

CHAPTER 2

SCHEDULE 1—ENTREPRENEURS' TAX OFFSET

Introduction

2.1 In his 2004 election policy statement, *Promoting an Enterprise Culture*, the Prime Minister announced that a re-elected Coalition Government would introduce tax incentives to encourage the development of an 'entrepreneurial spirit' within the small business sector—particularly among those businesses operating from home.¹

2.2 Schedule 1 of the bill is intended to deliver on this election promise by allowing a maximum 25 per cent "entrepreneurs' tax offset" (ETO) on the income tax liability of small businesses in certain circumstances.

2.3 The first threshold for eligibility is that the small business qualifies for, and has elected to be in, the simplified tax system (STS).²

2.4 Where a small business in the STS has an annual turnover of \$50 000 or less, the full 25 per cent ETO will apply. Where annual turnover exceeds \$50 000 but is less than \$75 000, the ETO will phase out for every \$1 over \$50 000.

2.5 To encourage more businesses to opt into the STS, Schedule 2 of the bill introduces changes that will allow STS taxpayers to calculate their taxable income by either the cash basis method or accruals system—whichever is more appropriate for their circumstances. At present, the cash basis method is mandatory for STS taxpayers.

2.6 The new measures in Schedules 1 and 2 will apply to assessments for the first income year starting on 1 July 2005 and subsequent income years.

1 *Promoting an Enterprise Culture*, p. 4.

2 The STS was introduced by the *The New Business Tax System (Simplified Tax System) Act 2001* to apply to income years commencing after 30 June 2001. Its purpose was to reduce compliance costs of eligible small business taxpayers. The STS allows for the application of a simplified depreciation system and simplified treatment of trading stock. The ATO advises in its publication, '*Simplified tax system—overview*', that the practical effect of these features is that eligible businesses do not have to account for trading stock each year or maintain separate depreciation schedules for each asset. STS taxpayers must use a cash-based accounting system (although Schedule 2 of the bill proposes to allow for cash or accruals accounting systems.) See <http://www.ato.gov.au/print.asp?doc=/content/19925.htm> for ATO publication.

Schedule 1 in more detail

Who qualifies for the ETO?

2.7 As indicated above, a taxpayer must first be an STS taxpayer for the year in question before eligibility for the ETO can be considered. Reduced to its simplest terms, Schedule 1 of the bill provides that the ETO is available to an STS taxpayer that is:

- (a) an individual or a company;
- (b) a partner of a partnership; or
- (c) a trustee or beneficiary of a trust (depending on who is liable for tax on the trust income).

2.8 An STS taxpayer for the year who fulfils the criteria in paragraph 2.7 above must also:

- (a) have an 'STS group turnover' for the year of less than \$75 000; and
- (b) have a 'net STS income' for the year.

2.9 For a partner in a partnership, the partner's assessable income for the year must include a share of the partnership's net STS income.³ For a beneficiary of a trust, the assessable income for the year must include a share of the trust's net STS income.⁴ In the case of trustees, they must be liable to be assessed under sections 98, 99 or 99A of the *Income Tax Assessment Act 1936* on a share of the trust's net STS income.⁵

2.10 Before looking at the formulae for the ETO, the Committee will examine in more detail the following terms which set the basic criteria for eligibility:

- (a) STS taxpayer;
- (b) STS group turnover; and
- (c) net STS income.

What is an 'STS taxpayer'?

2.11 Section 328-365 of the *Income Tax Assessment Act 1997* (ITAA 1997) provides that an entity is eligible to be an STS taxpayer for an income year if:

- (a) it carries on a business during the year;

3 Proposed paragraph 61-510(1)(e).

4 Proposed paragraph 61-520(1)(e).

5 Proposed paragraph 61-515(1)(e).

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- (b) the 'STS average turnover'⁶ of the business and related businesses for the year is less than \$1 million net of GST credits; and
 - (c) the business and related businesses have depreciable assets with values totalling less than \$3 million at the end of the year.

2.12 Under the ITAA 1997, an entity may calculate its 'STS average turnover' by averaging its STS group turnovers for any three of the preceding four years, disregarding a year when group turnover was unusually high. Should the STS average turnover exceed allowable limits using the retrospective test, the entity may take into account the actual turnover for the current year plus a reasonable estimate of turnover for the next two years. If the entity has only carried on a business for part of the current year, again, a reasonable estimate of STS group turnover may be used.

