

From: Mark Burton

Sent: Thursday, 22 February 2007 9:04 AM

To: Economics, Committee (SEN)

Subject: Submission with respect to Tax Laws Amendment (2006 Measures No 7) Bill 2006

Dear Secretary,

Further to your advertisement of today attached please find an article written by me which was recently published at (2006) 4 *Journal of the Australasian Tax Teachers' Association* 78-106.

In particular, I direct the reader to my observations regarding the then ITAA97 Div 152 in section 3.5.2 and also to my suggestions in section 4 for enhancing the substantive consideration of small business capital gains concessions.

It is with considerable concern that I see that the Australian government proposes to expend a further \$100 million dollars without, apparently, undertaking any credible study justifying such expenditure. I also note the compressed timeframe allowed for scrutiny of this proposed measure. Both aspects of the process by which this measure has arisen give great cause for concern if Australia is, truly, to achieve a minimum standard of public accountability.

I have no objection to this submission being made public by the Committee in the usual way.

Yours faithfully,

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Small business tax advantages – towards holism with a suggested definition, typology and critical review*

1 Introduction

Prior to the 2006 Budget extension of small business tax concessions, the *measured* Australian small business tax concessions alone were expected to cost the government \$1.2 billion in the coming 2006/2007 year.¹ Moreover, in the 2006 Budget the

* Dr Mark Burton, Law School, University of Canberra. I am grateful for the comments of an anonymous reviewer. The usual acceptance of fault for all errors etc applies.

¹ Commonwealth of Australia, *Tax Expenditures Statement 2005*, Treasury, Canberra, 2005.

Government announced further express small business tax concessions at a projected cost of \$159 million in the 2008/09 income year,² when the full revenue impact of these measures emerges. The measured small business tax expenditures are substantial in both absolute and relative terms.

In 1994 the OECD noted the paucity of information which might inform judgements regarding the relative effectiveness of small business tax concessions.³ The contemporary Australian experience indicates that little has changed, at least in Australia, in the intervening years. Indeed, so poor is the available information regarding the relative effectiveness of these concessions that one must wonder whether the Australian government is the least bit interested in obtaining such information. Given the current Australian government's rhetoric of financial prudence, it is somewhat surprising that measured government expenditure in excess of \$1.35 billion *per annum* can be allowed to pass with what has hitherto been minimal impartial and credible critical scrutiny as to the effectiveness of this program.

The primary purpose of this paper is to highlight the information gap with respect to the government's consideration of small business tax concessions, with the object of enhancing public scrutiny of those concessions. Such information shortfalls arise because of two reasons. The first is the hitherto limited concentration upon expressly legislated small business tax concessions,⁴ and the second is the failure on the part of government to conduct appropriate analysis of tax policy proposals. To redress these shortcomings, in this paper I:

- 1) propose an alternative terminology of 'small business tax advantages', which embraces the many forms of competitive advantage experienced by small business, including express and implied administrative advantages and express and implied substantive advantages;
- 2) offer a typology of small business tax advantages;
- 3) offer a critical review of all express Australian small business tax concessions; and
- 4) suggest a way forward in terms of institutional reforms which will enable credible, critical and open scrutiny of small business tax concessions to occur.

This paper has three parts. The first part sets out a definition of 'small business tax advantage', explains why this alternative discourse is to be preferred to 'small business tax concessions' and considers the difficulty of identifying a benchmark against which small business tax advantages might be identified and quantified. The second part of the paper develops a typology of small business tax advantages and offers a brief critical review of the legislated Australian small business tax concessions. The primary purpose

² The measures comprise extension to the small business capital gains concessions under Division 152 (\$97 million in 2008-09), extension to the simplified tax system under Division 328 (\$55 million in 2008-09) and extension of the depreciation asset rollover relief under Division 40 (\$7 million in 2008-09): Commonwealth of Australia, *Budget 2006-07*, Budget Paper No. 2 Part 1, Canberra, 2006.

³ OECD, *Taxation and Small Businesses*, OECD, Paris, 1994.

⁴ See, for example: OECD, *Taxation and Small Businesses*, OECD, Paris, 1994, 3; 17ff. As a result of this emphasis upon expressly legislated concessions, the OECD states that the only small business tax incentives are measures with respect to the tax base, the basis of assessment (ie lags in payment) and finally in the tax rate (including tax credits): Id, 46.

of this second part of the paper is to elaborate upon the contention that the public management of the Australian small business tax concessions has been undermined by poor information and poor public consultation. The third part of the paper sets out generally accepted norms with respect to sound public policy making, with a view to setting a benchmark against which the legislated Australian small business tax concessions might be measured. From this foundation, I suggest improvements to the process by which taxation law is made with a view to enhancing the public policy outcomes in the domain of taxation law more generally, and small business taxation measures in particular.

2 Reconstructing the discourse of small business taxation – adopting ‘small business taxation advantages’

2.1 ‘Small business tax advantages’ – a definition

‘Small business tax advantages’ are tax incidents which are available to at least some small business taxpayers but which are not available to at least some other categories of tax payers. ‘Tax advantages’ may be obtained unilaterally by the taxpayer as well as being conceded by an authorized decision maker (Parliament, tax administrator). By contrast, the concept of a ‘tax concession’ is restricted to a benefit considered, and expressly or impliedly conceded by, the relevant decision maker.

For example, one significant small business tax advantage which arguably is not a ‘concession’ is the practice of ‘skimming’ – not entering a proportion of cash receipts in the business accounts so that no tax is payable.⁵ Assuming that there is nothing more that the legislature or the Commissioner can do in a practical sense⁶ to reduce the scale of this sector of the cash economy, it is difficult to see how this small business tax advantage enjoyed by some proprietors is a ‘concession’. Nevertheless, it is an advantage enjoyed by some small businesses by comparison to other taxpayers.

Small business proprietors might also avail themselves of tax advantages which are also available to other groups of taxpayers. Such advantages should nevertheless be taken into account in developing an holistic picture of the taxation treatment of small businesses. For example, many small businesses will be conducted through an entity which will facilitate income splitting. From a tax policy perspective, income splitting will be benign where it merely enables the allocation of income according to the respective inputs of the income recipients, as in the ‘ordinary’ case of dividends paid by a public company in

⁵ Coleman and Evans suggest that ‘many’ surveyed small business proprietors indicated that this may amount to as much as 30% of turnover: Cynthia Coleman and Chris Evans, ‘Tax Compliance Issues for Small Business in Australia’ in Neil Warren (ed), *Taxing Small Business: Developing Good Tax Policies* ATRF, Sydney, 2003. Given the understandable reluctance of survey participants to admit to such criminal tax evasion, one wonders whether survey participants underreport such activity.

⁶ Note the constraint upon the Commissioner’s general administrative discretion imposed by section 44 of the *Financial Management and Accountability Act 1997* (Cth). Also note that the Australian National Audit Office recently provided a broadly favourable report regarding the Australian Taxation Office ‘management’ of the cash economy: Australian National Audit Office, *The ATO’s Strategies to Address the Cash Economy*, Report No 30, 2005-06, ANAO, Canberra, 2006.

respect of ordinary shares. Such income splitting is benign because the contribution to the business on the part of each income recipient is at least approximately commensurate with the income received. However, in many small businesses no such relativity will exist. Moreover, such incommensurate income splitting is not available to other groups of taxpayers such as sole traders and wage/salary earners, although it is available to yet other groups of taxpayers such as those deriving income from property. The fact that this form of income splitting is available to many small business taxpayers, and not to other groups of taxpayers, supports the proposition that it should be recognized as an advantage available to small businesses, notwithstanding that the ability to income split is not restricted to small businesses.

Small business tax advantages include:

1. criminal tax advantages, such as the practice of skimming referred to above, which are available to some categories of small business;
2. administrative concessions to small business with respect to the administration of the taxation law;
3. administrative concessions to small business with respect to the substantive interpretation of the law;
4. general express substantive tax concessions allowed to taxpayers, including (some) small businesses. An example here is landcare expenditure;
5. specific express substantive tax concessions allowed only to small businesses; and
6. implied/tacitly accepted substantive tax concessions which are available to small businesses, such as income splitting.

2.2 Why change the discourse to one of small business tax advantages?

2.2.1 Towards better public policy

Adopting a discourse of ‘small business tax advantages’ will reorient the discussion of small business taxation towards an holistic appraisal of the relative competitiveness of small business. In this way the consideration of small business taxation might be better informed, with a view to procuring better tax policy.

