

Australia's SME Tax System: Is it working?

By Mark Pizzacalla

Mark Pizzacalla is a Tax Partner at HLB Mann Judd (Melbourne office, Australia) and Fellow of the Taxation Law and Policy Research Institute at Monash University

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The purpose of this Paper is to analyse and review the preferential tax treatment afforded to Australia's small to medium size enterprises (SME) sector.

More specifically, this Paper will:

- overview Australia's SME taxation framework;
- identify tax concessions provided to SMEs in Australia;
- discuss the rationale behind their introduction;
- analyse and review the effectiveness of each tax concession; and
- make recommendations, where appropriate, for changes to the SME tax policy mix.

1 Overview of Australia's SME Taxation Framework

Australia's small business tax framework can be divided into two different and distinct periods; what I will refer to as the pre 30 June 2007 period and the post 1 July 2007 period. The reason for this distinction is that Australia had an optional "Simplified Tax System" (STS) regime which was available to certain small business taxpayers up to the 30 June 2007 income year. Effective 1 July 2007, this was replaced with the "Small Business Entities" (SBE) regime.

Whilst the focus of this Paper will be on the SME tax concessions available under the SBE regime, some commentary on the former STS provisions is unavoidable in order to place the current legislation into historical context.

The STS regime (1 July 2001 – 30 June 2007)

The STS was originally enacted in Division 328 ITAA 1997¹ applying to assessments for income years starting after 30 June 2001. Broadly, the STS provided taxpayers (which included individuals, companies, trusts and partnerships), who met certain threshold requirements regarding turnover (less than A\$1 million) and assets (less than A\$3 million in depreciable assets), the option of using cash accounting for tax purposes, as well as adopting simplified tax accounting practices in respect of depreciation and trading stock. For anti-avoidance purposes, the grouping provisions required turnover and assets of groups of related businesses to be aggregated when applying the threshold tests.²

As a result of the problems identified with the (former) STS system, over time, the government attempted to improve various aspects of its operation including:

¹ Division 328 inserted by Act 78 of 2001 s 3 and Sch 1 Item 1.

² Former Subdivision 328-F ITAA 1997.

- extension of the accruals accounting option (rather than restricting STS taxpayers to the cash basis only, as originally enacted);³
- eligibility for the entrepreneurs' tax offset (ETO); and
- reduction of ATO audit amendment period to 2 years (instead of 4 years).⁴

It would seem that these measures were all aimed at encouraging (if not coaxing) taxpayers to enter the STS, a system which was not generating any taxpayer interest as it was generally seen as being too complex and too costly to comply with.⁵ For example, in the 2002 tax year, only 14% of eligible businesses opted into the STS.⁶ The take up rate increased to 27% in later years.⁷

The operation of Australia's (former) STS for SMEs has been raised by some commentators as an example of how providing subsidies through the tax system creates complexity in the tax law.⁸ Depending on how the eligibility requirements are structured and the work required to be undertaken by the SME taxpayer to determine whether it satisfies such requirements, it may ultimately prove to be too difficult for SMEs to access the concession at all.⁹

SBE regime (effective 1 July 2007)

In November 2006, the (former) Howard government announced its proposal to introduce legislation to standardise the eligibility criteria for small business tax concessions effective from 1 July 2007.¹⁰ The former Treasurer, Mr Peter Costello,

³ When the STS was originally enacted, one of the major "simplifications" introduced was a requirement for the exclusive use of cash accounting by STS taxpayers. This meant that, for an STS taxpayer, an amount that would be assessable under Section 6-5 ITAA 1997 when derived was treated as having been derived only when it was received, and an amount that would be deductible under Section 8-1 ITAA 1997 was taken to be incurred only when the relevant expense was paid. Whilst this broadly describes how the rules operated, in practice, they were not that simple. For example, cash accounting applied to "ordinary" income, but not to statutory income (eg capital gains) or certain kinds of deductions. Cash accounting was not universally appealing to small businesses and many accruals taxpayers were reluctant to enter the STS because they could face significantly increased taxable income in the entry year. As result, the mandatory use of cash accounting by STS taxpayers was terminated from the start of the 2005-2006 income years, with transitional arrangements put in place to deal with those STS taxpayers who chose to move from cash accounting to the accruals method.

⁴ Garry Addison, 'STS simply needs improving' (2006) 76(3) *InTheBlack* 72

⁵ Senate Economics Legislation Committee, *Provisions of the Tax Laws Amendment (2004 Measures No.7) Bill 2004*, (2005) paragraph 2.47

⁶ Senate Economics Legislation Committee, *Provisions of the Tax Laws Amendment (2004 Measures No.7) Bill 2004*, (2005) paragraph 2.47

⁷ Paul Kenny, 'The 1999 Review of Business Taxation: Should We Fast Track Small Business Tax Reform?' (2008) 18(1) *Revenue Law Journal*

⁸ Richard Krever, 'Taming Complexity in Australian Income Tax' (2003) 22 *Sydney Law Review*

⁹ Rami Hanegbi, 'Tax Concessions Available to Small Business in Australia' (2001) *International Bureau of Fiscal Documentation* p.579

¹⁰ Joint Press Release Treasurer & Minister for Small Business and Tourism, 'Making the tax law easier for small business - The new small business framework' (Press Release No. 123, 2006)

indicated that this approach would remove the separate eligibility tests that existed in relation to small businesses accessing the various tax concessions and that a single definition of small business would result in reduced compliance costs for some 2m Australian small businesses (or 96% of all Australian businesses).¹¹

Tax Laws Amendment (Small Business) Bill 2007 was subsequently introduced in the House of Representatives on 10 May 2007. (It was previously released on 9 February 2007 in exposure draft form.) The SBE regime became effective from 1 July 2007 (i.e. for the 30 June 2008 income year and subsequent income years), and from 1 April 2007 for fringe benefits tax (“FBT”) purposes.¹² As a result of the amendments, small business taxpayers are now referred to as “small business entities” (SBEs) for tax purposes. Broadly, an entity is a “small business entity” if it:

- carries on a business; and
- satisfies the \$2m aggregated turnover test.¹³

The Explanatory Memorandum which accompanied the Bill indicated that the then existing small business framework was flawed in the following ways:

- 1.2 The current tax laws contain a number of special arrangements for smaller businesses (variously defined), which are often loosely referred to as ‘small business concessions’. Each concession has its own set of eligibility criteria based on the particular group of taxpayers being targeted. The criteria are tailored to the specific characteristics, policy objectives and constraints of each particular regime.
- 1.3 Multiple eligibility criteria across small business concessions, however justifiable when considered individually, are a source of complexity and unnecessary compliance costs for small businesses.¹⁴

The Explanatory Memorandum further indicated that by standardizing the eligibility criteria, this would mean that eligibility for all of the small business concessions would be based on one test about the size of the business, with the proviso that the entity seeking the concession also satisfies any additional criteria that already applies to each concession that do not relate to determining whether the business is in fact a small business.¹⁵

¹¹ Joint Press Release Treasurer & Minister for Small Business and Tourism, 'Making the tax law easier for small business - The new small business framework' (Press Release No. 123, 2006)

¹² Division 328 heading substituted by Act 80 of 2007 s 3 and Sch 3 Item 1, with effect from 21 June 2007, applicable in relation to the 2007-08 income year and later income years.

¹³ For these purposes, when calculating turnover, you must include the turnover of any other business connected with the entity seeking to access the concession (Section 328-115 ITAA 1997). Further, turnover includes all income earned in the ordinary course of business for the income year (excluding GST and fuel retail sales receipts).

¹⁴ Commonwealth, 'Explanatory Memorandum Tax Laws Amendment (Small Business) Bill 2007' (2007) at paragraphs 1.2 – 1.3.

¹⁵ Commonwealth, 'Explanatory Memorandum Tax Laws Amendment (Small Business) Bill 2007' (2007) at paragraph 1.5. Importantly, this meant that the A\$2m test represented an alternative to satisfying some of the pre-existing tests that would still be available. For example, a small business will be able to qualify for the small business CGT concessions if it satisfies the “net assets value” test or the new “A\$2m turnover” test.

A press release issued at the time indicated that this further demonstrated the (former) Howard government's commitment to reducing red tape and compliance costs for small businesses.¹⁶ Whether this is what actually transpired in practice is a different issue.¹⁷

Summary of the Major SME Tax Concessions

A summary of the tax concessions which are available to SBEs, as defined in the ITAA 1997, are outlined at **Table 1.1** below.

Table 1.1- Concessions available to small business entities

Item	Concession	Provision
1	CGT 15-year asset exemption	Subdivision 152-B of this Act
2	CGT 50% active asset reduction	Subdivision 152-C of this Act
3	CGT retirement exemption	Subdivision 152-D of this Act
4	CGT roll-over	Subdivision 152-E of this Act
5	Simpler depreciation rules	Subdivision 328-D of this Act
6	Simplified trading stock rules	Subdivision 328-E of this Act
7	Deducting certain prepaid business expenses immediately	Sections 82KZM and 82KZMD of the <i>Income Tax Assessment Act 1936</i>
8	Accounting for GST on a cash basis	Section 29-40 of the GST Act
9	Annual apportionment of input tax credits for acquisitions and importations that are partly creditable	Section 131-5 of the GST Act
10	Paying GST by quarterly instalments	Section 162-5 of the GST Act
11	FBT car parking exemption	Section 58GA of the <i>Fringe Benefits Tax Assessment Act 1986</i>
12	PAYG instalments based on GDP-adjusted notional tax	Section 45-130 of Schedule 1 to the <i>Taxation Administration Act 1953</i>

Source: Section 328-10(1) ITAA 1997.

It is important to note that SBEs can utilize these concessions provided they also satisfy any other additional criteria that may apply to each concession. This is a

¹⁶ Joint Press Release Treasurer & Minister for Small Business and Tourism, 'Making the tax law easier for small business - The new small business framework' (Press Release No. 123, 2006) (Press Release No. 123, 2006)

¹⁷ Helen Hodgson, 'Small business simplification - yet again?' (2007) 11(2) *The TAX Specialist*

“hangover” from the application of the previous STS regime, as well as other pre-existing small business tax concessions which were in place prior to the introduction of the SBE regime.