'STS group turnover'

2.13 Calculations of 'STS average turnover' must take into account 'STS group turnover' which is defined in the ITAA 1997 as the total value of the business supplies made during the year by the entity and by the entities it is grouped with. The definition does not include the value of business supplies made between the entity and the grouped entities or among the grouped entities themselves.⁷

2.14 Section 328-380 provides that an entity should be grouped with another where:

- (a) either entity controls the other;⁸
- (b) both entities are controlled by the same third entity; or
- (c) the entities are STS affiliates⁹ of the other.

2.15 The inclusion of grouped entities in the calculation is an anti-avoidance measure intended to prevent a taxpayer from structuring one business as several

6 Section 328-370. See also TR 2002/11, *Income tax: Simplified Tax System eligibility—STS average turnover*, 26 June 2002.

7 The value of business supplies is defined in section 960-345 of the ITAA 1997 as being the values of all taxable supplies (excluding GST and receipts from asset sales, interest, dividends and rental not in the ordinary course of carrying on the business).

8 Section 328-380 ITAA 1997 defines 'control' in the context of the STS grouping rules. In an overview of the STS, the ATO says that "In broad terms, you control another taxpayer in an income year if you and/or your STS affiliates: are entitled to at least 40% of any income or capital of the other taxpayer in that year; or if the other taxpayer is a company, have the right to exercise at least 40% of the voting power in the company. See TR 2002/6, *Income tax: Simplified Tax System eligibility—grouping rules (STS affiliate, control of non-fixed trusts)*, 13 March 2002. This ruling provides guidance on the application of the non-fixed trust control rule and the definition of 'STS affiliate'."

9 Under section 328-365 ITAA 1997, an 'STS affiliate' is an entity that could reasonably be expected to act in accordance with the taxpayer's wishes or in concert with the taxpayer in relation to the taxpayer's business. See also TR 2002/6.

smaller units so as to qualify for STS benefits. Nonetheless, a taxpayer may be eligible for more than one ETO where the businesses involved are not grouped entities, as the following excerpt from the Explanatory Memorandum makes clear:

A taxpayer may be eligible for more than one tax offset. For example, if a taxpayer is a sole trader who has elected into the STS and that taxpayer is also a partner in a partnership that has also elected into the STS, the taxpayer may be entitled to a tax offset in respect of their income as a sole trader and also in respect of their share of the STS income from the partnership...However, if the sole trader and the partnership are grouped entities, the amount of STS group turnover is relevant to determining eligibility for an offset.¹⁰

'Net STS income'¹¹

2.16 The 'net STS income' is the 'STS annual turnover' less deductions attributable to the turnover. The 'STS annual turnover' is the value of the business supplies made by the entity less 'supplies that constitute an insurance recovery or the principal component of a loan'.¹²

2.17 The Explanatory Memorandum further comments on the meaning of STS annual turnover that:

The turnover of a business reflects the ordinary activities of carrying on that business, such as the sale of goods and the provision of services, and also includes interest received on amounts deposited in business banking accounts. The turnover does not include items such as dividends, rental income where the rental activities do not form an ordinary part of the business or amounts resulting from realisation of an investment.¹³

Calculation of the ETO

2.18 Having discussed the eligibility criteria for the ETO, namely, that the taxpayer must be an STS taxpayer for the year with an STS group turnover of less than \$75 000 and a net STS income, it is proposed to look at the formulae for calculating the ETO.

2.19 Proposed sections 61-505 to 61-520 set out the ETO formulae. The sections provide working examples of ETO calculations for an individual or company; partner in a partnership; trustee of a trust and beneficiary of a trust.

10 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, pp. 15-16, para. 1.12.

11 Proposed section 61-525.

12 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, p. 17, para. 1.16.

13 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, p. 17, para. 1.19.

2.20 There are two basic formulae—one for the ETO where STS group turnover is \$50 000 or less for the year, and the other where it exceeds \$50 000 but is less than \$75 000.

ETO—STS group turnover of \$50 000 or less

2.21 To calculate the ETO where the STS group turnover is \$50 000 or less:

- multiply 25 per cent of the income tax liability for the year (excluding any tax offsets) by the 'STS percentage' which is calculated by dividing the net STS income by the taxable income and multiplying it by 100.

ETO—STS group turnover of less than \$75 000 but over \$50 000

2.22 To arrive at the ETO for group turnover exceeding \$50 000 but less than \$75 000, start with the basic formula above and multiply it by the 'STS phase-out fraction'.

