific tax measures that could be used to assist in encouraging investment in energy infrastructure so that private investment in such assets may become feasible (see our detailed comments at paragraph C(c) below).

(b). Stimulating domestic business opportunities

10. The middle market is a significant contributor to our economy. Based on the latest ATO statistics released for the 2015/16 income year, approximately 54.86% of all salary and wages is paid by private groups, as compared to 45.14% being paid by public and other groups. Furthermore, approximately 44.06% of total corporate tax is collected from privately owned businesses[1].

11. We believe that the Government should acknowledge the importance of this significant contribution by private groups. In doing so, we encourage the introduction

---

[1] Source – Latest ATO statistics 2015/16, see Appendix A.

of specific measures that continue to assist the middle market to thrive over the forthcoming years, as well as leveraging the middle market to avoid a potential economic downturn that may occur.

12. We would encourage the Government to consider both tax and non-tax policies. We have outlined specific tax policies below at paragraph C(c). Certain non-tax policies that are aimed at supporting the middle market could include: (a) programs and investment aimed at increasing the skill levels of our domestic work force; (b) measures that may reduce the attractiveness of offshoring and increase the attractiveness of using local employment; (c) incentives and spending on technology projects that could help to improve Australian agriculture practices; (d) targeted import replacement and improvement in self-sufficiency programs in areas where we export raw materials and repurchase as finished goods; (e) spending and other incentives that will help to ensure continued strong growth in some of our key industries, including the construction industry, tourism, education and financial services.

(c). Tax related measures targeting the middle market

13. Consistent with our comments above at paragraphs C(a) and C(b), we believe that a number of coherent tax policies could be announced in the budget that would help to stimulate economic activity in the middle market and provide a buffer in the event of a potential economic downturn over the forthcoming years.

14. Our recommendations with respect to tax reductions and tax concessions are in line with the Government's stated policy of maintaining a sustainable tax burden, consistent with the economic growth objective, by virtue of maintaining the tax-to-GDP ratio at or below 23.9% of GDP.

Corporate tax rate for middle market companies

15. Currently, the Government is seeking to reduce the corporate tax rate for entities with aggregated turnover of less than $50 million from 27.5% to 25% over the period to 30 June 2021/22. While this measure has already been brought forward, we would further encourage the Government to consider bringing this policy forward to 1 July 2019.

16. We understand that the estimated cost of this change would be approximately $7.5 billion[2]. However, the timing of this measure would coincide with any potential economic downturn that may occur in the near future. Accordingly, the measure could provide timely support and relief to the middle market in terms of additional working capital for their business and for employment in Australia. Furthermore, the cost of this measure could be partially offset by removing a number of untargeted concessions that, in our opinion, do not generally support economic growth in the middle market (as outlined below).

[2] The Treasury, "Tax Benchmarks and Variations Statement 2018 - Publication", January 2019, Item B52.

Removing and simplifying concessions that do not support economic growth

17. We highlight that there is significant complexity in certain concessions that are available for taxpayers in the middle market. Furthermore, a number of these concessions do not assist middle market taxpayers and provide untargeted incentives. We note that the Board of Taxation is currently conducting a review into small business concessions. However, we are concerned with the time being taken to complete this review and the missed opportunity in addressing this item.

18. We believe that there is a current opportunity to recommend the removal of certain concessions that will fund the earlier introduction of tax rate reductions (which do not increase complexity and which benefit a broader base of business taxpayers in the middle market).

19. An example of this is the CGT small business concessions (such as the active asset 50% concession and the 15-year concession). The cost to the revenue of these two measures alone is approximately $1.5 billion each year[3], with benefits provided to a small minority of taxpayers in the middle market. The complexity of the CGT small business concession measures is significant and (other than the CGT superannuation retirement exemption) the policy behind these measures is somewhat incoherent. Our recommendation to remove these two CGT concessions is in line with Recommendation 17 of the *Australia's Future Tax System Review*.

20. Removing the complex CGT small business concessions (and similar types of concessions) to fund a further tax rate cut would provide a greater benefit to more business taxpayers in the middle market and would replace complex measures with simple measures (helping to reduce further red tape).

21. In our view, this measure would provide significant assistance to the working capital and investment requirements of the middle market in Australia and would be consistent with the recent policy of the Government to provide a $2 billion fund to transform small business access to funding[4]. We would therefore strongly recommend a review of certain concessions, with a view to replacing them with corporate tax rate reductions for the middle market.