Other major small business tax concessions include, inter-alia, the following:

- entrepreneurs' tax offset (Subdivision 61-J ITAA 1997); and
- two-year period for amending assessments (Section 328-10(2) ITAA 1997 and Section 170 ITAA 1936).

If one considers that all of the different types of small business CGT concessions referred to above should be viewed as the one concession, then the ITAA 1936 and ITAA 1997 provides a total of 11 major tax concessions for small businesses. A summary of all the tax concessions currently available to SMEs in Australia (as at the time of writing on 3 August 2009) is located at **Appendix 1**.

Whilst the SBE regime provides a more streamlined approach in relation to the standardization of the eligibility criteria for access to small business tax concessions, what remains clearly evident is that there is still a lack of consistency in adoption of criteria and thresholds, and the compliance rules remain tedious and complex when you analyze and review each of the concessions in detail. It is outside the scope of this paper to compare the (former) STS regime with the new SBE regime and, in any event, this has already been dealt with by other commentators.¹⁸ However, refer **Appendix 2** for a summary of the transitional rules from the STS to the SBE regime.

A summary of the small business tax concessions vis-à-vis concessions available to other business entities is outlined at **Table 1.2** below.

¹⁸ PKF Australia Limited, 'Aligning Definitions for Small Business Basic Taxation - Small Business Entities (formerly Simplified Taxation System (STS))' (Paper presented at the, Grace Hotel, Sydney and the Crowne Plaza, Parramatta, 4-6 September 2007) ; Rob Power, 'When is small business small?' (2007) (8) *CCH Tax Week*

Table 1.2 - Comparison of SME tax treatment versus other taxpayers

Concession	Available to Small Business Entities	Normal Rules
STS Accounting Method	Income derived only when received and deductions allowed when paid. This method only available if you: <ul style="list-style-type: none"> - were in the STS in 2007; - have used the STS accounting method continuously since before 1 July 2005 (however, refer SBE rules for changes since 1 July 2007). 	Taxable income calculated under either an accruals or cash receipts basis (as appropriate). Deductions allowed when expenses are "incurred", irrespective of when paid.
Depreciation	Immediate write-off for depreciating assets < \$1,000 (excl. GST). Assets ≥ \$1,000 with an effective life of < 25 years depreciated at 15% in the first year & 30% thereafter. Assets ≥ \$1,000 with an effective life of ≥ 25 years depreciated at 2.5% in first year & 5% thereafter.	Immediate write-off for most assets costing < \$100 (GST incl.). Assets costing < \$1,000 may enter a low value pool (i.e. depreciated at 18.75% in first year & 37.5% thereafter). Other assets depreciated over the asset's effective life.
Prepayments	Immediate deduction available provided that: <ul style="list-style-type: none"> - ≤ 12 months; and - the prepaid period ends no later than the end of the next financial year. 	Immediate deduction allowed for prepaid expenses: <ul style="list-style-type: none"> - under \$1,000; - for salary and wages; - required under law (e.g. vehicle registration, workcover, FBT, PAYG, withholding tax, etc). - For amounts > \$1,000 a deduction needs to be apportioned over the income years it relates to.
Trading Stock	If the difference between opening and closing stock values for the income year can be reasonably estimated to be < \$5,000, the movement does not need to be accounted for and no stocktake is required.	All changes in the value of trading stock must be accounted for. A stocktake is required as at the end of the income year.
25% Entrepreneurs' tax offset	Up to 25% tax offset for the taxpayer's income tax liability that is attributable to its' small business income for the income year.	The tax offset is not available to taxpayers that are not "small business entities".

Source: Adapted from Saward Dawson Chartered Accountants.

2 Australia's SME tax concessions

The following is an analysis and review of Australia's major SME tax concessions.

2.1 *Small Business CGT Concessions*

Capital gains tax (CGT) was introduced into the Australian taxation system effective 20 September 1985.¹⁹

From its inception, the CGT provisions contained an exemption for certain capital gains made by small business in relation to the disposal of goodwill.²⁰ As part of the re-write of the ITAA 1936, Sections 118-F and 123 were introduced effective 1 July 1997 which dealt with the small business retirement exemption and the small business roll-over relief provisions respectively.

The small business CGT concessions, contained in Division 152 ITAA 1997, were introduced, effective 21 September 1999, which followed on from a report of the Ralph Committee. The rationalisation of these concessions was aimed at reducing compliance costs for small business taxpayers (refer below). However, the evolution of the small business CGT concessions under Division 152 provides a remarkable case study of well intentioned SME tax policy which has taken about a decade, since its introduction to Australia's SME tax landscape, to be effective.

These concessions were introduced to:

- streamline existing CGT concessions for small businesses (previously provided for under Division 123 – small business roll-over relief, and Division 118-F – small business retirement exemption); and
- provide a further concession for small businesses that dispose of 'active' assets (a defined term) held for at least 15 years on account of retirement being at least 55 years old (or due to being incapacitated).²¹

The accompanying Explanatory memorandum indicated that:

- 1.2 These amendments to the ITAA 1997 will significantly improve the way in which CGT concessions are delivered to small business entities by:
 - increasing the range of CGT concessions available;
 - rationalising and improving the current law; and
 - providing greater flexibility in accessing the various CGT concessions.
- 1.3 The interaction between the current roll-over relief, retirement exemption and goodwill exemption provisions is unnecessarily complex and, as a consequence, the law does not operate effectively.

¹⁹ The CGT provisions are located at Parts 3-1 and 3-3 ITAA 1997 and generally applies to CGT events (defined term) that happen to CGT assets (defined term) acquired by a taxpayer after 19 September 1985.

²⁰ The original CGT provisions were contained in Part IIIA ITAA 1936. Section 160 ZZR ITAA 1936 provided for a reduction of the capital gain upon the disposal of the goodwill of a business provided the net value of the business (including associates) was less than the exemption threshold for the year of A\$1m (unindexed). This threshold was later increased to A\$2m and indexed from 1 July 1993.

²¹ Commonwealth, 'New Business Tax System (Capital Gains Tax) Bill 1999 - Explanatory Memorandum' (1999)

These amendments will allow small businesses to benefit successively from all of the CGT concessions for any single eligible capital gain. This will reduce unnecessary compliance costs for small business entities in determining which concession provides the most benefit.²²

Whether these objectives have ever been fully achieved has been the subject of numerous commentaries.²³ On balance, the weight of literature clearly indicates that whilst the small business CGT concessions have been favourably received by taxpayers as an SME policy initiative, the complexity involved in the detailed application of the provisions has meant significant compliance costs are necessarily incurred to access the concessions. Moreover, the potential traps and pitfalls when applying the small business CGT concessions can have devastating consequences for taxpayers if their arrangements are not properly structured.²⁴

At the time the original Bill was introduced, the Explanatory Memorandum indicated that there was no data available to prepare a reliable estimate for this measure, and a small cost to revenue was expected.²⁵ In relation to the compliance cost impact, the Explanatory Memorandum noted that:

This measure will reduce compliance costs, particularly through the streamlining of the current small business concessions. These concessions are complex to apply. As a result of the amendments, small business taxpayers will no longer need to choose which of the concessions they will apply.²⁶

It would similarly appear here that these expectations have not come to fruition in the implementation process. The Board of Taxation (the Board), in October 2005, released a report²⁷ which recommended 39 changes to improve the operation of the small business CGT concessions.²⁸ Ultimately, the (former) Howard government adopted most of the changes with one exception.²⁹ Tax Loss Amendment (2006 Measures No 7) Bill 2006 was subsequently passed on 7 December 2006 which gave effect to the Board's recommendations.

²² Commonwealth, 'New Business Tax System (Capital Gains Tax) Bill 1999 - Explanatory Memorandum' (1999) paragraphs 1.2 – 1.3.

²³ Alexis Kokkinos, 'More flexibility for small business' (2007) *Charter*; Jeffrey Chang, 'Changes to Division 152 - details revealed' (2007) 41(7) *Taxation Institute of Australia*

²⁴ Thomson, 'SME liability trap' (2005) (February) *InTax*; Michael Laurence, 'Pitfalls and possibilities' (2006) 76(10) *InTheBlack*

²⁵ Commonwealth, 'New Business Tax System (Capital Gains Tax) Bill 1999 - Explanatory Memorandum' (1999) p.2

²⁶ Commonwealth, 'New Business Tax System (Capital Gains Tax) Bill 1999 - Explanatory Memorandum' (1999) p.2

²⁷ Board of Taxation, 'A Post Implementation Review of the Quality and Effectiveness of the Small Business Capital Gains Tax Concessions in Division 152 of the ITAA 1997' (2005)

²⁸ The Board of Taxation report outlined 39 recommended changes, of which 26 were legislative and 13 were for ATO administrative consideration.

²⁹ The one exception refers to the recommendation concerning the retirement exemption and the continued potential applicability of Section 109 ITAA 1936 which deals with excessive remuneration paid to private company directors and Division 7A ITAA 1997 which deals with payments made to shareholders (and their associates).

Whilst these changes were received favourably by the tax profession,³⁰ one really needs to ask the question “Why does it take nearly a decade, since the introduction of the small business CGT concessions, to correct the anomalies and problems which were clearly evident within a few years of its operation?” Unfortunately, some questions, however well framed, do not have satisfactory answers.

What is clear is that notwithstanding the well intentioned reasoning behind the original introduction of the small business CGT concessions, the complexity which lies in the detailed application of the law has meant that the concessions have been both difficult and costly to access with the result being that its effectiveness as an SME concession has been substantially reduced. Further, as these measures are purely focussed on the disposal of the business, they do not provide any CGT benefits during the normal course of the SME’s business’ lifecycle.

Nonetheless, the small business CGT concessions definitely reward SME business owners for their entrepreneurial risk taking upon the sale of the business and, to this extent, the (former) Howard government should be applauded for first providing, and then improving upon, the tax benefits that this concession affords SMEs.

2.2 Simpler Depreciation Rules

Both the simplified depreciation and trading stock regimes were introduced as a result of the Ralph Review's recommendations which were adopted by the (former) Howard government in The New Business Tax System. The purpose of the reform measures was to give certain business taxpayers access to a 'Simplified Tax System' (STS) consisting of three main elements, being:

- a cash accounting regime;
- a depreciation regime whereby assets costing less than \$1000 are written off immediately and most other assets are pooled and depreciated as a single asset; and
- a simplified trading stock regime.