To date the literature in the field of small business taxation has generally focused upon the provision of express legislative tax “concessions” conceded by Parliament and targeted at small business. The usual justifications for these small business tax concessions are:

1. compensating small business for regressive tax/regulatory compliance costs;⁷
2. neutrality;⁸

⁷ For studies regarding such costs see: C Evans, et al, *A Report into Taxpayer Costs of Compliance*, AGPS, Canberra, 1997; Binh Tran-Nam and John Glover, ‘Tax Reform in Australia: Impacts of Tax Compliance Costs on Small Business’ (2002) 5 *Journal of Australian Taxation* 338. For discussion of the literature in relation to small business tax compliance costs see: Mark Burton, ‘The Australian small business tax concessions – public choice, public interest or public folly?’ (2006) 21 *Australian Tax Forum* 91, para 2.1.2.

3. promoting entrepreneurial endeavour;⁹
4. reducing small business taxes;¹⁰ and
5. achieving macroeconomic objectives, such as securing economic stability. The small business sector may generate externalities such as countercyclical growth (by comparison to other sectors of the economy) and/or being a source of economic growth which does not merely mirror general economic growth.¹¹

In broad terms, these justifications reflect a desire to enhance the relative competitive position of small businesses, with the object of overcoming competitive disadvantage arising from government regulation/market failure, or merely with a view to advancing small business in a competitive marketplace. The perception that small business suffers from severe competitive disadvantages has been promoted by small business lobby groups by various means such as sponsoring funded research,¹² undertaking surveys,¹³ publishing reports¹⁴ and making submissions to government.¹⁵ These lobbyists emphasise the competitive disadvantages of small businesses by comparison to other taxpayer groups,¹⁶ and ignore or downplay the competitive tax advantages of small business. Thus, for example, much is made of the regressivity of small business tax compliance costs,¹⁷ but no mention is made of the myriad ways by which small businesses minimize their tax payments. Focusing upon expressly legislated ‘small business tax concessions’, rather than the broader range of small business tax advantages, creates a biased discourse of small business taxation. The result is that a lop-sided depiction of small business taxation – one of significant competitive disadvantage – has, apparently, been accepted uncritically by legislators.

‘Small business tax advantages’ is more appropriate nomenclature if we adopt the principle of neutrality which underpins the discourse of small business tax concessions.

⁸ Commonwealth of Australia, *A question of balance – the tax treatment of small business*, Final report of the Senate Economics References Committee (AB Ferguson Chairman), AGPS, Canberra, 1995; Commonwealth of Australia, *A Platform for Consultation*, AGPS, Canberra, 1998, 300.

⁹ C Evans and A Ryan, *Tax Reform Issues for Small Business*, Submission of the Australian Society of Certified Practising Accountants to the Commonwealth Review of Taxation, 1999: available at www.rbt.treasury.gov.au, 12.

¹⁰ See, for example, Explanatory Memorandum accompanying *New Business Tax System (Simplified Tax System) Act 2000*, para 1.7.

¹¹ OECD, above n 3, 99.

¹² See, for example, Tran-Nam and Glover, above n 7 (research funded in part by the National Farmers Federation).

¹³ CPA Australia, *Small Business Survey – Compliance Burden*, CPA Australia, Melbourne, 2003.

¹⁴ See, for example, Business Council of Australia, *Business Regulation Action Plan for Future Prosperity*, BCA, Canberra, 2005.

¹⁵ See, for example, Institute of Chartered Accountants, *2006-2007 Pre-Budget Submission*, ICAA, Canberra, 2006; CPA Australia, *Pre-Budget Submission 2006-07*, CPA Australia, Melbourne, 2005.

¹⁶ Note that the OECD observes that such competitive disadvantage would not necessarily warrant government intervention if small businesses only competed against small businesses. However, as small businesses compete against larger businesses and also against businesses in other jurisdictions, the imposition of disproportionate compliance costs upon small business does warrant closer consideration: OECD, 111.

¹⁷ CPA Australia, Submission to the Board of Taxation regarding Small Business Tax Compliance Costs, CPA Australia, Melbourne, 2006.

The principle of neutrality suggests that we should seek to holistically identify and quantify *all* relative competitive advantage/disadvantage which small businesses enjoy/suffer as a result of the operation of Australia's Commonwealth taxation laws. Only after this is done will it be possible to undertake an analysis of the net effect of Australia's taxation, and perhaps other,¹⁸ laws upon various categories of small business. In this way a more informed debate may take place with respect to the quantum and nature of small business tax concessions. For example, by the time one has taken into account the benefits of specific express substantive tax concessions and implied/tacitly accepted substantive tax concessions such as income splitting, it might be the case that the 'excessive' compliance costs over and above some normative compliance cost threshold might already be overcompensated for. If so, a *reduction* in the scale of small business tax advantages might be indicated.

2.2.2 Pragmatic tax system design

There are good pragmatic reasons for ensuring that a holistic approach is taken to quantifying small business tax advantages. The proliferation and growth of such advantages without credible and transparent justification may serve to fuel widespread skepticism regarding the fairness of the taxation system on the part of taxpayers who do not benefit from such largesse.¹⁹ As perceived legitimacy is critical to maintaining and enhancing voluntary tax compliance,²⁰ ensuring that small business tax advantages are subjected to credible and critical scrutiny is essential if the tax system is to be protected from the criticism that it works to the advantage of political elites.²¹ If such criticism were widely perceived as justified, Australia might revisit the dark days of the 1970s, when declining public confidence in the taxation system and cynicism regarding the rule of law threatened the integrity of the Australian taxation system.²²

2.3 'Small business tax advantage' – defining the benchmark

In the past, the discourse of 'small business tax concessions' meant that the criterion used to determine whether a tax rule was a small business tax concession was simply whether it was expressly identified as such by the legislature. However, discussion of 'small business tax advantages' begs the question of how the benchmark is to be defined such that the existence of an advantage might be ascertained.

¹⁸ Julie Roin, 'Truth in Government: Beyond the Tax Expenditure Budget' (2003) 54 *Hastings Law Journal* 603.

¹⁹ Michael Wenzel, 'Tax Compliance and the Psychology of Justice: Mapping the Field' in Valerie Braithwaite (ed), *Taxing Democracy*, Ashgate, Aldershot, 2003, 41, 51-2.

²⁰ Valerie Braithwaite, *Perceptions of Who's Not Paying Their Fair Share*, Working Paper No 54, Centre for Tax System Integrity, Canberra, 2004; T R Tyler, *Why People Obey Laws*, Yale University Press, New Haven, 1990; Makkai T and Braithwaite J, 'Procedural Justice and Regulatory Compliance', (1996) 20 *Law and Human Behaviour* 83.

²¹ Thus, in response to the proposition that 'the Tax Office listens to powerful interest groups more than to ordinary Australians' and on a scale of 1 (strongly disagree) to 5 (strongly agree), 1143 survey respondents returned a mean of 3.52 with a standard deviation of 1.04: Valerie Braithwaite, *The Australian Tax System: Fair or Not Survey*, Centre for Tax System Integrity, Canberra, 2002, Item 4.1.7. It is possible that the reference to the 'Tax Office' was interpreted by respondents to mean 'the government' more generally, including the Treasury, Ministers, etc.

²² Margaret Levi, *Of Rule and Revenue*, Uni of California Press, Berkeley, 1988.

As noted above, the discourse of small business tax advantage focuses upon the relative advantage of small businesses. However, in identifying and measuring such advantages one must identify the benchmark against which such advantage is to be measured. This will inevitably engender debate because of the heterogeneity of small businesses and also because the absence of a coherent framework of principles underlying the Australian taxation legislation means that there is no obvious benchmark. In this regard the definition of an appropriate benchmark is akin to the problem of defining the income tax benchmark for the purposes of identifying 'tax expenditures'.²³

The definition of a benchmark might entail the adoption of:

1. a universal normative benchmark such as the 'benchmark taxation system' founded upon normative principles such as horizontal equity and neutrality;²⁴
2. a relative normative benchmark tax system, which is founded upon the principles which purportedly underpin the particular tax legislation as a whole;²⁵ or
3. a flexible benchmark which does not identify one 'ideal' tax treatment of the taxpayer but rather examines whether the taxpayer is treated (dis)advantageously by comparison to any other taxpayer or group of taxpayers who are in some sense comparable.