Reducing complexities associated with the taxation of structures and income types

22. As outlined in our White Paper submission in 2015, significant compliance issues occur due to difference in the tax treatment of various entity structures and income types, in particular for trusts and companies.

23. We would encourage the Government to conduct a review into these differences, through the Board of Taxation, with a view to removing tax as a key reason for choosing one structure over another. Some of these key aspects of such a review would include:

    23.1. By allowing trusts to accumulate active business income, to help remove the need for trusts to distribute to corporate beneficiaries with respect to active

---

[3] The Treasury, "Tax Benchmarks and Variations Statement 2018 - Publication", January 2019, Items C12 and E30.

[4] Media Release 051-2018, the Hon Josh Frydenberg MP.

business income, allowing business trusts to reinvest their after-tax profits into their business.

23.2. Examining whether there is scope to equalise the tax treatment of passive income (e.g. CGT assets and other passive income) for both companies and trusts. For example, by allowing passive income (e.g. capital gains, interest income etc) to flow through a company with passive income taxed at individual marginal tax rates.

23.3. Examining the use of corporate structures and whether flattening the income tax rates over a certain income threshold (e.g. up to $200,000 per individual) could help to reduce the incentive to use a corporate vehicle. For example, contractors or small business operators.

Addressing the uncertainty on the application of Division 7A

24. Significant uncertainty has been created in the middle market through the release of the Treasury Paper in 2018 on the future of the proposed Division 7A amendments.

25. In particular, the Treasury Paper proposed to change the direction of the reforms to Division 7A in a manner that would significantly penalise business taxpayers, with a proposed start date of 1 July 2019.

26. We would strongly encourage the Assistant Treasurer to respond to the large number of submissions that were made to address the significant shortfalls that were contained in the Treasury Paper. We believe that this is critical; to restore certainty and trust in the middle market business community with respect to the proposed changes. We would also encourage the Government to extend the proposed start date of the measures.

Domestic infrastructure tax concessions

27. As outlined at paragraph C(a) above, we would encourage the Government to seek to invest in infrastructure assets in the short to medium term, particularly in the energy and transport sector. We recommend consideration be given to providing certain tax concessions to infrastructure related investments, which would encourage investment in those critical areas.

28. This recommendation would be targeted at providing domestic tax concessions only, rather than concessions to foreign investors. This would potentially encourage significant investment by domestic superannuation funds into infrastructure projects (being a significant source of potential funding) and may provide alternative investment and return options to domestic superannuation funds as compared to franked dividends.

29. We have outlined three potential tax incentives below that could be provided to encourage infrastructure projects in Australia.

29.1. The first could consist of providing concessional taxation treatment for interest derived on infrastructure bonds that meet certain criteria. These could consist of long-term debentures (e.g. 5 to 10 years) that provide a tax concession on the receipt of interest on such bonds. We note that we do not propose to replicate the somewhat deficient rules that were previously contained in the former Division 16L of the Income Tax Assessment Act 1936 (which provided for tax-exempt infrastructure borrowings). That is, some of the shortcomings of those provisions could be addressed to ensure that the measures are properly targeted. For example, the Government could cap the annual tax concession on interest income derived for each individual investor (or each individual member of a superannuation fund) in a similar manner to the ESIC provisions contained in Division 360. However, as Division 16L contained rules on identifying infrastructure and the kinds of infrastructure facilities (such as land transport or electricity generation), we believe that this would be a relatively easy and targeted measure to implement.

29.2. The second could consist of providing concessional taxation treatment for returns paid by a managed investment trust to Australian resident investors, where the fund invests in certain infrastructure assets. There are a number of examples of this type of concession targeting a particular asset class through a managed investment trust (MIT). For example, MITs that invest in clean buildings provide non-resident investors with a reduced withholding tax[5]. There are also concessions provided to investors in affordable housing projects. This measure could help to promote domestically funded infrastructure projects.

29.3. Finally, a tax concession could consist of providing concessional depreciation rates for certain infrastructure assets, whereby they are treated as depreciating assets rather than capital works. This could result in a depreciation rate increase from 2.5% to a rate based on the effective life of the infrastructure asset (which could be statutorily set in line with other statutory effective lives).

30. We believe that these policies would help to encourage domestic investment in desired infrastructure projects and would also assist in stimulating economic activity over the medium to longer term.