2.23 The STS phase-out fraction is calculated by dividing by \$25 000, the difference between \$75 000 and the taxpayer's STS group turnover for the year.¹⁴

Matters of interest—overview

2.24 As indicated in chapter 1 of this report, supporting documents attached to the Selection of Bills Committee's report raised the following matters in relation to Schedule 1:

- (a) whether Schedule 1 measures pose a threat to the tax base by opening significant tax avoidance opportunities;
- (b) whether Schedule 1 measures create an incentive for a taxpayer to split income between different taxation entities (e.g. a company or partnership);
- (c) whether the grouping rules for the simplified tax system are sufficient to prevent tax avoidance given that they are designed to operate from a much higher threshold; and
- (d) whether the measures in Schedule 1 are appropriately targeted to entrepreneurial activity.

2.25 In the course of its hearing on 1 March 2005, the Committee heard evidence from the Department of the Treasury (Treasury) and Australian Tax Office (ATO) about these and related matters.

14 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, pp. 20-21, para. 1.25.

Grouping rules and tax avoidance

2.26 The Committee questioned officers from Treasury and the ATO about the effectiveness of the STS grouping provisions as an anti-avoidance measure.

2.27 Both Treasury and the ATO expressed confidence in the grouping provisions and added that business splitting as a tax-avoidance measure was not without its drawbacks. On these points, Mr Mark O'Connor, Treasury, told the Committee that:

The grouping rules attached to the simplified tax system are very robust; they have been working for the simplified tax system since 2001. To our knowledge—and, I understand, the knowledge of the ATO—there have been no concerns with them. There is a very strong and robust link there to what is referred to as an STS affiliate, which is that basically anyone who is related to you could act under your direction or control and also be held to be acting in concert with you. It is a very wide application of a grouping provision. We do not anticipate this measure giving rise to people seeking to split businesses—and I think that was also referred to in the explanatory memoranda. We do not see that, by splitting their businesses, they would be able to overcome the grouping provisions. There are other circumstances that would give rise to people not wishing to split businesses, such as the cost. In the *Hansard* of the debate in the House of Representatives, I noticed there was concern about the cost of getting accounting advice. The cost of restructuring a business from, say, a sole trader to a corporate or a trust is fairly significant, seeking legal and accountancy fees.

We also see other blockers to restructuring a business, such as the incurrance of potential stamp duty on transfer of assets and potential triggering of capital gains tax provisions when assets are moved from one entity to another. Given that (1) you have the integrity of the grouping measures and (2) there are outside forces and market forces, such as the cost of setting up a company or a trust and the ongoing compliance costs associated with that, we did not think there was a large compliance risk in this measure...¹⁵

2.28 As far as enforcing compliance with the grouping rules was concerned, Mr Mark Konza of the ATO said that the department had not rated the avoidance risk as 'significantly high' but was looking at a range of computerised tests to identify possible instances of non-compliance. He added that with first returns for ETO taxpayers not due until the 2006 financial year, this allowed the ATO 'some little time' to design a compliance program.¹⁶

Conclusions and recommendations—grouping rules

2.29 The Committee is reassured by evidence from Treasury and the ATO that the grouping rules are an effective anti-avoidance measure. Given the time available to

15 *Proof Committee Hansard*, 1 March 2005, pp. E2-3.

16 *Proof Committee Hansard*, 1 March 2005, p. E3.

the ATO to design a compliance program, the Committee accepts that enforcement should not be a problem.

2.30 The Committee also appreciates that incentives to qualify for STS benefits and ultimately, the ETO, through business splitting may be dampened by the costs entailed.

2.31 For these reasons, the Committee does not consider that the measures to be introduced by Schedule 1 will provide new opportunities for tax avoidance.

The rationale for the ETO

2.32 As mentioned earlier, the ETO is intended to deliver on the government's 2004 election promise to foster an 'entrepreneurial spirit' in the small business sector.