The problem of choosing an appropriate benchmark from this list can be illustrated by addressing the question of whether the income of a small business company should be attributed to its shareholders? In the context of closely held business entities, common within the small business sector, retention of corporate income will be significant because of the differential between the top and second highest marginal personal rates of tax and the corporate tax rate.²⁶ Given the tax rate differential between personal income over \$75,000 and corporate income, there is clearly an incentive for closely held entities to retain profits in the corporate form with a view to investing the corporate after-tax profits in assets (which may or may not be actively used in the course of business). Recognising closely held small business companies as separate entities therefore opens up the opportunity for income alienation and sheltering, with the free *use* of corporate assets (acquired with profits taxed at the lower corporate rate) by shareholders left untaxed.²⁷ Such tax planning advantages are not recognized as 'small business tax concessions'. For

²³ Louis Eisenstein, *The Ideologies of Taxation*, Ronald Press, New York, 1961.

²⁴ Commonwealth of Australia, *A Strong Foundation*, Review of Business Taxation, Canberra, 1998.

²⁵ Commonwealth, above n 1, ch 4.

²⁶ Currently the top personal marginal rate of tax is 45% (applicable to taxable income in excess of \$150,000, the next personal marginal tax rate of 40% applies to taxable income in excess of \$75,000. A Medicare levy of 1.5% applies on top of these rates of tax. Tax upon corporate taxable income is imposed at the flat rate of 30%: *Income Tax Rates Act 1986* (Cth).

²⁷ Had the unified entities regime been introduced this form of tax planning would have been eliminated, given the proposed definition of 'distribution': Commonwealth of Australia, *A Tax System Redesigned*, Australian Treasury, Canberra, 1999, 429ff. The suggestion that a robust Div 7A and Fringe Benefits Tax rules are sufficient to counteract this form of tax planning must be read with some caution: cf, C Evans and A Ryan, *Tax Reform Issues for Small Business*, Submission of Australian Society of Certified Practising Accountants to Commonwealth Review of Taxation, 1999, available at: www.rbt.treasury.gov.au, 14. For an interesting account of the political economy of the failure of the proposed unified entities regime see: Brett Freudenberg, 'Entity Taxation: The Inconsistency between Stated Policy and Actual Application' (2005) 1 *Journal of the Australasian Tax Teachers Association* 458.

present purposes, then, the question is whether such tax planning gives rise to a ‘small business tax advantage’, the total benefit of which should be added to the list of small business tax advantages allowed to small business by the government?

In answering this question there are three possibilities, drawn from the different approaches to benchmark definition outlined above:

- 1) require attribution of profits to the shareholders of the company on the basis of the ‘transparency principle’. It is a bold person who argues that there are universal taxation norms, but nevertheless it is fair to say that the attribution of corporate profits to a company’s proprietors generally is consistent with the principle of horizontal equity – assessing to tax each natural person’s net increase in economic income over a period entails inclusion of the increase in a shareholder’s wealth attributable to their share of increased corporate wealth.

However, the adoption of such a universal attribution rule is beset with practical difficulty²⁸ and also engenders pragmatic shortcomings in terms of fiscal outcomes for Australia. A general attribution rule has therefore not been seriously considered for eighty years or more.²⁹ Nevertheless, in limited circumstances such an accruals rule has been adopted within the Australian taxation legislation.³⁰ Moreover, in the past an attribution rule, known as the sufficient distribution requirement,³¹ meant that the capacity to alienate income within closely held companies was limited. However, even if such a rule were adopted in the context of closely held small business companies, it would allow some income splitting in the case of a personal services company by virtue of the allocation of corporate profits across the shareholders.

An alternative approach to application of the principle of horizontal equity dictates that a substance approach should be adopted by recognizing that the source of at least some of a company’s profits may be a natural person who exercises actual control of the company. On this approach, that person should be assessed to tax with respect to ‘the company’s’ income. Thus, the Australian income tax includes rules which ignore the corporate veil in those circumstances which might loosely be defined as ‘tax avoidance’ arrangements. This substance oriented approach has been adopted, albeit somewhat meekly, with respect to ‘personal services income’.³² Under these rules some ‘personal service entities’, including companies, are required to attribute the bulk of their ‘personal services income’ to the natural person ‘behind’ the company who generates at least the bulk of that income.

²⁸ Commonwealth, *Second Report of the Royal Commission on Taxation*, Parl Paper No 1 (1922) 80-8; Commonwealth, *First Report of the Royal Commission on Taxation*, Parl Paper No 199 (1933) 7-18; Commonwealth, *Report on Taxation of Income of Companies - Private and Non-Private - and of Shareholders*, Parl Paper No 143 (1952); Commonwealth, above n 109, 13-19.

²⁹ Commonwealth, *A Tax System Redesigned*, Treasury, Canberra, 1999, 429ff; see also Commonwealth, *Taxation Review Committee - Full Report*, Parl Paper No 136 (1975) ch 17.

³⁰ ITAA36 Part X (the attribution of some ‘controlled foreign income’ within a ‘controlled foreign company’).

³¹ ITAA36 Div 7.

³² ITAA97 Part 2-42. Note also that the general anti-avoidance rules in ITAA36 Part IVA may apply in those cases where personal services income is not attributed to a natural person under Part 2-42.

However, there are difficulties in applying this substance rule, particularly where at least some of the income is attributable to a source other than the provision of personal services. For example, in the case of a services provider who obtains financial support from an associate, who is to say exactly what proportion of the services income is attributable to the 'finance' as opposed to the services provided by the service provider? And what of the different levels of risk assumed under different structures – how much of the services income should be considered to be a premium for exposing corporate assets to risk? In his recent statement the Commissioner officially recognized this problem, at least with respect to partnerships.³³ There is no reason why the same problem might not exist in other factual scenarios, such as a corporate personal services entity which obtains finance secured by a guarantee provided by the company's shareholders. Such vagaries of the substance approach have meant that a general substance rule has limited practical application because it embroils tax administrators in what are ultimately subjective, case by case decisions. In an era of managerial accountability,³⁴ tax administrators will often decide that the cost/benefit calculus dictates that such individualized application of the taxation law is not worth pursuing.

Like a general attribution rule, a general substance rule is theoretically appealing but its subjective application means that it is not an optimal benchmark against which to assess relative tax (dis)advantage;

- 2) the second option is to recognise the legal form of the structure and therefore allow retention of profits in the company. On its face, this approach would seem to be consistent with the recognition of the separate entity status of companies for the purposes of the Australian income tax.³⁵ This approach would therefore allow the alienation of any income, whether of a small business or otherwise, within the corporate form.

However, as noted in #1 above, the Australian taxation legislation does not uniformly recognize the corporate veil. Constructing a benchmark upon the proposition that the Australian income tax legislation adopts a uniform treatment of the corporate form – the relative normative benchmark – is therefore not possible. The alienation of income within the corporate form therefore does not fall within a relative normative benchmark; or

- 3) a third option is to compare the tax treatment of small business incorporated entities with other comparable entities, with a view to ascertaining whether small business entities are treated in such a manner that they experience relative (dis)advantage.

In applying this variable benchmark, there are two problematic issues:

³³ Commissioner of Taxation, *Media Release Nat 2005/66*, 17 November 2005, Australian Taxation Office, Canberra.

³⁴ See *Financial Management and Accountability Act 1997* (Cth); Anuphan Kitnitchiva, 'Accountability and Fairness in Tax Administrations – A Case Study of the Thailand Revenue Department' (2006) *Asia-Pacific Tax Bulletin* 76.

³⁵ Commonwealth, above n 1, 24.

- i) the heterogeneity of small businesses means that multiple categories of taxpayers might comprise benchmarks against which relative advantage is identified; and
- ii) the variability of the benchmark is neutral as to the appropriate level of tax, as it would equally support a 'ratcheting up' or a 'ratcheting down' of the tax base. However, with respect to small business tax concessions there has been a tendency for the variable benchmark to be applied in a 'ratcheting down' manner, such that we see a drive to the bottom in tax base erosion.³⁶

To illustrate the first problem, and depending upon the definition of 'small business' adopted, an incorporated consultancy business may range from one conducted by a sole shareholder/employee to one with a substantial number of employees and also a substantial number of shareholders. At the sole shareholder end of this spectrum, and taking the example of an incorporated consultancy business, one comparable or benchmark taxpayer would be a wage/salary earner because:

- a) both are utilizing their effort/skill to generate income;
- b) application of the employee benchmark also would be consistent with what is effectively a full attribution regime applicable generally to partnerships and trusts and also with the taxation of sole traders; and
- c) although the consultant will often assume greater risk than an employee, the consultant's income should incorporate a risk premium which can be retained if services are performed with sufficient skill so as to minimize their risk. Thus, in a sense, the derivation of income will be attributable to the provision of personal services and therefore be analogous to the wage/salary earner.