(The Bill which introduced these measures also removed a 13 month prepayment rule for 'small business' taxpayers and replaced it with a 12 month prepayment rule, as discussed below in more detail.)³¹

More specifically, in relation to depreciation, SBEs can choose to claim depreciation deductions under the special depreciation regime that previously applied to STS taxpayers pursuant to Subdivision 328-D ITAA 1997. However, if a taxpayer chooses to be subject to this regime, they will not be able to access the usual depreciation rules applicable to all other taxpayers pursuant to Division 40 ITAA 1997.³²

Effectively, SBEs can choose to deduct amounts for most depreciating assets on a diminishing value basis using a pool that is treated as a single depreciating asset. Broadly, under the small business depreciation regime, SBE taxpayers are eligible to receive the following tax treatment:

³⁰ Jeffrey Chang, 'Changes to Division 152 - details revealed' (2007) 41(7) *Taxation Institute of Australia*; Alexis Kokkinos, 'More flexibility for small business' (2007) *Charter*

³¹ Commonwealth, 'Revised Explanatory Memorandum, The New Business Tax System (Simplified Tax System) Bill 2000' (2000)

³² Sub-division 328-175 ITAA 1997.

Immediate write-off for assets costing less than A\$1,000

- Assets (referred to as “low-cost assets”) receive an immediate deduction if their acquisition cost is less than \$1,000 (GST exclusive).
- Unpooled low-cost assets that were held before the taxpayer chose to apply the small business depreciation provisions do not qualify for the immediate deduction, but may be pooled (refer below).

Small business depreciation pools

- With limited exceptions, depreciating assets (excluding buildings) costing \$1,000 or more are automatically pooled. Assets with an effective life of less than 25 years are depreciated in a *general small business pool*, using a diminishing value rate of 30% per year. Assets with an effective life of 25 years or more are depreciated in a *long-life small business pool*, with a diminishing value rate of 5% per year.
- Further, deductions of half the normal rate (15% or 2.5%) are allowed in the year of acquisition.
- Assets are allocated to a small business pool at their GST-exclusive cost if the taxpayer is eligible for input tax credits (Section 27-100 ITAA97).

Other rules

- Subdivision 328-D ITAA 1997 also sets out how to calculate the pool deductions, and the consequences of:
 - disposal of depreciating assets; and
 - not choosing to use this Subdivision for an income year after having chosen to do so for an earlier income year; and
 - changing the business use of depreciating assets.

The capital allowance rules for SBEs are contained in Sub-division 328-D ITAA 1997 and have been effective from 1 July 2001. The accompanying Explanatory Memorandum indicated the following:

- 5.6 Under the current provisions, items are generally treated on an individual basis. The rate of depreciation is determined by the plants effective life. This can result in a multitude of depreciation rates. Hence, it is often a time consuming task having to calculate the depreciation deductions allowable each year.
- 5.7 If an item is used for both business and private purposes, apportionment calculations are required each year to determine the amount of depreciation that may be claimed. When items are disposed of, a separate calculation is also needed to determine any balancing charge. These requirements further increase the compliance burden for small business taxpayers.
- 5.8 The capital allowance provisions for STS taxpayers will result in compliance cost savings by removing much of the need to maintain

individual asset schedules and perform separate calculations for each asset for deduction and balancing charge purposes.³³

Notwithstanding the well intentioned reasoning behind the introduction of the simplified depreciation measures, which was to reduce and simplify compliance with the tax depreciation regime, arguably, this reform measure has failed the SME taxpayer on the basis that (i) utilization of this regime depends on the depreciation rates available to taxpayers in relation to key asset holdings which will vary from taxpayer to taxpayer, (ii) the regime is unlikely to benefit taxpayers with a high number of depreciable assets costing more than A\$1,000 and (iii) it is unlikely to benefit taxpayers that have assets with effective lives shorter than the pool life.³⁴

Notwithstanding the problems and anomalies with the rules, it is interesting to note how other jurisdictions come to learn of the changes and then would like them introduced in their home country. For example, some commentators in New Zealand were quite interested in the Australian depreciation provisions for SMEs when they were first introduced and wanted similar rules to be considered.³⁵ The lesson here is that you should first wait and see how the rules operate in practice before taking on a similar regime.

Temporary Investment Allowance

The *Tax Laws Amendment (Small Business and General Business Tax Break) Bill 2009* was passed by the House of Representatives (on Wednesday 13 May 2009) with four amendments, and was then passed by the Senate (on Thursday 14 May 2009) without further amendment and subsequently received Royal Assent on 22 May 2009 as Act No 31 of 2009. These amendments implemented the Rudd government's recent expansion of the allowance (e.g. the new 50% rate for small businesses), announced in the 2009 Federal Budget, and to resolve a number of technical issues in the Bill.³⁶

A number of issues have been identified with the new Temporary Investment Allowance since its introduction, including:

- the asset must be 'owned' by the taxpayer which means that lease financing arrangements would not qualify;
- this initiative was only able to be accessed by taxpayers which were able to have access to funds in the first place;
- permanent relief was only available to individuals or partnerships, and not companies (given that Australia has a full imputation system, any tax savings

³³ Commonwealth, 'Revised Explanatory Memorandum, The New Business Tax System (Simplified Tax System) Bill 2000' (2000) at Chapter 5

³⁴ Michael Dirkis, 'Simplified Tax System: or STS Exposed: A Simplified Tax System for Small Business or a Tax System for Simple Business?' *Overview Seminar, Taxation Institute of Australia*

³⁵ Ralph Penning, 'What great leap forward?' (2002) August 2002 *NZ Business*

³⁶ For example, a taxpayer that chooses to self-construct an eligible asset may also qualify for the temporary investment allowance. One of the technical amendments provides that the taxpayer has started to construct an eligible asset when they first incur expenditure in respect of the construction of the asset or the modifications to an existing asset.

-
- would ultimately be taxable to a company's shareholders upon the payment of unfranked dividends); and
 - the deduction was only available in the income year when the asset was installed ready for use, rather than the date the taxpayer committed to the expenditure.

Similar incentives existed in Australia during recessionary times from the late 1970s to the early 1980s and again in the early 1990s. At its peak, an investment allowance of 40% applied in the late 1970's progressively falling to 10% by June 1985 as the economy recovered. The new investment allowance was part of a larger package which included large government spending on infrastructure, however, arguably, the issue facing the local economy (and particularly SMEs) relates more to the availability of credit rather than enhanced tax incentives to promote capital equipment investment. Some in the business community have argued that this aspect was not adequately addressed by the Rudd government.³⁷

This only serves to further demonstrate the difficulties in formulating SME policy and then implementing such policy. This is particularly disappointing given that Australia has previously provided an 'investment allowance' to taxpayers, it would seem that lessons learned from those experiences were not taken into account when formulating the new legislation.

2.3 Simplified Trading Stock Rules

Recommendation 170 of 'A Tax System Redesigned' proposed that a simplified treatment of trading stock rules be implemented for small business.

As a result of this recommendation, SBEs can now choose not to account for changes in the value of stock for an income year if the difference between the opening value of stock on hand and a reasonable estimate of stock on hand at the end of that year does not exceed A\$5,000 (Section 328-285(1) ITAA 1997). It should be noted that a SBE is not required to make a specific election to use this trading stock concession (Sub-division 328-E ITAA 1997). Accordingly, if a SBE chooses to account for changes in the value of trading stock, the usual trading stock rules in Subdivision 70-C ITAA 1997 will apply.³⁸

The relevant factors that the ATO considers should be taken into account when making such a reasonable estimate include:

- the type of trading stock held (e.g. large variety versus large numbers of items);
- where and how it is stored (e.g. number of locations);
- the valuation method;
- whether there are material variations in the value of items of stock;
- how sales and purchases of stock are recorded;

³⁷ 10X Limited, 'Business owners put at risk by government small business tax break' (2009) *Media Release 17 July 2009*

³⁸ It is interesting to note that previously, an STS taxpayer could choose to account for changes in the value of trading stock even if the reasonably estimated difference between opening and closing values was less than \$5,000 (Section 328-285(2) ITAA 1997). There were two main reasons why a taxpayer might choose to do so: either to avoid a large adjustment in the calculation of taxable income in a future year when the benefit of Section 328-285(2) is not available, or to claim a deduction in the current year for a reduction in the value of trading stock. Section 328-285(2) has been repealed effective 2007-08 and does not apply in relation to SBEs.

- inventory systems used and their known accuracy;
- information from previous stocktakes; and
- any significant changes from previous income years to the type and quantity of stock held.

The accompanying Explanatory memorandum indicated that this treatment is designed to reduce compliance costs by requiring that changes in trading stock only be brought to account in limited circumstances.³⁹ However, having regard to the foregoing work required to be undertaken by SMEs in accessing this concession, it is difficult to understand how this policy objective could ever be achieved.

Arguably, this reform measure has failed the SME taxpayer on the basis that: (i) the A\$5,000 annual movement is so small, that this concession would have relatively limited application, and (ii) in order to make a reasonable estimate of whether trading stock has in fact changed by more than A\$5,000 probably requires some form of stocktake anyway.

2.4 Deducting certain prepaid expenses immediately

For Australian tax purposes, expenses incurred by a business are generally fully deductible in the year incurred pursuant to Section 8-1 ITAA 1997. However, there are special prepayment rules⁴⁰ that affect the timing of deductions for certain prepaid expenditure relating to a period extending beyond the income year in which the expenditure is incurred.

The status of the payer - individual (business and non-business expenditure), small business entity or other (business and non-business expenditure) - determines the period over which the deduction for the prepaid expenditure must be apportioned, if any. The prepayment rules do not apply to "excluded expenditure", namely expenditure that is:

- less than \$1,000 (GST-exclusive amount if the taxpayer is entitled to an input tax credit in respect of the expenditure);⁴¹
- required to be made by a Commonwealth, State or Territory law or by a court order. Expenditure required to be made by a Commonwealth, State or Territory law is seemingly intended to cover statutory fees and charges (e.g. car registration fees) and does not cover audit fees as they are not required to be paid by law (even though the *Corporations Act 2001* requires a company to have its accounts audited each year);⁴²
- under a contract of service (ie salary or wages);
- of a capital, private or domestic nature;
- incurred after 21 September 1999 by a general insurance company by way of apportionable issue costs (commonly referred to as acquisition costs in the general insurance industry); or

³⁹ Commonwealth, 'Revised Explanatory Memorandum, The New Business Tax System (Simplified Tax System) Bill 2000' (2000)

⁴⁰ Subdivision H, Division 3 in Part III ITAA 1936 (Subsections 82KZL - 82KZO).