2.33 Certainly, the Coalition's proposed package of reforms for small businesses¹⁷ was well received by the Council of Small Business Organisations of Australia Ltd (COSBOA) which saw it as 'a significant step in the right direction for start-up small businesses'.¹⁸

2.34 In his second reading speech for the bill, the Minister for Revenue and Assistant Treasurer, the Hon. Mal Brough MP, said of Schedule 1 that it 'provides an incentive for the growth of very small, micro and home-based businesses' and, later, that 'allowing these small businesses in their micro phases to be able to hang on to more of their income gives them capital and greater incentive to be innovative and, therefore, to be able to grow and to build their businesses'.¹⁹

The ETO—costs and benefits

2.35 The Regulation Impact Statement (RIS) included with the Explanatory Memorandum for the ETO estimates that 'more than 300 000 small and home-based businesses will be able to benefit from the 25 per cent tax offset'.²⁰

2.36 While the ATO's estimated total administrative costs of \$7.3 million for Schedule 1 from 2004-05 to 2007-08 are relatively small, the estimated cost to the revenue for this period is \$790 million.²¹

17 *Promoting an Enterprise Culture*, The Howard Government Election 2004 Policy Statement. The package of reforms for small business included proposals for the ETO; introduction of optional cash or accrual accounting methods for STS taxpayers; a reduction in the tax adjustment period from four to two years for STS businesses and the establishment of a Regulation Reduction Incentive Fund.

18 Council of Small Business Organisations of Australia Ltd, Media Release, *Big benefits for Micro Business!*, 26 September 2004.

19 *House Hansard*, 10 February 2005, p. 37.

20 RIS, Explanatory Memorandum, p. 32, para. 1.50.

21 RIS, Explanatory Memorandum, p. 34, paras. 1.60-1.61, p. 34.

2.37 In this context, the Committee sought additional information about the proposed beneficiaries of the ETO; whether the scheme was appropriately targeted and whether on a costs/benefit analysis, it should proceed.

Entrepreneurial activity and the ETO target group

2.38 The RIS states the policy objective for the ETO thus:

The objectives of this measure are 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.²²

2.39 While the RIS estimated that more than 300 000 small businesses could benefit from the ETO, the Committee was unable to find data to support this estimate. Mr Mark O'Connor, Treasury, indicated at the start of the Committee's hearing that Treasury and the ATO were presently compiling figures on 'STS take-up and those sorts of things'.²³ This information was supplied in a letter to the Committee dated 4 March 2005, in which Schedule 1 is estimated to attract 440 000 taxpayers into the STS and provide benefits to 540 000 small businesses.²⁴

2.40 Another matter of interest to the Committee was whether the ETO was appropriately targeted. While Treasury and ATO officers confirmed that businesses offering, for example, cleaning or grass cutting services might qualify for the ETO, they could not provide evidence of a need to stimulate growth in this area in response to a shortage of supply.²⁵

2.41 The Committee canvassed the idea that where there was a shortage of businesses offering certain goods or services, these might be a more appropriate target for tax incentives. On this point, the Committee asked the ATO for an estimate of the number of businesses offering services in a trade such as plumbing or bricklaying, for example, which would fall within the qualifying annual turnover threshold for the ETO.

2.42 This information is in Appendix 4 and indicates that for bricklayers and carpenters, just under one-third of sole traders have a turnover of \$50 000 or less. With plumbers, the figure for sole traders is roughly one-quarter.

2.43 Another matter of interest when looking at the ETO's targeted beneficiaries is the method of calculating the ETO. It appears to the Committee that basing the ETO

22 RIS, Explanatory Memorandum, p. 30, para. 1.41.

23 *Proof Committee Hansard*, 1 March 2005, p. E1.

24 A copy of this letter is in Appendix 3.

25 *Proof Committee Hansard*, 1 March 2005, p. E7.

on a taxpayer's net income has the effect that a business with high operating expenses will qualify for a lower ETO than a business with lower operating expenses.

2.44 While superficially, operating costs might be an indication of business efficiency thereby justifying higher tax offsets to low-cost as opposed to high-cost businesses, this fails to take into account that some businesses of necessity have higher operating costs than others. A consultancy business providing specialised advice and report-writing services, for example, is more likely to incur lower operating costs than, say, a landscaping business.

Practicality of the provisions

2.45 The Committee heard evidence that predicating ETO eligibility on STS taxpayer status could entail a level of complexity and expense that might deter participation by some of the intended beneficiaries.

2.46 The Ralph Review referred to studies²⁶ showing that tax compliance costs for small businesses were disproportionately high and commented that:

Labour time spent on taxation activities by owners, employees and helpers is the most significant component of tax compliance costs. There are substantial opportunity costs associated with this, as time spent on compliance reduces the time available to invest in business growth.²⁷

2.47 Anecdotal evidence from professional sources suggests that small business has largely kept away from the STS because it is seen as too complex and too costly to comply with.²⁸ Certainly, ATO figures for the 2002 tax year show that only 14 per cent of eligible businesses opted into the STS.²⁹

2.48 Having said this, the Committee is encouraged that Schedule 2 of the bill will remove one significant impediment to taxpayer participation in the STS by permitting

26 The studies cited were Evans C, Ritchie K, Tran-Nam B and Walpole M (1996), *Costs of taxpayer compliance—Final Report*, Revenue Analysis Branch of the ATO, Canberra, pp. 9-67, and Evans C, Ritchie K, Tran-Nam B and Walpole M (1997), *A report into taxpayer costs of compliance*, Commonwealth of Australia, Canberra, p. 51.