However, a second comparable or benchmark taxpayer might be an incorporated entity in which the shares are widely held and/or the services are conducted by a number of employees. Both the sole shareholder personal services company and the widely held personal services company are engaged in similar activity and, issues of scale aside, would often have similar commercial constraints such as the need to maintain/expand goodwill etc. Both types of personal service entity might quite justifiably wish to retain after tax profits for reinvestment for commercial purposes. Given that the income tax system recognizes the separate entity status of companies (as detailed in #2 above), allowing the alienation of profits within a widely held entity while not allowing a similar facility to a closely held entity would create competitive advantage in favour of widely held entities in those cases where closely held and widely held entities are actually (rather than hypothetically) competing in the same market.³⁷ This would suggest that alienation of income within the corporate form is not a tax advantage, at least in those cases where income is retained for the purpose of business investment.

However, in other cases closely held entities will retain profits for non-commercial purposes such as the purchase of unproductive private assets as detailed above. Such tax effective income alienation is less likely to arise in the

³⁶ See, for example, the application of the neutrality principle in justifying the extension of small business capital gains concessions: Burton, above n 7, para 2.1.4.

³⁷ OECD, above n 3

case of widely held entities. In such cases, allowing the alienation of profits within the corporate form is clearly a tax advantage, as it effectively allows ‘the shareholder’ to purchase private assets from income which has been taxed at the lower corporate tax rate.

The preceding discussion suggests that a relative benchmark is more appropriately referred to in the plural form – in many cases there will be more than one benchmark. In such cases according priority to a particular relative benchmark will be subjectively grounded.

This review of various benchmarks against which small business tax advantages might be identified and measured suggests that all of these benchmark definitions suffer from some theoretical and/or practical limitations. Given that there is no one benchmark which wins universal support, the selection of a benchmark will be influenced by an individual’s subjective perspective. For example, some will be attracted to the apparent objectivity of the ‘theoretically pure’ first definition of a benchmark while others will prefer the ‘practical’ assessment of the realpolitik of tax law apparent in the latter two definitions. However, given that the recent discourse of small business tax concessions has relied upon the third, floating benchmark, for the purposes of the next part of this paper I am prepared to adopt a benchmark grounded upon the neutrality principle as outlined in #3 above. In doing so, I am not suggesting that this discourse should be adopted for the future, but am prepared to adopt it for present purposes because small business advocates can hardly challenge this paper for adopting the discourse which they have embraced. Nevertheless, if pressed, in my view it would be preferable if a benchmark framed broadly upon normative principles, as outlined in #1 above, were adopted.

3 A typology and critical review of Australian Small business tax advantages

The literature regarding small business tax concessions generally focuses upon the category I have called ‘specific express substantive tax concessions’ – those express tax concessions which are targeted at some or all small businesses. One of the key purposes of offering this typology of small business tax concessions is to illustrate the range of small business tax advantages which have hitherto been ignored in the tax policy literature.

3.1 Criminal tax advantages

As noted above, the ability of some small businesses to evade taxation constitutes a small business tax advantage, when compared to the employee/medium enterprise norm. Although the literature on this matter is somewhat sparse, what literature there is indicates that small businesses form the preponderant part of ‘hard to tax’ taxpayers engaged in the cash economy.³⁸ Further, it seems that the risk of participation in the cash economy diminishes as the enterprise increases in size and employs more staff.³⁹

³⁸ Australian National Audit Office, *The ATO’s Strategies to Address the Cash Economy*, Report No 30, 2005-06, ANAO, Canberra, 2006, para 1.15; David E.A. Giles and Lindsay M Tedds, *Taxes and the Canadian Underground Economy*, Canadian Tax Foundation, Toronto, 2002, 36; see also James Alm,

The extent of this criminal underpayment of tax is difficult to quantify, however the work of Coleman and Evans,⁴⁰ and also anecdotal evidence received by the author, indicates that a significant number of businesses underdeclare gross income by as much as 30%. Such a tax advantage is clearly significant, and both legislative and administrative strategies need to be employed to address this threat to tax system integrity. For example, the merits of a presumptive tax regime applicable to small businesses should be examined, with a view to determining whether a double dividend of reduced tax compliance costs and enhanced voluntary tax compliance might be obtained.⁴¹

3.2 Administrative concessions regarding the operation of administrative provisions

In some instances small businesses have received the benefit of considerable administrative lenience. For example, the Inspector-General of Taxation last year reported that the ATO had been lenient in not enforcing the tax debts of a substantial number of small businesses.⁴² Although the General Interest Charge is applicable to such debts, and that interest rate is greater than the interest rate with respect to secured debt, the GIC rate is less than interest charged with respect to unsecured finance such as credit card debt. Moreover, the GIC is tax deductible,⁴³ whereas interest with respect to credit card debt will not be deductible if the debt has arisen with respect to personal expenditure. It is quite possible that small business proprietors prefer to defer payment of tax debts.

Applying the benchmark of ‘competitive advantage’ in this context would entail consideration of whether the Australian Taxation Office has been more lenient with respect to small business operators by comparison to other categories of taxpayers. Again, taking employees as the benchmark, the PAYG withholding regime as applied to wage/salary payments means that employees generally do not have the opportunity of delaying payment of their tax obligations in order to pay down personal debt which carries a greater, non-deductible interest burden.

Jorge Martinez-Vazquez and Friedrich Schneider, ‘“Sizing” the Problem of the Hard to Tax’, in James Alm, Jorge Martinez-Vazquez and Sally Wallace (eds), *Taxing the Hard to Tax*, Elsevier, London, 2004, 11 at 13.

³⁹ David E Giles, ‘Modelling the Tax Compliance Profiles of New Zealand Firms: Evidence from Audit Records’ in Gerald W Scully and Patrick J Caragata (eds), *Taxation and the Limits of Government*, Kluwer, Boston, 2000, 243.

⁴⁰ Cynthia Coleman and Chris Evans, ‘Tax Compliance Issues for Small Business in Australia’ in Neil Warren (ed), *Taxing Small Business: Developing Good Tax Policies* ATRF, Sydney, 2003, 153-4.

⁴¹ See Victor Thuronyi, ‘Presumptive Taxation of the Hard-To-Tax’ in James Alm, Jorge Martinez-Vazquez and Sally Wallace (eds), *Taxing the Hard to Tax*, Elsevier, London, 2004, 101; OECD, above n 3, 50 (discussion of ‘forfaitaire’ arrangements by which a flat rate of tax is applied to a simplified tax base (ie gross turnover less certain expenses)).

⁴² Inspector -General of Taxation, *Review into the Tax Office’s Small Business Debt Collection Practices*, Commonwealth of Australia, Canberra, 2005

⁴³ ITAA97 s 25-5.

3.3 Administrative concessions with respect to operation of substantive rules

Although the Commissioner might be criticized for adopting a partial, pro-revenue interpretation of the taxation law,⁴⁴ there are also instances where the Commissioner appears to have adopted an interpretation of the law which is unduly favourable to small businesses. For example, in his recent statement with respect to personal services income,⁴⁵ the Commissioner stated that he considered that 'in the usual case' a partnership could not derive personal services income because of the assumption of risk by the partners. This proposition applied, the Commissioner added, even where the partnership income was in a sense solely attributable to the performance of services by one of the partners.

This conclusion is open to doubt for a number of reasons:

1. the personal services income rules themselves acknowledge that a partnership can derive personal services income, without any apparent restriction of this proposition to 'unusual cases';⁴⁶
2. the associated extrinsic materials also clearly accepted that the personal services income rules might apply to partnerships;⁴⁷ and
3. the Commissioner's rationale is that the assumption of risk by the partners means that the income is earned, not by the partner providing the personal services, but rather predominantly with respect to the assumption of risk by each of the partners.⁴⁸ As the assumption of risk does not entail exercise of personal effort or skill, the argument continues, Part 2-42 cannot apply to this income.

However, although it is true that a partner's income will compensate a partner for the risks that they assume, it is doubtful that the assumption of risk will be the predominant source of partnership income. Section 84-5 defines personal services income as income which is 'mainly a reward for your personal efforts or skills (or would mainly be such a reward if it was your income)'. Therefore it would be possible for a partnership to receive PSI, notwithstanding that some part of the partnership income is attributable to the assumption of risk by the partners. This will be the case provided that the income with respect to the assumption of risk, combined with income from assets used in deriving income, does not form the preponderant part of the partnership income.