⁴¹ ATO Interpretative Decision 2004/398.

⁴² ATO Interpretative Decision 2006/218.

- incurred after 21 September 1999 by a general insurance company in payment of treaty non-proportional reinsurance premiums and reinsurance premiums that are not deductible because of Section 148(1) ITAA 1936.⁴³

The nature and type of the prepayment rule has been “watered down” over time such that it now only provides a limited cash flow benefit to SBEs. That is, expenses incurred may be deductible in the year of payment provided the “eligible service period” (a defined term which is effectively the prepayment period) is not longer than 12 months and ends before the income year following the year of expenditure.

2.5 R&D Tax Off-Set

In Australia, the R&D concession may only be claimed by “eligible companies” (ie generally companies incorporated in Australia, including limited partnerships) and specified types of partnerships.⁴⁴ Individuals and trusts are not eligible to claim the R&D concession.

Subject to a A\$20,000 threshold, companies may claim an accelerated deduction of 125% in relation to eligible R&D expenditure. Further, an incremental concession at the rate of 175% applies where companies increase their level of R&D expenditure (subject to certain criteria being satisfied).

More specifically, in relation to SMEs, Australia’s R&D tax regime was modified to assist eligible small companies to access the cash equivalent of the R&D tax benefit, instead of by way of tax deduction. This change was effective 30 June 2001 and later income years.

The Taxation Laws Amendment (Research and Development) Bill 2001 Explanatory Memorandum states that:

- 3.2 The tax offset gives eligible small companies, in cases where the company is not yet profitable, the benefit of the R&D tax concession earlier. It could provide a cash flow when they need it most.
- 3.3 The grouping rules ensure that large businesses do not receive the tax offset by virtue of their operation being divided into several smaller units.⁴⁵

To be eligible for the R&D tax offset, the company must meet the following four criteria (Section 73J ITAA 1936):

- it would be eligible for the R&D tax concession;
- its total R&D expenditure exceeds A\$20,000;
- the total R&D expenditure of the company and other companies or persons in the group is less than A\$1m; and
- the R&D turnover of the company and other companies or persons in the group is less than A\$5m.⁴⁶

⁴³ Subsection 82KZL(1) ITAA 1936.

⁴⁴ Section 73B ITAA 1936.

⁴⁵ Commonwealth, 'Taxation Laws Amendment (Research and Development) Bill 2001 Explanatory Memorandum' (2001) paragraphs 3.2 - 3.3

⁴⁶ 'R&D group turnover' is defined in Section 73K. It includes the turnover of other companies or entities in the group. It also includes gambling supplies, but excludes insurance payouts under an insurance policy and loan repayments.

In relation to compliance costs, the Explanatory Memorandum notes that:

- 5.39 Under this aspect of the R&D tax concession, a prospective company will need to incur a number of recurring costs to avail themselves of the tax offset. Included amongst these are:
- determining their eligibility against the definition of R&D activities;
 - complying with the definition of turnover used in threshold limits to determine eligibility; and
 - work in determining the total turnover of a group they are a part of to ensure they are eligible for the tax offset.
- 5.40 Some businesses may use the services of a tax agent or an R&D consultant to determine their eligibility for the refundable tax offset. However, as the companies eligible for this tax offset are small and unlikely to be extensively grouped, the costs of compliance associated with the refundable tax offset are expected to be small for both individual companies and when viewed as a group.⁴⁷

The changes made to the R&D rules were specifically aimed at assisting “small companies” by giving them the cash equivalent of the R&D tax concession. This was recognized by the (former) Howard government as being particularly important for those companies who were in a tax loss position and not able to benefit from any increased R&D deductions,⁴⁸ or who were in need of cash flow during their initial growth phase.⁴⁹ This is clearly a good result for SME companies in a tax loss position as they will immediately derive a benefit from claiming the tax offset, whereas a deduction would have been required to be carried forward to later years and offset against future taxable income.⁵⁰

The accompanying Explanatory Memorandum states that the benefits accruing to small companies as a result of the R&D tax offset are as follows:

- 5.4 A refundable tax offset for small companies to have access to the cash equivalent to the R&D tax concession will:
- increase the benefit of the R&D tax concession for small companies in tax loss which cannot obtain immediate support through the concession as they are not part of taxable groups; and
 - provide direct and timely support through improving the cash flow for up to 1,300 companies that fall under the eligibility criteria, and currently claim the R&D tax concession (recognising the greater cash constraints of early stage innovative

⁴⁷ Commonwealth, 'Taxation Laws Amendment (Research and Development) Bill 2001 Explanatory Memorandum' (2001) paragraphs 5.39 - 5.40

⁴⁸ The Hon. Warren Entsch, 'second reading speech on the Taxation Laws Amendment (Research and Development) Bill 2001' (2001) *House of Representatives, Hansard* 28647; Australian Taxation Office, 'Research & development tax concession: tax offset' (2006)

⁴⁹ The Hon. Warren Entsch, 'second reading speech on the Taxation Laws Amendment (Research and Development) Bill 2001' (2001) *House of Representatives, Hansard* 28647; Australian Taxation Office, 'Research & development tax concession: tax offset' (2006)

⁵⁰ Weiran Wang, 'Understanding R&D tax benefits for small companies' (2008/2009) (8) *The Taxpayer*, Commonwealth, 'Research & development tax concession: tax offset' (2006)

companies), thereby improving their chance of survival. These companies will also be able to access the other measures arising from this Bill.

- 5.5 This proposal has advantages over a competitive granting program, as it is eligibility based and non-distortive.
- 5.6 Its broad-based nature also enables support to be given to the whole of a company's R&D activities rather than to specific R&D projects. Grouping rules will apply.⁵¹

Finally, the tax offset is subject to the refundable tax offset rules (Section 67-25 ITAA 1997). That is, any R&D refund payable will be reduced if the company has other Commonwealth tax liabilities (such as GST, FBT, withholding taxes). Further, any refund of monies from the R&D tax offset does not give rise to a franking debit (ATO Interpretative Decision 2004/345).

In an Australian context, there is no doubt that the R&D tax offset has provided SME companies with a substantial upside of being able to obtain a cash flow advantage by effectively bringing forward the R&D tax benefit. The real issue is whether, in a global context, the R&D tax concession in its current form is sufficient with the suggestion being that a 40% R&D tax credit should be available to large firms, with a refundable tax offset of 50% provided to smaller companies with a turnover of under A\$50m.⁵²

Federal Budget 2009

In its 2009 Federal Budget, the Rudd government has indicated that it will increase spending on science and innovation by 25% in 2009-10 as part of an innovation package worth \$3.1 billion over the next four years. The centrepiece of the Government's "Innovation Agenda for the 21st Century" – a \$1.4 billion R&D tax credit scheme that will double the level of assistance available under the current R&D tax concession scheme – will not be available until 2010-11.⁵³

Broadly, a new R&D Tax Credit is proposed to replace the existing R&D Tax Concessions effective 1 July 2010. The new R&D Tax Credit will consist of a 40 per cent non-refundable tax credit and a 45 per cent refundable tax credit for firms with a turnover of A\$20 million or less (which the government says is equivalent to a tax concession of 150% and that around 5500 small firms stand to benefit under the new arrangements). This means that eligible firms will receive a tax refund of 45 per cent of their R&D expenditure upon filing of their income tax return. Businesses with a turnover of more than A\$20 million will be able to access a 40 per cent non-refundable credit.

⁵¹ Commonwealth, 'Taxation Laws Amendment (Research and Development) Bill 2001 Explanatory Memorandum' (2001) paragraphs 5.4-5.6

⁵² Weiran Wang, 'Understanding R&D tax benefits for small companies' (2008/2009) (8) *The Taxpayer*

⁵³ In this context, it is interesting to note that the Rudd government was heavily criticised by business groups in 2008 when it removed the (former) Howard government's "Commercial Ready" scheme, which provided \$700 million of assistance to early-stage technology companies each year. While the 2009 Budget did not include a direct replacement for Commercial Ready, the enlargement of the R&D tax incentives will be welcomed and viewed as a compensatory measure, notwithstanding that the new incentives do not commence until 1 July 2010.

Importantly, the refundable credit will be available to small companies in tax loss, with no limit on the level of R&D expenditure they undertake which should provide assistance to start-up companies.

As an interim measure, until the program starts on 1 July 2010, the government will lift the expenditure cap on eligible R&D that can be claimed under the existing R&D Tax Offset from A\$1m to A\$2m effective 1 July 2009

2.6 The 25% entrepreneurs' tax offset

The 25% entrepreneurs' tax offset (ETO) was first mooted by the former (Howard) government in its 2004 election policy statement, 'Promoting an Enterprise Culture',⁵⁴ where it identified a number of measures designed to foster the entrepreneurial spirit of small business.⁵⁵

These measures were divided into two categories. The first was in relation to the reduction of small business taxes by extending the STS to include businesses that account on an accrual basis (as previously discussed above) and the introduction of the 25% ETO. Secondly, the government wanted to improve the regulatory environment for small businesses by reducing the amendment period by which the ATO can amend assessments for STS taxpayers to two years (instead of four years) and by reducing local Council restrictions imposed on small businesses operating from home.⁵⁶

More specifically, in relation to the ETO policy, this was targeted at very small, micro and home based businesses that were eligible to be in the (former) STS regime.⁵⁷ The Regulation Impact Statement in the accompanying Explanatory Memorandum identified the group of taxpayers who would benefit most by this measure as follows:

Groups affected by the 25 per cent entrepreneurs' tax offset are STS taxpayers and non-STS taxpayers⁵⁸ in receipt of gross STS income under \$75,000, namely very small, micro and home-based businesses who are in the STS. It is estimated that more than 300,000 small and home-based businesses will be able to benefit from the 25 per cent tax offset.⁵⁹

⁵⁴ Commonwealth Government, 'The Howard Government Election 2004 Policy, Promoting an Enterprise Culture' (2004)

⁵⁵ Commonwealth, 'Explanatory Memorandum - Tax Laws Amendment (2004 Measures No 7) Bill 2004, Chapter 1' (2004)

⁵⁶ Commonwealth Government, 'The Howard Government Election 2004 Policy, Promoting an Enterprise Culture' (2004)

⁵⁷ In this regard, Subdivision 61-J was enacted by Tax Laws Amendment (2004 Measures No 7) Act 2005 (Act 41 of 2005) and effective from the 2005-06 income year. Subdivision 61-J was amended by the Tax Laws Amendment (Small Business) Act 2007 (Act 80 of 2007) as part of the replacement of the simplified tax system with the small business entity rules. For the 2005-06 and 2006-07 income years, the ETO was only available where the relevant taxpayer, partnership or trust was eligible for and chose to be an STS taxpayer for the relevant income year. From the 2007/08 income years, the ETO applies where the relevant individual, company, partnership or trust is a SBE for the relevant income year.