27 *Review of Business Taxation*, Final Report—Section 17: Small Business Initiatives. Accessed at <http://www.rbt.treasury.gov.au/publications/paper4/part6/section17.htm> on 28 February 2005.

28 'Advisers call for simpler simplified tax', *Australian Financial Review*, 18 February 2003, p. 49. This article canvasses the views of William Buck Accountants; BDO Kendalls; Hayes Knight; and CPA Australia.

29 ATPF Issues Log, A27—Simplified Tax System take-up rate. Accessed on 2 March 2005 at http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/39983.htm&page=249&H22_1.

accrual-based accounting.³⁰ The extent to which this concession will reduce the compliance cost burden can only be a matter of conjecture but it will at least obviate the need for some businesses to keep accounts based on both cash and accrual methods.

2.49 In a recent study by Michael Dirkis, Tax Director, Taxation Institute of Australia, and Brett Bondfield, Lecturer, Faculty of Law, University of Technology Sydney, the authors refer to the low take-up rate of STS and attribute it in part to the 'convoluted' nature of the provisions and accompanying tax rulings.³¹ The authors state, for example, that:

Conceptually, STS is a potentially concessional tax system that sits on top of and has to interact with the rest of the tax laws. Surely having an add on system that delivers concessional treatment of some tax items...is not inherently simple...

....STS eligibility is set out in s328-365 and contains 11 terms that themselves have a definition, which illustrates that the basic proposition that eligibility to STS is a simple three point test is misleading. Those three points are tightly defined and potentially complex in their operation so much so that the ATO has issued...two TRs...³²

2.50 At the Committee's public hearing, the ATO told the Committee that it was looking at ways to simplify the paperwork and calculations—and thus reduce costs—for taxpayers assessing their ETO eligibility. In this regard, Mr Brett Peterson told the Committee that:

Where we have taxpayers with just one eligible stream of STS income we will ask them to let us know the amount of their STS income. On the strength of that we will be looking to calculate the size of their offsets. So we will take the manual calculation out of the process for taxpayers to the extent we can. For taxpayers who may have multiple offsets available to them, rather than multiply the number of labels on the form our approach will be to provide a third label whereby a taxpayer can—probably using a calculation product we will provide or will be provided through software providers—calculate and add a single figure to the label, claiming the offset from multiple STS entitlements.³³

30 Criticisms of the STS are discussed in 'Advisers call for simpler simplified tax', *Australian Financial Review*, 18 February 2003, p. 49; 'Small business shuns STS use', *Australian Financial Review*, 10 June 2003, p. 59; 'Tax cut at micro end of town', *Australian*, 27 September 2004, p. 8.

31 *The RBT ANTS Bite: Small Business the First Casualty*, (2004) 19 Australian Tax Reform, p. 148.

32 *The RBT ANTS Bite: Small Business the First Casualty*, (2004) 19 Australian Tax Reform, p. 148.

33 *Proof Committee Hansard*, 1 March 2005, p. E3.

2.51 The Committee welcomes the ATO's moves and considers that this should go some way towards reducing compliance costs. Nonetheless, the Committee is concerned that the costs entailed in establishing and monitoring STS eligibility (on which ETO eligibility depends) may still be prohibitive for some taxpayers.

Conclusions and recommendations—utility of the ETO

2.52 The Committee believes that, conceptually, the ETO has merit as a means of encouraging entrepreneurial activity and—where it already exists—nurturing it.

2.53 The Committee appreciates the arguments for narrowing the application of Schedule 1 to businesses where there is untapped demand. However, it seems to the Committee that limiting the ETO to certain groups will deprive many worthy businesses of the chance to grow and also to create a demand where one does not exist at the moment.

2.54 The Committee believes that the bill should be passed without alteration to Schedule 1. However, as with any initiative such as this, the Government should closely monitor the uptake of the ETO and its impact on small business. The Government should also investigate, as part of its monitoring exercise, whether compliance costs involved in the ETO meet acceptable levels.