Given the express legislative acknowledgement that the PSI rules might apply to partnerships, and the opacity of the Commissioner's unconvincing reasoning in

⁴⁴ See, for example, Gordon Cooper's analysis of the Commissioner's recent taxation ruling with respect to professional service entities (TR2006/2): Gordon Cooper, 'Service Entities' (2006) 40 *Taxation in Australia* 592.

⁴⁵ Commissioner of Taxation, 'Refocus of the income-splitting test case program', Canberra, 13 December 2005

⁴⁶ See, for example, ITAA97 s 86-10.

⁴⁷ See, for example, Explanatory Memorandum accompanying *Alienation of Personal Services Income Act* 2000 (Cth), para 1.1.

⁴⁸ Michael D'Ascenzo, 'Along the Road to Damascus: A Framework for Interpreting the Tax Law' (2000) 3 *Journal of Australian Taxation* 384.

apparently concluding that a service partnership will derive the preponderant part of its income with respect to the assumption of partnership risks, it is difficult to conclude that the Commissioner's statement is anything but an administrative concession with respect to the operation of the substantive law in relation to a significant number of small businesses.⁴⁹

3.4 Legislative concessions with respect to tax administration

There are also a range of express administrative concessions allowed to small businesses, including the annual turnover registration threshold for the purposes of the goods and services tax,⁵⁰ modified remittance rules with respect to tax payments,⁵¹ modified record keeping obligations⁵² and modified tax return filing obligations.⁵³ Such provisions are expressly allowed competitive advantages which focus upon small business. These provisions are justified upon the basis that small business bears the brunt of the competitive disadvantage of regressive tax compliance costs. It is therefore quite reasonable to argue that the modification of tax compliance rules for small business does not confer a competitive advantage, but rather seeks to neutralize the competitive disadvantage arising from a 'one size fits all' approach to framing a tax system.

However, as noted in section 2.2.1, one of the reasons for legislating small business tax concessions is to compensate small businesses for regressive tax compliance costs. Presumably, then, as government takes action to lift this compliance burden by modifying the tax compliance rules for small business, so government would be justified in withdrawing some small business tax concessions. Unfortunately, this balancing of tax concessions and tax compliance costs would necessitate accurate information regarding the nature, extent and incidence of express administrative concessions. The benefit of such concessions generally is not expressly recognised, largely because they do not fall within the concept of a 'tax expenditure' adopted by Australian Treasury.⁵⁴ Nevertheless, to the extent that such concessions reduce the tax compliance costs borne by small business, and assuming accurate compliance cost measurement, these concessions will be recognized in reports regarding small business tax compliance costs.

However, some express administrative concessions will not necessarily reduce tax compliance costs. Thus, a rule which merely defers the date for lodgement of a tax return and simultaneous payment of tax does not reduce the tax compliance workload, but it may constitute, in effect, the provision of an interest free loan by the government to small business. Such administrative concessions should be expressly identified as a tax expenditure and recorded in the tax expenditures statement.

⁴⁹ For the 2004/05 income year there were 370,725 'micro' partnerships, being partnerships with 'total business income' (which may be gross income or taxable income) of at least \$1 but less than \$2 million: Australian Taxation Office, *Taxation Statistics 2003-04*, ATO, Canberra, 2006, 74.

⁵⁰ *A New Tax System (Goods and Services Tax) Act 1999*, Division 23.

⁵¹ *Tax Administration Act 1953* s 45-140.

⁵² ITAA97 Subdivision 328-E.

⁵³ *A New Tax System (Goods and Services Tax) Act 1999*, Division 31.

⁵⁴ Commonwealth of Australia, *Tax Expenditures Statement*, Treasury, Canberra, 2005, ch 4.

3.5 Legislative concessions with respect to substantive rules

There is a range of substantive ‘small business tax concessions’, advantages with respect to the substantive operation of the tax law which are expressly allowed by Parliament and which target some or all small businesses.

3.5.1 Simplified Tax System

The *Tax Expenditures Statement 2005* states that the STS is expected to cost \$200 million in the 2006/2007 year.⁵⁵ This figure will have to be revised upwards in light of the Budget 2006 extension of the STS system to include businesses with an annual turnover of up to \$2 million.

The STS provisions within ITAA97 Div 328 allow qualifying small businesses to:

1. pool depreciating assets and write off the value of the pool at accelerated rates of depreciation;⁵⁶
2. account on a receipts basis of accounting;⁵⁷ and
3. escape trading stock accounting where the difference between the value of trading stock at the start of the income year and the end of the income year is reasonably estimated to be \$5000 or less.⁵⁸

Stated purpose

These provisions were proposed on the basis that they would ameliorate small business tax compliance costs,⁵⁹ while the Government added the objective of lowering small business taxation when the measures were introduced into Parliament.⁶⁰

Evidence based justification?

The Committee undertaking the Review of Business Taxation did not undertake an analysis of the particular sources of the small business tax compliance burden⁶¹ and nor, it seems, has such an analysis been undertaken since the introduction of these measures. Further, there is no published information which indicates that the Committee and/or Treasury modeled the impact of the STS system with a view to determining whether or not the STS benefits flowed to those businesses which incurred tax compliance costs which are at the higher end of the scale.

Such an analysis would need to identify:

⁵⁵ Commonwealth of Australia, *Tax Expenditures Statement*, Treasury, Canberra, 2005, 94 item B51.

⁵⁶ See ITAA97 Subdivision 328-D.

⁵⁷ See ITAA97 Subdivision 328-C.

⁵⁸ See ITAA97 Subdivision 328-E.

⁵⁹ Commonwealth of Australia, *A Tax System Redesigned*, above n 8, 575ff.

⁶⁰ Explanatory Memorandum accompanying *New Business Tax System (Simplified Tax System) Act 2000*, para 1.7; although note that the Regulation Impact Statement only referred to the reduction in compliance costs: Explanatory Memorandum, para 8.7.

⁶¹ For a discussion of the outcomes of the A New Tax System and Review of Business Taxation reforms in terms of small business compliance costs see: Michael Dirkis and Brett Bondfield, ‘The RBT ANTS Bite: Small Business the First Casualty’ (2004) 19 *Australian Tax Forum* 107.

- 1) the profile of small businesses which bore the brunt of tax compliance costs. The limited evidence on this point indicates that some industries bear higher compliance costs, while costs increase also as the business encounters more taxes with which it must comply;⁶²
- 2) the type of business which encounters particular forms of compliance costs. For example, 'lifestyle' small businesses might incur additional compliance costs in arranging for the proprietor/employee to take some business 'profits' in the form of concessionally treated fringe benefits rather than in the form of fully assessable income. By contrast, a growing small business might need to attract good staff by offering a competitive remuneration package which includes concessionally taxed fringe benefits. Perhaps ideally the STS measures would benefit the latter business while excluding the former, assuming that the underlying purpose of small business tax concessions is to foster entrepreneurship;
- 3) the types of entity which bear higher compliance costs. For example, given the advantages of conducting a business through a discretionary trust, such additional compliance costs should only be recognized for tax policy purposes if the tax advantages are also weighed in the tax policy calculus;
- 4) the types of transactions which attract higher compliance costs; and
- 5) the managerial benefits which emerge from incurring tax compliance costs.⁶³

Targeting

A review of the extrinsic literature regarding the Simplified Taxation System leaves the reader guessing as to just what compliance costs were targeted with this tax expenditure, the extent of those compliance costs and the extent to which the tax expenditure was intended to counteract those costs.⁶⁴ For example, offering tax concessions in the form of accelerated depreciation and/or trading stock accounting concessions⁶⁵ will be of little benefit to small business employers if prohibitive compliance costs are associated with employing additional staff. While accelerated depreciation might be beneficial, Dirkis and Bondfield have noted the compliance costs associated with accessing such concessions.⁶⁶

The poor targeting of these rules in their original form is reflected in the relatively low take up rate of the measures. When introducing the STS legislation the government boasted that a substantial majority of the 1 million eligible businesses were expected to

⁶² Commonwealth of Australia, *Working Overtime: A National Survey of the Paperwork Burden on Small Business*, Background Paper 3, A Report Commissioned by the Small Business Deregulation Taskforce prepared by Marsden Jacob Associates and Brian Sweeney and Associates, Commonwealth of Australia, Canberra, 1996, 23.