⁵⁸ There is an error in this paragraph of the Explanatory Memorandum as it also refers to non-STS taxpayers as being eligible for the entrepreneurs' tax offset which is clearly not the case.

⁵⁹ Commonwealth, 'Taxation Laws Amendment (Research and Development) Bill 2001 Explanatory Memorandum' (2001) paragraph 1.50

The (former) Treasurer, Mr Peter Costello, indicated that around 540,000 Australian small businesses would benefit from this concession (although it is not clear why there is a difference as between the 300,000 figure used in the Explanatory Memorandum vis-à-vis the Treasurer's figure of 540,000).⁶⁰

At that time, Treasury estimated the cost to be \$400m (in 2006-07) and \$390m (in 2007-08).⁶¹ The issue which arises is that the success or otherwise of this policy has not been measured since its introduction. Some commentators have validly questioned that if this is not the actual cost and the figure is less, whether the government would then consider other options for the development of an entrepreneurial culture in Australia.⁶²

The potential benefits arising from this concession and its proposed operation were succinctly summarised by the (former) Treasurer Mr Peter Costello, as follows:

The discount allows businesses operating in the Simplified Tax System a 25 per cent discount on the income tax in respect of their business income. Businesses with turnover up to \$75,000 will benefit, while those with turnover of \$50,000 or less able to claim the maximum 25 per cent. The maximum possible benefit depends on the amount of tax that would otherwise be paid. For example, if a company has a turnover of \$50,000, the maximum tax it would pay would be \$15,000 (i.e. 30 per cent of \$50,000), although this would usually be reduced by deductions.

- The 25 per cent discount would reduce this tax liability by \$3,750, to only \$11,250.

If the business is not a company, such as a sole trader, then the maximum tax it would pay on a \$50,000 turnover would be \$11,172 (i.e. the application of the tax free thresholds and lower marginal rates), although again, this would usually be reduced by deductions.

- The 25 per cent discount would reduce this tax liability by \$2,793 to \$8,379.⁶³

Put simply, the ETO provided STS taxpayers with a discount on their income tax liability of up to 25% (for those STS taxpayers with a taxable income of up to A\$50,000) with the benefit phasing out for every dollar of taxable income assessed greater than A\$50,000 and less than A\$75,000.

Notwithstanding that the original design of the ETO was to incentivise and encourage small businesses (particularly those that set up and operated from home),⁶⁴ the detailed operation of this tax concession was, and remains, problematic for a number of reasons:

⁶⁰ Peter Costello, 'Tax Cut For Small Businesses' (2005) *Media Release 17 March 2005*

⁶¹ Commonwealth, 'Taxation Laws Amendment (Research and Development) Bill 2001 Explanatory Memorandum' (2001) paragraph 1.60

⁶² John McLaren, 'The Tax Offset for entrepreneurs: A critical review of the 25 percent tax offset for small business' (2006) 20 *Journal of the Australasian Tax Teachers Association*

⁶³ Peter Costello, 'Tax Cut For Small Businesses' (2005) *Media Release 17 March 2005*

⁶⁴ Commonwealth Government, 'The Howard Government Election 2004 Policy, Promoting an Enterprise Culture' (2004)

- **The qualifying criteria are subjective.** When starting up a business, it is not always clear (initially at least) whether the taxpayer is in business or has a hobby. Only bona-fide businesses are eligible for the tax offset, however Australian tax law in this area requires very specific steps to have been undertaken by the taxpayer before it is considered to be carrying on a business.⁶⁵ In this context, if expenses are incurred at a point too early for there to be a business, taxpayers will be denied a deduction (or, alternatively, may be subject to the non-commercial loss rules).⁶⁶ On the other hand, if the taxpayer starts to make money, the ATO will tax them on such amounts. Either way, this does not seem to provide an appropriate tax environment for which an 'entrepreneurial spirit' can be said to be fostered and developed.
- **Qualifying criteria discriminates against certain businesses.** The eligibility criteria tends to favour low turnover, high margin businesses and, accordingly, service based businesses operating from home would be the main beneficiaries of the ETO. For this reason, some commentators have labelled the ETO as the "consultants' tax discount".⁶⁷
- **Taxpayers must have elected the STS system to apply to them.** Under the former STS regime, to be a STS taxpayer, the entity, inter-alia, must have been carrying on a business with a gross turnover of less than A\$1m (GST-exclusive).⁶⁸ Arguably, this is unreasonable given the problems which have been identified with the STS system which ultimately resulted in a low level take-up.⁶⁹
- **Actual tax savings can be achieved through the existing tax framework.** It has been commented that taxpayers on a taxable income of A\$50,000 - A\$75,000 can reduce their tax payable to nil by utilising existing tax rules including the tax free threshold and superannuation.⁷⁰ Accordingly, it would appear that the 25% ETO rate was not properly considered in the context of tax deductions and concessions already available to taxpayers under the pre-existing tax framework.
- **Tax compliance costs.** Assuming the taxpayer's return is prepared by a tax agent, in order to mitigate his/her professional indemnity liability, the overall tax saving is less than that predicted by the (former) Treasurer which does not take compliance costs into account. Compliance costs will increase further where the taxpayer has other income that must be separated from the business income.⁷¹ This is because taxpayers are required to isolate their gross business income and associated deductions to calculate the net taxable income in relation to their small business.

⁶⁵ Australian Taxation Office, 'Taxation Ruling 97/11: Income tax: am I carrying on a business of primary production?' (1997)

⁶⁶ Division 35 ITAA 1997.

⁶⁷ Tony Greco, 'Calling all entrepreneurs' (2005) 23(5) *Personal Investor*

⁶⁸ Former Subdivision 328-A, 328-F, and 328-G (repealed by Act 80 of 2007).

⁶⁹ Mark Burton, 'The Australian Small Business Tax Concessions - Public Choice, Public Interest, or Public Folly?' (2006) 21 *Australian Tax Forum*; Margaret McKerchar, 'Is the simplified tax system simple?' (2007) 10(3) *The Tax Specialist*

⁷⁰ John McLaren, 'The Tax Offset for entrepreneurs: A critical review of the 25 percent tax offset for small business' (2006) 20 *Journal of the Australasian Tax Teachers Association*

⁷¹ John McLaren, 'The Tax Offset for entrepreneurs: A critical review of the 25 percent tax offset for small business' (2006) 20 *Journal of the Australasian Tax Teachers Association*

- **Insufficient taxpayer awareness.** Some commentators have suggested that many small businesses will not access the ETO simply because they are not fully aware of it.⁷²

The issues identified above conflict with the government's policy objective when the ETO was first introduced which was to:

provide encouragement for enterprising Australians in the early days of a small business, in particular to provide a greater benefit to businesses with greater productivity, and to provide incentive for the growth of small business especially the very small, micro and home-based businesses which are in the STS.⁷³

Further, this concession may become even more difficult to access with the Rudd government proposing to apply a family income test in order to restrict access to the ETO in relation to businesses which have high alternative sources of income.⁷⁴ The Rudd government indicated that the ETO is claimed by many taxpayers for whom business is not a primary source of income and who have other, more significant, forms of income. Accordingly, it argues that the family income test is necessary to restrict access to the offset for businesses with high alternative sources of household income.

When originally announced in the 2008 government budget,⁷⁵ the proposed income test was to limit the offset by restricting eligibility for singles from A\$75,000 and for families from A\$120,000 annual adjusted taxable income per year. However, in the 2009 Federal Budget, the government has indicated that it will consult on the form of the income test.⁷⁶ Under the Rudd government's 2009 Federal Budget, it was announced that the application of the income test for access to the ETO would be deferred for 12 months at a cost to revenue of A\$35m (2009-10) and A\$3m (2010-11).⁷⁷ This has not yet become law as at the time of writing (i.e. as at 3 August 2009).

It was noted by Dr Ken Henry that:

Entrepreneurial activity can make an important contribution to economic growth. New entrants in a market can introduce more highly valued products, new production methods and processes, and organisational innovations. These in turn can provide spill over benefits to existing firms. Potential entrepreneurs typically face a choice between returns from risky entrepreneurial projects and a more stable income from the current use of production factors.⁷⁸

In relation to the application of the ETO, Dr Ken Henry went on to say that:

The income tax system can also distort risk-taking behaviour where tax is not levied proportionately, for example where there are progressive income tax rates as may apply to a sole trader or partners in a partnership. Where gains

⁷² Peter Switzer, 'Pollies hiding website crackers' (2005) *The Australian*

⁷³ Commonwealth, 'Explanatory Memorandum Tax Laws Amendment (2004 Measures No.7) Bill 2004' (2004) paragraph 1.41; Commonwealth, 'Government acts to reduce compliance costs and improve the tax law' (2009) *Media Release No. 48 12 May 2009*

⁷⁴ Commonwealth, 'Entrepreneurs' Tax Offset' (2008) *Media Release No. 50 13 May 2008*

⁷⁵ Commonwealth, 'Entrepreneurs' Tax Offset' (2008) *Media Release No. 50 13 May 2008*

⁷⁶ Commonwealth, 'Entrepreneurs' Tax Offset' (2008) *Media Release No. 50 13 May 2008*

⁷⁷ Commonwealth, 'Budget Measures - Budget paper No. 2' (2009) at p14.