Introducing a new capital investment allowance for certain industries

31. To reinvigorate and encourage investment in certain specific, strategic, key industries in Australia, we request the Government to consider a next level asset write off concession that is linked to capital investment.

32. Attracting investment in capital intensive industries is often difficult, due to the significant cost of upfront investment. We believe that there is an opportunity to address this by providing certain start-up concessions to middle market taxpayers, that are targeted at certain industries.

33. As outlined previously in paragraph C(b), key industries that could fall into this category include the Australian agricultural industry; import replacement industries; and the construction industry (to name a few). By way of example, there is currently an opportunity to help significantly grow our dairy export industry, especially in the area of related dairy products such as baby food products. There is currently

[5] Although the CGT concession applies to non-residents, we are only highlighting this an example of a concession provided to a certain type of asset through an MIT.

significant Global demand for such products, with only a handful of Australian manufacturers dominating the market. These proposed rules could help encourage new investment in Australia into this potential thriving export industry.

34. The depreciation rules could be labelled "capital investment" rules and could be limited to those taxpayers that are private companies only that satisfy the lower corporate tax rate threshold (i.e. with less than $50 million turnover on an associate inclusive basis). The rules could be limited to certain assets (capital intensive assets), with expenditure capped at up to $2 million (total investment cost). The write off concession could be spread be over a short-term period (e.g. a 3-year period).

Superannuation incentives

35. Numerous changes have been made to the superannuation system over the last number of years which have had the effect of significantly reducing the attractiveness of using the superannuation system to fund retirement.

36. We highlight that we believe the changes have gone too far and now there are no incentives left in the system to attract taxpayers to save above the compulsory contribution rate. Some of these policies include the reduced deductible contribution cap of $25,000 per year, the $1.6M pension cap, and the 30% contribution tax rate applicable to individuals deriving more than $250,000 per annum.

37. We are concerned that the outcome of these significant policy changes, which collectively eliminate most of the voluntary savings incentives from the super system, will be to discourage retirement savings from those taxpayers with the capacity to save. Over time, we believe that this will create a new class of taxpayer with insufficient savings to self-fund their retirement who will qualify for, and need to rely on, the age pension.

38. We would strongly encourage the Government to reintroduce voluntary savings incentives back into the system as well as encouraging middle income earners to use those incentives to self-fund their retirement.

39. Policies could include increasing the deductible contribution cap from $25,000 to $50,000; providing flexibility by allowing individuals to determine their deductible contribution cap by taking into account unutilised amounts from prior years; pooling thresholds and limits within families (e.g. allowing couples 2 times the pension cap that can be used between the couple in any way they choose, 2 times the deductible contribution limit that again can be used between a couple any way they choose; increasing both the total superannuation balance threshold where non-concessional contributions are prohibited and the transfer balance cap amounts from $1.6M to double those amounts; increasing the threshold where the 30% contributions tax rate applies to at least $300,000 and indexing that threshold to wages growth. We acknowledge that there would be strong community support for limiting the above concessions so they do not accrue to high wealth individuals.

40. We are also concerned with the significant complexity that now exists in the system. The number of different rates and thresholds that now exist, particularly with the introduction of limits on non-concessional contributions and pensions, is not sustainable.

41. We would support a wholistic review of the superannuation system to better align the systems objectives with the goal of accumulating wealth for retirement, reintroducing voluntary saving incentives and reducing system complexity.

Addressing the cost of domestic employment

42. Over time there has been a significant and continual trend of replacing domestic employment with foreign outsourced or offshored employment. We believe that the Government has a great opportunity to seek to address this and to implement policies that could help to bring jobs back to Australia.

43. For example, the Government could announce a substantive reduction or the elimination of payroll tax (being a regressive tax), which could be achieved through a Government led COAG agreement with the States. In our view, this would support greater business activity and would help to provide an incentive to increase domestic employment. The Government could also look at measures that encourage local business to use local employment as compared to offshoring, which could range from certain incentives (e.g. tax reductions) to discouraging outsourcing (e.g. withholding on offshore payments).

*** ***

We would be more than happy to discuss any aspect of this submission with you and provide you further thoughts on any of our recommendations. Please contact Alexis Kokkinos on (03) 8610 5170 at any time to discuss.

Yours sincerely

A M KOKKINOS
Executive Director