⁶³ Philip Lignier, 'A Silver Lining in the Tax Compliance Cost Cloud? A Study of the Managerial Benefits of Tax Compliance in Small Business', Paper delivered at the 7th International Tax Administration Conference, Crown Plaza Resort, Coogee, Sydney, 21 April 2006.

⁶⁴ PL Kenny 'A Simplified Tax system for small business: Or, just another tax preference?' (2002) 6 *Taxation Specialist* 36; Brett Bondfield, 'If there is an Art to Taxation the Simplified Tax System is a Dark Art' (2002) 17 *Australian Tax Forum* 313.

⁶⁵ As currently allowed under Division 328 of the ITAA 1997.

⁶⁶ Dirkis and Bondfield, above n 61, 147ff; Bondfield, above n 64, 327ff.

elect into the STS.⁶⁷ However, to date the response has been less impressive⁶⁸ - with a take up of just 20% of eligible businesses.⁶⁹ The government's bullish claim that the take up rate had 'met projections',⁷⁰ must be questioned. More recently, the government amended the operation of the STS by enacting the *Tax Laws Amendment (2004 Measures No 7) Act 2005*. The Explanatory Memorandum merely noted that:

For many small businesses the cash accounting requirement is not appropriate for their business or financial circumstances. The requirement to use this method has been seen as a restriction which has prohibited many small businesses from accessing the benefits of the STS. The removal of this restriction will permit more businesses, including many in the farming sector, to take advantage of the concessions associated with the STS. The removal of the cash accounting requirement will enable more businesses to access the benefits of the STS whilst calculating their taxable income using the most appropriate method applicable to their circumstances.⁷¹

It might be observed that this amendment suggests that the government is less concerned with the nexus between compliance costs and tax concessions and more concerned with allowing qualifying small businesses substantial tax concessions by allowing them to cherry pick the most advantageous tax accounting rules.

Compliance costs?

The Regulation Impact Statement accompanying the original STS legislation made vague references to 'some' up front compliance costs,⁷² while suggesting that on-going compliance costs would be reduced as a result of these measures.⁷³ No specific data was referred to, and nor has there been any subsequent public study focusing upon STS compliance costs.

⁶⁷ Explanatory Memorandum accompanying *New Business Tax System (Simplified Tax System) Act 2000*, para 1.6. In the Second Reading Speech with respect to the *New Business Tax System (Simplified Tax System) Act 2000* the Minister for Financial Services and Regulation observed: 'The government considers that the consultations with small business representatives have been a very positive and important part of the development of the simplified tax system. I would like to thank those involved in that extensive process for their efforts.' See also Peter Costello, *Media Release 101/2000*, 26 October 2000.

⁶⁸ See, for example, Sue Prestney, 'Fessing up about STS' (2003) 74 *CA Charter* 40; Mark Fenton-Jones, 'Push for simpler tax mode' *Australian Financial Review* 29 June 2004; 'Diminishing Attractions of STS' *Manly Daily*, 9 April 2003; CPA Australia, *Small Business Survey – Compliance Burden*, CPA Australia, Melbourne, 2003, 16. Such reports confirm the anecdotal evidence offered by some accountants to the author that they advise their clients not to bother with STS because the benefits are generally marginal at best. See also R Brass, 'The Simplified Tax System - Are There Any Winners?' (2002) 15 *Taxpayer* 227.

⁶⁹ CPA, above n 68, 16: the source for this statement is not provided by the CPA; see also Australian Tax Practice, 'Simplified Tax System (STS): 14% take-up rate so far', ATP Latest Tax News (No 163, 25 August 2003).

⁷⁰ John Howard, *Promoting an Enterprise Culture*, Election policy of the Coalition Government, 2004, 3.

⁷¹ Explanatory memorandum accompanying *Tax Laws Amendment (2004 Measures No 7) Act 2005*. See also John Howard, *Promoting an Enterprise Culture*, Election policy of the Coalition Government, 2004, 3.

⁷² See, for example, Explanatory Memorandum accompanying *New Business Tax System (Simplified Tax System) Act 2001*, para 8.17.

⁷³ *Id.*, para 8.19.

3.5.2 Division 152

Division 152 incorporates rules which allow concessional treatment of capital gains emerging from CGT Events with respect to ‘active assets’ of qualifying small businesses. The concessions comprise:

- 1) Complete exclusion from assessable income with respect to gains:
 - a) emerging from active assets, provided that the relevant active asset(s) have been held for more than 15 years; and
 - b) the CGT Event which gave rise to the gain happens in connection with the retirement of a business proprietor who is 55 or over at the time of the CGT Event or where the proprietor is permanently incapacitated at the time of the CGT Event;⁷⁴
- 2) if #1 does not apply, a further 50% discount with respect to capital gains, in addition to the general 50% discount which will be allowable with respect to active assets held for more than 12 months;⁷⁵
- 3) after allowing for the general capital gains discount and the concession allowed under section 152-205, any remaining active asset gains rolled over into a superannuation fund by a small business proprietor who is less than 55 at the time the capital proceeds are received will be exempt from taxation in the hands of the proprietor (but will be assessable income in the hands of the superannuation fund). A lifetime limit of \$500,000 applies to this exemption;⁷⁶ and
- 4) after allowing for the general capital gains discount and the concessions allowed under sections 152-205 and 152-305, a gain emerging from a CGT Event with respect to an active asset will be rolled over if the business proprietor acquires a replacement active asset within 1 year before and two years after the relevant CGT Event. If the replacement asset is subsequently disposed of, the key cost base elements of the original asset will apply for the purposes of calculating the capital gain emerging from the replacement asset.⁷⁷

To qualify for these concessions, the following threshold conditions must be satisfied:

1. the net value of CGT assets of the business must not exceed \$6 million;
2. the CGT Event must arise with respect to an ‘active asset’ of the small business; and
3. if the asset is a share or an interest in a trust, there must be a controlling individual just before the CGT Event and the entity claiming the concession must be a ‘CGT concession stakeholder’ (the controlling individual or their spouse) in the company or the trust.⁷⁸

The small business tax concessions allowed under ITAA97 Div 152 are estimated to cost \$624 million for the 2006/2007 income year.⁷⁹ This figure may need to be revised

⁷⁴ ITAA97 s 152-105.

⁷⁵ ITAA97 s 152-205.

⁷⁶ ITAA97 s 152-305.

⁷⁷ ITAA97 Subdivision 112-C.

⁷⁸ ITAA97 Subdivision 152-A.

⁷⁹ Commonwealth of Australia, *Tax Expenditures Statement 2005*, Treasury, Canberra, 2005, 115 (items C6, C7), 140 (items E13, E14).

upwards in light of the Budget 2006-07 announcement that STS businesses will automatically qualify for Division 152 concessions.⁸⁰

Stated purpose

The extrinsic materials accompanying the legislation which inserted Division 152 into the ITAA97 and also later amendments indicate that the purposes of Division 152 are:

1. to promote small business investment;⁸¹
2. to enhance the retirement savings of small business proprietors;⁸² and
3. to lower the compliance costs of pre-existing small business capital gains concessions.⁸³

The Board of Taxation's post implementation review of these provisions more boldly states that 'Division 152 gives effect to the overall policy to provide significant relief from the CGT system for eligible small business entities.'⁸⁴ The difference in the perceived purpose of Division 152 reflected in these official statements may be significant. By restricting the perceived purpose effectively to tax reduction, rather than the provision of a tax reduction to promote small business growth and investment, the Board of Taxation obviated the need to consider how the benefit of these concessions was applied by small business taxpayers. Thus, for example, the Board did not see fit to consider whether Division 152 actually does 'promote small business investment'.

Target group, and those implicitly/explicitly excluded

Given the definition of 'active asset', the primary 'active assets' of a small business will be goodwill and any real property used in the course of carrying on the business. Depreciating assets, including intellectual property, are specifically excluded from the capital gains provisions and so gains made upon such assets will not attract the Division 152 concessions. Many small businesses will not hold significant appreciating active assets – more than two thirds operate from the home of the business proprietor and many will hold insignificant goodwill. Nevertheless, Treasury estimates of the cost of these tax expenditures indicate that those businesses which do hold appreciating active assets obtain a substantial benefit from these concessions. For the 2002-2003 year, the Board of Taxation found that approximately 20,000 small businesses utilized Division 152.⁸⁵ Unfortunately, a breakdown of such businesses by industry sector and size of enterprise indicia (ie number of employees, turnover, gross assets held) and growth phase (ie mature businesses or developing?) is not publicly available.