⁷⁸ Commonwealth, 'Australia's Future Tax System - Consultation Paper' (2008) at p149.

are assessed against a higher tax rate than the rate at which losses are accessed, progressive personal rates effectively tax success more than they subsidise failure. This effect can be further exacerbated by progressive credits such as the entrepreneurs' tax offset, which reduces the tax liability for entrepreneurs whose income is lower than a specific threshold.⁷⁹

Accordingly, whilst it is common ground that Australia's tax system should have concessions to encourage entrepreneurial activity, the real issue lies in determining whether the current system achieves this end. Having regard to the problems and anomalies identified above, it would seem that Australia's ETO regime is not effective. Certainly, anecdotal evidence suggests that few people would venture into entrepreneurial business activities as a direct result of being eligible to access the ETO.⁸⁰

With the benefit of hindsight, the Australian Democrats submission to the Senate Economics Legislation Committee is prophetic. They branded the ETO as 'bad' policy on the basis that:

- no evidence was produced by the government to demonstrate that Australian micro and small businesses lacked entrepreneurial spirit or that the ETO would further encourage entrepreneurial activity;
- the ETO represents an untargeted measure equally applying to all classes of micro and small businesses irrespective of whether the goods or services they provide are in short supply;
- the accompanying legislation is unduly complicated and will add to compliance costs; and
- the ETO does not satisfy any of the three elements of an ideal tax system; being efficiency, simplicity, and equity.

It would seem that whilst all of these points, arguably, have merit, it does further illustrate the issues and problems which can arise when formulating and implementing SME tax policy against a highly charged political background.

2.7 Review of Assessments

Resulting from a review of Australia's income tax self assessment system, the former (Howard) government, in its 2004 election policy statement 'Promoting an Enterprise Culture', indicated that it would reduce the period in which the ATO can audit and adjust the tax assessments of STS taxpayers (now SBEs) from four years to two years.⁸¹ Importantly, this concession applies to SBEs automatically. However, the four year amendment period would continue to apply to taxpayers with more complex tax affairs.

The rationale behind this concession was to improve the regulatory environment for small businesses and, in this case in particular, to significantly ease the record

⁷⁹ Commonwealth, 'Australia's Future Tax System - Consultation Paper' (2008) at p149.

⁸⁰ In this context, anecdotal evidence refers to my experience as a tax advisor and information gleaned by me from being a regular attendee at various tax discussion groups in Australia, as well as discussions held with tax colleagues from other organisations.

⁸¹ Commonwealth Government, 'The Howard Government Election 2004 Policy, Promoting an Enterprise Culture' (2004)

keeping requirements of individuals and small businesses and to give them “peace of mind”.⁸²

Whilst one can understand how this may help to reduce record keeping requirements, if only because the actual period for which records are required to be maintained has been reduced by two years, it is difficult to understand how this change, in itself, would ease the compliance burden on small business. In order for an SME to prepare its annual tax return, it is still required to adhere to the relevant tax compliance obligations, rules and processes. Once this is done, the retention of the paperwork in its filing system for four years (or now two years) would be the least of its concerns.

In fact, arguably, this approach encourages SMEs to not comply with tax laws on the basis that the ATO has a reduced period in which to conduct an audit. This was introduced by the (former) Howard government under the guise of improving the regulatory environment for small businesses, however, this measure does nothing in terms of reducing an SME’s “front end” compliance requirements which must be adhered to and followed in relation to the preparation of the documents which are required to be lodged for tax purposes.

2.8 Non Commercial Losses

As a result from a Ralph Committee recommendation, a tax measure was introduced, effective 1 July 2000, seeking to limit the extent to which non-commercial losses from an individual’s business activities can be used to reduce tax paid on other income such as salary or wages (refer the New Business Tax System (Integrity Measures) Bill 2000).

This provision applies in the context of “what constitutes the carrying on of a business activity” for individuals who are able to claim business deductions. Previously, an individual “carrying on a business” was able to claim the excess of deductions over assessable income from this activity against other income, enabling one to reduce his/her after taxable income and tax payable. From the ATO’s perspective, historically, it has had difficulty administering what constitutes “carrying on a business” because in most cases compliance with the law requires a case by case analysis. This had become a “resource intensive” exercise involving substantial ATO participation. Consequently, there has been a significant leakage of revenue from individuals claiming deductions from unprofitable activities and from activities that appear to have business characteristics but, in reality, unlikely to ever be profitable.

Individuals “carrying on a business” can now only apply a loss from a business activity against other income provided they satisfy any one of the following four tests:

1. Is the assessable income from the business activity at least \$20,000?
2. Has the business activity produced a profit (for tax purposes) in at least 3 out of the last 5 years, including the current year?
3. Is the value of real property used in carrying on a business at least \$500,000?
4. Is the value of other assets used in carrying on a business at least \$100,000?

⁸² Commonwealth Government, 'The Howard Government Election 2004 Policy, Promoting an Enterprise Culture' (2004)

If none of these tests are satisfied, the deductibility of losses may be deferred until later years and can only be offset against any income from the same business activity in a future year. Also, should any of the four tests be satisfied in a future year, the deferred loss can be deducted against any assessable income. Despite these 4 tests, the threshold question for Pitt Street (or Collins Street) farmers will be what constitutes “carrying on a business activity” for tax purposes.

Federal Budget 2009 changes

Treasury released exposure draft legislation to implement changes announced in the 2009-10 Federal Budget to ‘tighten’ the non-commercial losses rules for individuals. In the Budget, the government announced that taxpayers with an ‘adjusted taxable income’ of over \$250,000 will only be able to deduct expenses from non-commercial business activities against the income from those activities. Any excess deductions will be quarantined to the business activity.

The proposed changes essentially add a \$250,000 income test limit so that unless this income requirement is met and one of the four existing objective tests is met (as discussed above), losses from non-commercial business activities are quarantined. The income requirement will be met when, in a given income year, the sum of an individual's taxable income, reportable fringe benefits, reportable superannuation contributions and total net investment losses is less than \$250,000.

The changes also introduce a new Commissioner's discretion for individuals who do not meet the income requirement, but who have excess deductions from a business that, based on an objective assessment, is a commercial business (i.e. on an objective basis, is expected to produce assessable income).

2.9 Simplified Transfer Pricing

In the ATO's 1999 compliance improvement program, it noted that it suspected a high level of non-compliance by small businesses involved in international transactions. The ATO indicated that 50% of small business taxpayers using related party dealings did not lodge a Schedule 25A with their income tax returns and that they also misunderstood transfer pricing procedures.⁸³

Notwithstanding this, it was not until 2005 that the ATO allowed SMEs to adopt a simplified approach to their compliance obligations in relation to transfer pricing.⁸⁴ The simplified approach applies to businesses with an annual turnover of less than A\$100m, unless they are:

- part of a multinational group that is listed on any stock exchange; or
- part of a private group with any international subsidiary or other offshore related party that has the resources to deal with global transfer pricing issues.⁸⁵

This simplified approach is outlined in Chapter 6 of Taxation Ruling TR 98/11 and was developed as a way of reducing compliance costs for SMEs. Some relevant extracts are referred to below:

6.2 The various possible situations arising in business do not lend themselves to a code of practice or formal process being spelt out for

⁸³ Thomson ATP, 'Tax Office Targets' (1999) (September 1999) *InTax* p.6

⁸⁴ Commonwealth, 'International Transfer pricing: A simplified approach to documentation and risk assessment for small to medium businesses' (2005)

⁸⁵ Commonwealth, 'International Transfer pricing: A simplified approach to documentation and risk assessment for small to medium businesses' (2005) p.3.

small business taxpayers. The wide range of situations give rise to different judgments about what to do, or not do, with no consistent line of reasoning emerging. Small business taxpayers need to exercise good commercial judgment in determining the level of documentation they think appropriate for their international dealings with associated enterprises.

- 6.3 For example, a small business which has turnover of \$10 million and international dealings with associated enterprises of \$500,000 may not deem it prudent business management to undertake extensive analysis and documentation of its transfer pricing practices to demonstrate compliance with the arm's length principle. This is an exercise of commercial judgment made by a manager having regard to the particular circumstances of the taxpayer's business, the complexity of the dealings and the risk of an ATO review.
- 6.4 On the other hand, if the particular example above involves a dealing that is narrowly focused and can be benchmarked against arm's length outcomes by reference to readily available data, then a prudent manager, at little cost and with little effort, could document the process used and the comparison with arm's length outcomes.
- 6.5 In order to assist small business taxpayers, the ATO suggests managers consider the following issues to assist in determining the nature and extent of documentation required in order to satisfy themselves that international dealings with associated enterprises accord with arm's length outcomes:
- (1) Is the dealing significant, in terms of quantum or proportionality, to the overall business turnover?
 - (2) Are there any features of the dealing(s) that make them unusual, one-off or distinguishable from international dealings with associated enterprises that had been assessed against the arm's length principle? and
 - (3) Would the features in (1) and (2), or other features of the dealings, lead the ATO to question their basis or outcomes?
- 6.6 If the answer to any of (1) to (3) above is 'yes', then the small business taxpayer manager would want to consider what further work might be done to satisfy themselves and the ATO of the arm's length nature of the dealings. This is an exercise in commercial judgment, balancing the risk associated with doing nothing and the potential outcomes of that decision (e.g., non compliance with the law and ATO intervention) with the cost of doing something, perhaps only a bare minimum, that may satisfy these concerns.

Having regard to the foregoing, arguably, the gulf which exists between the pragmatic needs of SMEs and the complexity and length of ATO rulings on a taxpayer's obligations in relation to transfer pricing documentation continues to be significant. From the viewpoint of tax practitioners advising the SME market, clients with international transactions have been described by certain tax commentators as a "nightmare", particularly for those who transact with overseas related parties.⁸⁶

⁸⁶ Thomson ATP, 'Big issues for small fish' (2006) (June 2006) *InTax*

Whilst Australian taxpayers can enter into advanced pricing agreements (APA), certain transfer pricing specialists have been concerned that this process has been handled in such a way by the ATO that discriminates against SMEs. This is on the basis that the ATO may argue that such SMEs are either not 'big' enough, or their transactions are not complex enough to warrant the level of certainty that an APA can offer.⁸⁷

In practice, the reality is that the costs involved in preparing an APA makes it difficult for SMEs to access in the first instance anyway. Nonetheless, in the author's view, the A\$100m threshold is more than reasonable as an appropriate 'cut off' for SMEs.