⁸⁰ Commonwealth of Australia, *Budget 2005-06 - Budget Paper No 2*, Australian Treasury, Canberra, 2006, 31.

⁸¹ ITAA97 s 152-1; Peter Costello, *Press Release No 058*, 21 September 1999.

⁸² Peter Costello, *Press Release No 058*, 21 September 1999.

⁸³ Paragraph 4.9 of the Regulation Impact Statement accompanying *New Business Tax System (Capital Gains Tax) Act 1999*.

⁸⁴ Commonwealth of Australia, *A Post-implementation Review of the Quality and Effectiveness of the Small Business Capital Gains Concessions in Division 152 of the Income Tax Assessment Act 1997*, The Board of Taxation, Canberra, 2005, 8.

⁸⁵ *Id.*, 145.

Evidence based justification?

As Freedman notes, if there are to be small business tax concessions it would make sense for them to be targeted at entrepreneurial small businesses which are growing.⁸⁶ Further, it would make sense for the concessions to be of most benefit to those who use them to reinvest in their business (rather than taking them for consumption expenditure). In this way, the government would maximise the macroeconomic growth return on its tax expenditure investment. With these objectives in mind the evidence necessary to mount a justification of the Division 152 concessions would include:

1. data with respect to the extent to which the concessions influence small business investment decisions; and
2. information with respect to the principal beneficiaries of the concessions and the uses to which the benefit of the concessions is put by those beneficiaries.

Unfortunately, in the absence of publicly available data as to the beneficiaries of these capital gains concessions, and the use to which the benefit of the concessions is put, it is impossible to assess the merits of the concessions. Presumably, if such data existed, it would have been referred to in the original explanatory memorandum or in subsequent explanatory memoranda accompanying amendments to Division 152. However, no such data has been referred to.

Compliance costs?

The Explanatory Memorandum accompanying the Division 152 measures indicated that compliance costs associated with access to the small business capital gains measures would be reduced. No data was tendered in support of this claim, and nor was baseline data regarding the compliance costs associated with the former rules available. In other words, the claim in the Regulation Impact Statement was not verifiable. However, it seems that Division 152 has actually increased the compliance costs borne by taxpayers, and that these compliance costs are substantial in absolute terms.⁸⁷

3.5.3 Entrepreneurs' tax offset

This measure provides qualifying STS taxpayers with a tax offset of up to 25% of their tax liability for a particular income year. STS taxpayers with an STS turnover of less than \$50,000 will qualify for the full offset. If STS turnover exceeds \$50,000 the offset phases out on a straightline basis until STS turnover reaches \$75,000.

The Regulation Impact Statement with respect to this measure indicates that it is expected to cost \$125 million per year. However, the *Tax Expenditures Statement 2005* estimates that the offset will cost \$380 million in the 2006/07 income year.⁸⁸

Stated purpose

The Explanatory Memorandum accompanying the entrepreneurs' tax offset legislation stated:

⁸⁶ Judith Freedman, 'Small Business Taxation: Policy Issues and the UK' in Neil Warren, above n 5, 15.

⁸⁷ Commonwealth of Australia, above n 84, 175.

⁸⁸ Commonwealth of Australia, *Tax Expenditures Statement 2005*, Canberra, 2005, 82 item B23.

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.⁸⁹

Target group, and those explicitly/implicitly excluded

The explanatory memorandum accompanying this measure does not explain why:

1. it is dependent upon the relevant entity having a turnover of less than \$75,000 rather than net STS income being the qualifying condition. Focusing upon gross turnover will exclude many high volume/low margin businesses while those with a high turnover/ expenses ratio, such as those in the service sector, will benefit most;
2. the offset is only relevant if a qualifying business is profitable, such that taxation is payable by the relevant entity. Many entrepreneurial small businesses do not generate profits in the startup phase and do not survive. Those small business taxpayers who are only marginally profitable will obtain a miniscule benefit from this measure, if at all. The combined effect of the zero rated threshold and low income rebate mean that no tax is payable until taxable income exceeds \$10,000.⁹⁰ By contrast, this measure will be of most benefit to those earning high income from other sources (ie wage/salary) and carrying on a small business part time. For these taxpayers, there will be substantial tax savings;
3. the offset applies equally to entrepreneurial small businesses as well as non-entrepreneurial small businesses; and
4. where the relevant STS entity is a company, this tax preference is washed out if/when the low taxed profits are distributed to shareholders. By contrast, there is no such washout with respect to STS partnerships and trusts.

Evidence based justification?

The Explanatory Memorandum does not refer to any tax expenditure analysis undertaken with respect to the entrepreneurs' offset, and nor does it attempt such an analysis by referring to relevant data. If this measure is intended to promote startup entrepreneurial activity, it would be necessary to consider a range of questions, including:

- 1) the types of entrepreneurial activity which the government wishes to promote. For example, does the government wish to encourage home-based retail businesses such as Amway distributors, or does it wish to focus its limited tax expenditure resources upon enterprises in the 'dynamic' services and technological sectors?
- 2) whether the imposition of income tax upon the profits of entrepreneurial activities constitutes an actual/perceived barrier to entry into those entrepreneurial activities. Further, whether the imposition of income tax upon the entrepreneurs' profits constitutes an actual/perceived impediment to expansion of the entrepreneurial activity. It is possible, for example, that entrepreneurial activities have accumulated

⁸⁹ Explanatory memorandum accompanying *Tax Laws Amendment (2004 Measures No. 7) Act 2005*, para 1.41.

⁹⁰ Commonwealth of Australia, *Budget 2006-07*, Budget Paper No 2.

tax losses which soak up profits in the first years that the activity turns a cash profit, and that, by the time the losses have been absorbed, the relevant business exceeds the upper gross turnover threshold such that the offset is never available to many expanding entrepreneurial enterprises. Further, it is possible that the slight reduction in tax received at the enterprise level is of only marginal benefit to growing businesses which might have limited income in the first year and income in excess of the maximum income threshold in subsequent years; and

- 3) whether the provision of \$125 million might be better spent. For example, by expanding small business support services or by providing finance guarantees with respect to private sector finance or by expanding the venture capital tax incentives.

It seems that no such analysis has been undertaken.

Compliance costs associated with accessing the concession

The Explanatory Memorandum accompanying the entrepreneurs' offset legislation stated that 'this measure is expected to have minimal impact on compliance costs'. No attempt at quantifying these compliance costs appears to have been made. As discussed above in the context of the small business capital gains concessions, it is possible that these compliance costs are substantial in absolute terms.⁹¹

3.6 Indirect express small business advantages

There are also legislated indirect small business advantages such as tax expenditures with respect to venture capital investments. To the extent that such tax advantages are passed through to 'small businesses', for example in the form of cheaper capital than would otherwise be available, such benefits comprise a small business tax advantage.⁹²

3.7 General express concessions which benefit small business

There are also a number of taxation expenditures which are of general application but which may be of benefit to small businesses. Thus, for example, the capital gains discount will apply with respect to small business active assets, allowing the small business entity to reduce any capital gain by 50% with respect to an asset held for more than 12 months. Given that section 152-205 allows a further 25% discount of the capital gain, and that this is estimated to cost \$300 million for the 2006/7 income year, the allowance of the general discount with respect to small business active assets presumably would cost something approaching twice as much as the section 152-205 concession.⁹³ Thus, capital gains concessions with respect to small business active assets will cost up to a total of \$900 million for the 2006/7 income year.

⁹¹ See section 3.5.2 above.

⁹² For recent reviews of the operation of such tax expenditures in the Australian context see Miranda Stewart, 'Venture Capital Tax Reform in Australia and New Zealand' (2005) 11 *New Zealand Journal of Taxation Law and Policy* 216; Stephen Barkoczy and John Glover, *Venture Capital Tax Expenditure Programs*, A Report Prepared for the Department of Industry, Tourism and Resources, 2006 (unpublished as at 4 July 2006).

⁹³ It is reasonable to expect that not all active assets will be held for the minimum 12 months, so there will be something less than 100% takeup of the 50% discount allowed under ITAA97 Div 115.