2.10 Taxation of Financial Arrangements

By way of background, changes to the taxation of financial arrangements (TOFA) have been contemplated since December 1993 when the then government released a consultative document, *Taxation of Financial Arrangements*. In July 1999, the Ralph Report recommended that specific TOFA rules be adopted, which in November 1999 the government indicated that it would support in principle.

The first stage of TOFA reforms - the debt/equity rules, was implemented in 2001, and the second stage, the taxation of foreign exchange gains and losses, was largely implemented in 2003.

The government proposed in the 2002 Federal Budget that stage 3 of the TOFA reforms would deal with the taxation of commodity hedges and stage 4 would contain general tax timing rules for financial arrangements (including elective mark-to-market rules and an accruals/realisation framework).

In relation to tranches 3 and 4 of TOFA, the Senate agreed to an extension from 20 February 2009 to 26 February 2009 of the due date for the report of the Senate Economics Committee on the *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008*. During this time, the Bill was still before the House of Representatives.

The 2008 Bill subsequently passed all stages of Parliament without amendment, and implemented, via a new Division 230 ITAA 1997, the final stages of the TOFA reform program which commenced in the early 1990s.⁸⁸ Generally, Division 230 will apply on a mandatory basis to all income years commencing on or after 1 July 2010, although taxpayers can elect to apply Division 230 to income years commencing on or after 1 July 2009.

From an SME perspective, the new TOFA rules will only have limited application to the following categories of entity:

- an individual;
- a superannuation entity or a funds management entity with assets of less than \$100m;
- an ADI, securitisation vehicle or other financial sector entity with aggregated annual turnover of less than \$20m; and
- any other entity with an aggregated annual turnover of less than \$100m, financial assets of less than \$100m and assets of less than \$300m.

⁸⁷ Bruce Andrews, 'Sanctuary denied' (2006) (November 23-29) *Business Review Weekly* p.68

⁸⁸ The Bill received Royal Assent on 26 March 2009 as *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* - Act No 15 of 2009.

Whilst the above entities can elect into the TOFA regime, if they do not make that election, the new TOFA rules will apply only to qualifying securities (as defined in Division 16E ITAA 1936) that have a duration for the taxpayer of more than 12 months. For all taxpayers, the new TOFA rules will not apply to specified arrangements including leases, licences, interests in partnerships and trusts, certain insurance policies, guarantees and indemnities, the provision of personal services, personal injury claims, rights to receive pension or superannuation income and earn-out arrangements on the sale of a business.

Originally, the threshold was set at A\$20m which was heavily criticised by various industry groups as an arbitrary figure that was set too low, especially for certain industries. For example, car dealerships traditionally have high turnovers but low margins, and so will almost always exceed the A\$20m threshold. In addition, larger SME tax consolidated groups would also be required to consider the group's turnover, rather than each separate entity.

Having regard to the foregoing, it would seem that the potential application of the TOFA provisions have now been excluded from the wider SME net which represents a common sense approach in relation to what is highly complex legislation.

2.11 GST - Simplified accounting

When originally introduced, Division 123 ITAA 1997 allowed the Commissioner to determine a "simplified accounting method" which may be adopted by retailers dealing with supplies of food. Where a retailer elected to use the simplified accounting method, the net amount for that retailer would be determined in accordance with that method, rather than in accordance with the usual method under Section 17-5 GST Act 2000.⁸⁹

Importantly, it should be noted that effective 1 July 2007, the Commissioner is now able to determine a simplified accounting method, on application, for:

- any entity making mixed supplies with a turnover of less than \$2m (i.e., a taxpayer qualifies if it meets the SBE definition); or
- an entity that does not carry on a business, but has an annual turnover that does not exceed A\$2m as calculated under the GST turnover test in Division 188 GST Act 2000.⁹⁰

Accordingly, whilst the application of Division 123 has been extended to include entities that do not carry on a business, in applying this provision, taxpayers must use the "GST turnover" definition instead of the "annual turnover" definition applicable to SBEs.

It would seem that for every positive step forward, this is usually accompanied by a number of paces backwards. Ideally, some adoption of a pre-existing definition

⁸⁹ The current determination regarding the operation of the Simplified GST Accounting Methods is A New Tax System (Goods and Services Tax) (Simplified GST Accounting Methods) Determination 2001. However, small supermarkets and convenience stores (but not petrol stations) may apply the A New Tax System (Goods and Services Tax) (Simplified GST Accounting Methods) Determination 2005 to calculate input tax credit entitlements from 1 October 2005 and restaurants, cafes and catering businesses may use the A New Tax System (Goods and Services Tax) Act 1999 Simplified Accounting Method Determination (No 1) 2006 to calculate input tax credit entitlements from 1 October 2006.

⁹⁰ Commonwealth, 'Tax Laws Amendment (Simplified GST Accounting) Bill 2007' (2007) paragraphs 1.11 – 1.12

“turnover” in the tax law should have been the preferred approach, rather than creating yet another definition for SMEs to be aware of.

2.12 FBT – Car parking exemption

Car parking provided by a small business, or SBE, on its premises is exempt from FBT under Section 58GA FBTA (subject to certain other criteria). For FBT purposes, a small business is a taxpayer with gross income of less than A\$10m (subject to certain exceptions).⁹¹

Importantly, the income of other entities in the same group is not taken into account when determining whether an employer taxpayer exceeds the A\$10m threshold.⁹² This approach to the definition of small business is a departure from, say, that in the small business CGT concessions which provides rules for related entities of the taxpayer seeking the concession to be grouped, in order to determine eligibility for the concession.

The only issue here is whether the A\$10m is a sufficiently low enough threshold but, in any event, it is much higher than the A\$2m threshold which applies to SBEs and, coupled with the fact that grouping of entities is not required to be undertaken to determine eligibility, there is rarely any adverse criticism in relation to this SME tax concession.

2.13 Debt/Equity Rules

Broadly, Division 974 ITAA 1997 classifies shares in a company and certain financing arrangements as “debt interests” or “equity interests”. It contains various tests for distinguishing between “debt” and “equity” which is designed to assess the economic substance of an interest in terms of its impact on the position of the issuer of the interest (Section 974-5 ITAA 1997). The object of the Division:

is that the test ... is to operate on the basis of the economic substance of the rights and obligations arising ... rather than merely on the basis of the legal form ...⁹³

As a concessionary measure, related party at-call loans (a defined term), entered into on or after 21 February 2001 and before 30 June 2005, were deemed to be debt interests and not equity interests until 1 July 2005 (Section 974-75(4)).

Importantly for SMEs, since 1 July 2005, all related party at-call loans (ie loans satisfying certain conditions under Section 974-75(4)) continue to be deemed to be “debt interests” (and not “equity interests”) in an income year if, at the end of the income year, the borrowing company has an annual turnover of less than A\$20m (Section 974-75(6) ITAA 1997). For these purposes, a company's annual turnover is to be calculated in the same way that it is for GST purposes (Section 974-75(7) ITAA 1997). This applies to loans made on or after 1 July 2005 and loans made before 1 July 2005, in so far as they continue to exist on and after that date.

⁹¹ Other than government bodies for FBT purposes, listed public companies and their subsidiaries.

⁹² The A\$10m threshold is calculated on a GST-inclusive basis (refer ATO Interpretative Decision 2004/935).

⁹³ Section 974-10(2) ITAA 1997

The only issue in question here, in relation to the application of these complex rules to SMEs, is whether the A\$20m threshold is considered to be a sufficiently high enough “cut off” point for SMEs.

2.13 Thin Capitalisation

Australia has had a Thin Capitalisation regime in one form or another since 1987 (Division 16F of Part IIIA ITAA 1936). The rationale behind these provisions has always been to counter the strategy adopted by taxpayers of using debt over equity funding so as to obtain a more favourable tax treatment of debt in relation to cross-border investments.

Importantly, the Thin Capitalisation rules contain a number of exceptions which apply where the entity:

- conducts its operations wholly within Australia or outside Australia (i.e., it is neither an inward nor an outward investing entity as defined); or
- satisfies the ‘de minimis’ rule (ie debt deductions related to its debt do not exceed A\$250,000 (Section 820-35 ITAA 1997); or
- is an outward investing entity and has 90% or more of the total average value of all its assets represented by Australian assets (Section 820-37 ITAA 1997); or
- is an exempt special purpose (securitisation) entity (Section 820-39 ITAA 1997).

The main exception that SMEs ordinarily fall under is the ‘de minimis’ rule referred to above. Here again, the only issue is whether the A\$250,000 debt threshold is considered to be a sufficiently high “cut off” point for SMEs. In practice it is, at least in this case, a relatively straight forward exercise to determine whether the entity has interest deductions in excess of A\$250,000. The only real concern is for those SMEs that do not qualify for the ‘de minimis’ rule and that are expanding their businesses offshore. In these circumstances, their method of funding for such an expansion will be required to be closely monitored.

3 Conclusion and Recommendations

In Australia, policy makers have failed to properly identify and target relevant tax concessions in the SME sector. Historically, tax initiatives in the SME sector have been ad-hoc and reactive in nature. The (former) Howard government's legislation to standardise the eligibility criteria for small business tax concessions was a (small) step in the right direction. However, what is clear is that a change in approach is well overdue.

A summary of the problems and anomalies which have been identified in relation to Australia's SME tax concessions is located at **Appendix 3**. It is clearly evident that more needs to be done to make the SME concessions simpler to understand and less costly to access.

The importance of the SME sector to the Australian economy means that economic policy must take into account the impact on SMEs and that SME specific policies must be developed in a co-ordinated and logical manner, with the emphasis being on moving towards the development of appropriate medium to longer term SME tax policy.

This can be achieved in a number of ways, including; by a lowering of the overall tax burden for SMEs, having a more focused approach on developing appropriate SME tax strategies rather than tax compliance, increase investment tax incentives and initiatives for SMEs, encourage the retention of taxable profits, increase management and employee tax participation incentives, allow small businesses access to a higher R & D concession rate, and increase simplicity in the tax law.⁹⁴

In the medium to longer term, one would also like to see agreed upon definitions not only around the term SME, but also its various sub-sets (e.g. micro-business, entrepreneur etc) and tax policy set accordingly.

⁹⁴ Mark Pizzacalla, 'Dr Ken Henry Submission – Australia's Future Tax System Consultation Paper: Tax treatment of Small to Medium Sized Enterprises' (2009)

4 Further Research

With the results of this Paper in mind, some future research directions are suggested. More specifically, further research should focus on the following areas:

- Future research should investigate the impact that the introduction of the ETO has had on the establishment of small businesses.
- Future research should be directed towards the current state of the entrepreneurial sector in Australia and whether the tax system sufficiently addresses the needs and requirements of this sub-set of the SME sector.
- Future research should be directed towards understanding the relationship between any future proposed changes to SME tax policy and how such policy changes can be expected to interact with the tax incentives already provided for under the existing tax regime. This should minimise any unnecessary overlap as between the old and new provisions.

Policy recommendations would include:

- Removal of the ETO regime, and examination of alternative forms of preferential tax treatment for small businesses in the start up phase of an SME's business lifecycle.
- Review of the demographics of taxpayers that fall within the entrepreneurial sector such that policies can be tailored to properly meet their needs and requirements.
- Simplification of tax policy as it relates to SMEs generally, and entrepreneurs and micro-businesses more specifically.

Appendix 1 – Summary of Australia’s SME tax concessions

Item	Concession	Provision	Qualifying criteria and thresholds			
			SBE	Other turnover A\$	Assets A\$	Other Criteria A\$
1	CGT 15-year asset exemption	Subdivision 152-B ITAA 1997	✓	-	\$6m	-
2	CGT 50% active asset reduction	Subdivision 152-C ITAA 1997	✓	-	\$6m	-
3	CGT retirement exemption	Subdivision 152-D ITAA 1997	✓	-	\$6m	-
4	CGT roll-over	Subdivision 152-E ITAA 1997	✓	-	\$6m	-
5	Simpler depreciation rules	Subdivision 328-D ITAA 1997	✓	-	-	-
6	Simplified trading stock rules	Subdivision 328-E ITAA 1997	✓	-	-	-
7	Deducting certain prepaid business expenses immediately	Sections 82KZM and 82KZMD ITAA 1936	✓	-	-	< \$1,000 expenses
8	Accounting for GST on a cash basis	Section 29-40 GST Act	✓	\$1m	-	-
9	Annual apportionment of input tax credits for acquisitions and importations that are partly creditable	Section 131-5 GST Act	✓	\$2m	-	-
10	Paying GST by quarterly instalments	Section 162-5 GST Act	✓	\$2m	-	-

11	FBT car parking exemption	Section 58GA of the Fringe Benefits Tax Assessment Act 1986	✓	\$10m (ordinary and statutory income)	-	-
12	PAYG instalments based on GDP-adjusted notional tax	Section 45-130 of Schedule 1 to the Taxation Administration Act 1953	✓	-	-	-
13	Entrepreneur's tax offset		✓	\$75,000	-	-
14	Two year period for amending assessments		✓	-	-	-
15	R&D tax offset			\$5m	-	\$20,000-\$1m (R&D spend)
16	Debt/equity rules – at-call loans			\$20m	-	-
17	PAYG remittance – medium withholder			-	-	\$2m (amts withheld)
	PAYG remittance – small withholder			-	-	\$25,000 (amts withheld)
	PAYG instalments – annual			-	-	\$8,000 (notional tax)
18	GST – non-compulsory registration		-	\$75,000	-	-
	GST – Annual tax periods		-	\$75,000	-	-

	GST – quarterly tax periods		-	\$20m	-	-
	GST – non-electronic lodgement		-	\$20m	-	-
	GST – ITCs – financial acquisitions		-	-	-	\$50,000 (input tax credits)
	GST – simplified accounting methods		-	\$2m	-	-
	GST – business norms method		-	\$1m	-	-
19	FBT – record-keeping		-	-	-	\$5,000+index (agg FB amt)
	FBT – annual payment		-	-	-	\$3,000 (FBT previous year)
20	Thin capitalisation – exemption	Section 820-35 ITAA 1997	-	-	-	< \$250,000 debt deduction
21	Transfer pricing – simplified	-	-	< \$100m	-	-
22	Taxation of Financial Arrangements	-	-	< \$100m	-	-

Notes: 1 Adapted and revised from the paper entitled “Research and recommendations on definition of small business” prepared by The Institute of Chartered Accountants (January 2006).

2 Turnover and assets are not defined in the same manner for each concession.

Appendix 2: Transition from the STS to the SBE System

Australia's small business framework changed significantly with the enactment of *Tax Laws Amendment (Small Business) Act 2007*. Importantly, this legislation provided for a standard definition of a 'small business entity' for the purpose of accessing any of the small business tax concessions. Summarised below are the salient changes which were introduced at that time, however, it is important to note that some of these turnover and asset thresholds referred to below have since changed.

Small business entity

As a result of the amendments, STS taxpayers are now referred to as "small business entities". An entity is a "small business entity" if it:

- carries on a business; and
- satisfies the \$2m aggregated turnover test.

These two elements together are referred to as the "small business entity" test.

The threshold eligibility test for the concessions under GST, PAYG, FBT and CGT were changed and access to these concessions are now based on the above test which focuses on the turnover of the business. Previously, separate eligibility tests existed in order to gain access to these concessions. SBEs can utilize these concessions provided they also satisfy any additional criteria that apply to each concession.

Goods and services tax

Under the former eligibility test, an entity's annual turnover for GST purposes could not exceed either \$2m, in the case of GST installments and annual apportionment, or \$1m in relation to the cash accounting method. The eligibility test was amended to increase the GST cash accounting threshold to \$2m (previously \$1m).

Capital gains tax

The maximum net asset value threshold test for accessing the small business CGT concessions was increased from \$5m to \$6m. It is critical to note that entities that satisfy the SBE threshold of \$2m can access the small business CGT concessions (even if they do not satisfy the \$6m maximum net asset value test).

Fringe benefits tax

SBEs able to access FBT car parking exemptions from 1 April 2007.

PAYG installments

SBEs that are full self assessment taxpayers will be eligible to calculate PAYG installments based on the gross domestic product (GDP) adjusted notional tax method.

Existing STS taxpayers

Importantly, various tax concessions under the former STS regime continue to be available to SBEs including:

- the availability of the 25% entrepreneurs' tax offset;
- immediate write-off of depreciating assets costing less than \$1,000;
- ability to claim prepayment deductions;

-
- exemption from the requirement to account for changes in value of trading stock (if less than \$5,000); and
 - allocation of acquired assets to STS pools.

Appendix 3 – SME tax concessions: Summary of problems and anomalies

Small Business Entity definition	
Entities with: <ul style="list-style-type: none"> - Aggregated turnover < \$2m; and - Carries on a business 	Overlap exists between the SBE definition for access to tax concessions and other eligibility criteria that must be met for concessions already in existence.
Simplified depreciation concession	
<ul style="list-style-type: none"> - Immediate write-off for assets < \$1,000 - Small business depreciation pooling for assets ≥ \$1,000 	<ul style="list-style-type: none"> - If taxpayers cease to apply small business depreciation if they are still eligible for simplified depreciation in the coming year, re-apply is not allowed for a further 5 years. - Assets deductions continue to be claimed even if ceasing to apply simplified depreciation method. - Not suit business where debtors and creditors or stock fluctuate from year to year as it my risk becoming ineligible due to change turnover and may still need to do physical stocktakes and calculate a stock adjustment.
Simplified trading stock concession	
If the difference between opening and closing trading stock values ≤ \$5,000 <ul style="list-style-type: none"> - Choose not to value each item of trading stock on hand as at year end - Choose not to account for change in the value of trading stock on hand 	<ul style="list-style-type: none"> - The A\$5,000 difference means that this concession is of limited usefulness to many small businesses. - Taxpayer is required to cumulatively account for increases/decreases in the value of trading stock of more (less) than A\$5,000. - Taxpayer would prefer not choose this concession when trading stock decreases by less than \$5,000. - Have to pay a suddenly much larger tax bill once the threshold has been passed on an accumulated basis.
Entrepreneurs' tax offset	
Annual aggregated turnover below \$75,000 <ul style="list-style-type: none"> - Offset up to 25% of the taxpayer's income tax liability 	<ul style="list-style-type: none"> - The A\$75,000 threshold is low and is of limited usefulness to many small businesses. - Complicated calculations required. - More tax savings than 25% tax offset if taxpayers use superannuation contributions in some cases.

Small business CGT Concessions	
<p>Net value of assets does not exceed \$6m; The CGT asset is an active asset</p>	
<ul style="list-style-type: none"> - 15-year held asset exemption 	<ul style="list-style-type: none"> - Sophisticated test conditions; active asset test; controlling individual test - Taxpayers that have rolled over the business assets from their own or a partnership business to a company within the 15-year period will not be entitled to the 15-year exemption even though the same taxpayer has control over the assets over the 15-year period. - No clear definition of the meaning of “in connection with retirement” or “permanent incapacity” - If the asset was previously subject to a CGT roll-over, other than due to marriage breakdown or compulsory acquisition, the period of ownership commences again. - Deem assets purchased pre-1985 to be post-CGT do not preclude use of the 15 year exemption.
<ul style="list-style-type: none"> - 50% active asset reduction 	<ul style="list-style-type: none"> - Possibility of unfranked retained profits being “trapped” in the company.
<ul style="list-style-type: none"> - Retirement exemption 	<ul style="list-style-type: none"> - For individual, deemed eligible termination payment (ETP) must roll over into superannuation fund or RSA if taxpayer is under 55 years - For company or trust, controlling individual must exist - CGT retirement exemption limit at time is \$500,000 - The exemption is only available to the extent of the actual proceeds received
<ul style="list-style-type: none"> - Asset roll-over 	<ul style="list-style-type: none"> - Taxpayers will be charged more tax if they didn’t purchase a replacement asset within two years of the last CGT event in the year of income. - No option of returning the capital gain in the year.
GST Concessions	
<ul style="list-style-type: none"> - Choice to account for cash basis 	<ul style="list-style-type: none"> - Strict application of a payments basis for claiming deduction for general expenses
<ul style="list-style-type: none"> - Choice to pay GST by quarterly instalments - Annual apportionment of GST input tax credits 	
FBT car parking exemption	
<ul style="list-style-type: none"> - the employer’s ordinary and statutory income is less than \$10m 	

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