There is some difficulty in including all of this \$600 million expenditure under the category of ‘small business tax advantages’. The \$600 million figure is derived from the calculation of the expenditure under section 152-205 with respect to small business active assets, and the two primary categories of active business assets are real property and goodwill (given the exclusion of depreciating assets from the capital gains rules). The difficulty of treating all of the \$600 million as a small business tax advantage arises because the benchmark taxpayer, for example a wage/salary earner, may also access the general capital gains discount by investing in appreciating assets. Thus, while a small business proprietor may invest in real property which is an active asset, so may the wage/salary earner also invest in appreciating real property. Thus, to the extent that the derived figure of \$600 million is attributable to active assets which are real property, that proportion should be excluded (on the assumption that the small business proprietor would have made a similar investment in appreciating property even if they were not carrying on a small business). However, the second principle category of active assets is goodwill, which may consist of acquired goodwill and/or self-generated goodwill. The treatment of acquired goodwill is no different to appreciating real assets – both small business proprietors and wage/salary earners may invest in a business which holds appreciating goodwill. However, to the extent that the \$600 million figure is based upon self generated goodwill, that amount is a concession which is not available to a wage or salary earner. Self generated goodwill arises from the exertion/skill of the business proprietor (and quite possibly the business employees) – the capital gain received with respect to such goodwill is in a sense a payment for the exertions/managerial skill of the business proprietor. By contrast, a wage or salary earner is paid fully taxed income for their personal exertions. Thus, that part of the \$600 million figure which is attributable to self generated goodwill, is a small business taxation advantage.

Other tax concessions are of a more general nature but nevertheless either expressly or impliedly also apply to small businesses. For example, the limitations upon the prepayment rule which include an express modified operation of the rule with respect to STS taxpayers might be considered to fall within this category.⁹⁴ An example of an express, general tax expenditure which impliedly benefits many small businesses is the income averaging rules applicable to primary producers.⁹⁵ This tax expenditure clearly benefits all primary producers, but nevertheless should be taken into account when quantifying small business tax advantages because income averaging is not available to other categories of taxpayers such as employees (who may experience fluctuating incomes owing to unemployment, performance based pay mechanisms, etc).

The relative benchmark definition is also apt in the context of exclusions from the operation of specific anti-avoidance rules inserted into the ITAA which are designed to counteract some forms of tax minimization which would otherwise be open to small businesses. For example, Division 7A of the ITAA36 contains provisions designed to prevent closely held ‘private’ companies from effectively distributing corporate profits in an untaxed form, such as by way of interest free loans. However, Division 7A will not apply where a private company allows a shareholder to use a company asset (ie a beach

⁹⁴ ITAA36 s 82KZM.

⁹⁵ ITAA97 Division 392.

house) free of charge.⁹⁶ Nor will Division 7A apply to an interest free loan which is repaid by the specified time,⁹⁷ with the company shortly thereafter making a fresh loan which is less than and not 'similar to' the amount of the payment (which would usually equate to the amount of the original loan).⁹⁸ Should such a limitation embodied in the legislation be classified as a small business tax concession/relief/advantage? On one view, describing such a rule as a 'limitation' or an 'exclusion' is inappropriate because the rule might be described as a part of the definition of the proscribed 'tax avoidance' conduct rather than an exclusion from the anti-avoidance rule. However, this approach misunderstands the nature of the foundation of the benchmark upon the principle of competitive neutrality. Allowing a shareholder the free use of sheltered income which had been taxed at a rate lower than the shareholder's marginal rate is a tax advantage which is not available to wage/salary earners. The principle of neutrality would suggest, therefore, that such free use of corporate assets should be classified as a tax advantage. The semantic question of whether the legislature has chosen to allow such advantages by creating a circumscribed anti-avoidance rule or by carving out exclusions from the relevant anti-avoidance rule is irrelevant.

3.8 Implied/tacit substantive tax advantages

There are also small business tax advantages which arise implicitly as a result of the operation/exploitation of the general taxation provisions. Income splitting is perhaps the primary example of such small business taxation advantages.

Income splitting is commonly used by small businesses where those businesses are conducted through partnerships, companies or trusts. A discretionary trading trust offers considerable flexibility with respect to the admission of new family members into the business structure, streaming of particular categories of income to particular beneficiaries, income sheltering within a company (which might lend the money back to the trust to enable the trust to acquire assets which the 'proprietors' use free of charge, and without any taxation consequences), pass-through of business tax preferences such as accelerated depreciation, flexibility of distribution amounts with respect to particular beneficiaries as well as the ability of being able to employ the 'proprietors' in order to provide them with concessionally treated fringe benefits. A typical structure would allow for splitting of business income between a domestic couple and a family company (to access the lower corporate tax rate, with the company acquiring assets and allowing family members to use those assets without tax consequences). Dependent adult children, who fall outside of ITAA36 Div 6AA by virtue of their age, add to the pool of family members to whom income may be alienated.

To illustrate the tax savings that such a structure might achieve, it is worthwhile taking the situation of a small business which generates a 'profit'⁹⁹ of \$150,000 and comparing

⁹⁶ See n 27 above.

⁹⁷ ITAA36 s 109D(1)(b).

⁹⁸ ITAA36 s 109R(2).

⁹⁹ That is, excluding any salary or other benefits to the 'proprietors' of the business, who will control the trust through a corporate beneficiary.

the tax paid by a wage and salary earner on that sum to illustrate what might be achieved in terms of tax savings.

Obviously the quantum of the tax advantage which such a structure offers will depend upon a number of variables – the number of adult family members, the quantum of the business income, etc. However, the point is that substantial tax savings may be achieved with little additional compliance costs. Such tax relief has, as far as I am aware, never been referred to in the course of discussing small business tax concessions.

4 Towards better tax system design

The preceding discussion of small business tax advantages indicates that, to date, the Australian Treasury has not undertaken critical analysis of small business tax concessions by, for example, considering the competitive advantages which benefit small business. If such critical analysis has been undertaken, that analysis has not been made public. If we are to have a government which truly is committed to transparency,¹⁰⁰ the release of information regarding the existence/absence of such information is highly desirable. In this section of the paper I will outline what such a critical review of small business tax concessions should entail.

4.1 International norms upon public policy making

The United Kingdom government has adopted a statement of nine principles of public policy-making, which hold that good public policy is:

1. forward looking;
2. outward looking;
3. innovative, flexible and creative;
4. evidence-based;
5. inclusive;
6. 'joined up', or holistic;
7. subject to ongoing review
8. subject to built in evaluation; and
9. built upon learning lessons from the past.¹⁰¹

To similar effect, the OECD specified ten guiding principles for promoting the active engagement of citizens in public policy making. These principles include:

1. commitment to active engagement on the part of those ultimately responsible for public policy;
2. broad rights of the citizenry to access information, provide feedback, be consulted and actively participate in policy making;
3. information provided to the citizenry should be objective, complete and accessible;
4. mechanisms for promoting active engagement on the part of the citizenry should be adequately resourced;

¹⁰⁰ Commonwealth of Australia, *Making Transparency Transparent*, AGPS, Canberra, 1999.

¹⁰¹ Helen Bullock, Juliet Mountford and Rebecca Stanley, *Better Policy-making*, Centre for Management and Policy Studies (a branch of the UK Cabinet Office), London, 2001, 14.

5. there must be appropriate feedback provided to those engaged in the consultation process;
6. governments should adopt measures which build the capacity of citizens to actively engage in the process of shaping public policy.¹⁰²

Other examples of policies which promote active engagement in public policy formation on the part of the citizenry are readily identified.¹⁰³ The broad proposition which emerges from these policies is that public policy formation is no longer generally conceived in terms of a top-down, hierarchical or inside-out manner.¹⁰⁴ Rather, public policy formation is widely perceived as a process in which a well informed citizenry is equipped with the skills, and given ample opportunity, to actively engage in public policy formation. Of course, such democratic processes do not entail abdication from public accountability on the part of those charged with government – democratically elected governments must remain ultimately responsible for the legislative outcomes. However, the concept of accountability means that citizens must be adequately informed so as to be in a position to hold governments accountable. As such, democratic participation should enhance transparency and accountability, while also promoting better public policy.

4.2 What would these norms mean in the context of taxation expenditures?

In the context of taxation expenditures such as small business tax concessions, these norms would mean that:

1. sufficient, appropriate and credible information is available to policy makers, including the general public, at the commencement of the policy design process. In particular, information regarding the net (dis)advantage of small business by comparison to a defined benchmark would be critical to an informed discussion of public policy in the domain of small business taxation. This would entail compliance with items 1, 2, 4, 6 and 9 in the preceding list of public policy norms;
2. broad consultation would be undertaken with respect to the decision to utilize tax expenditures and also with respect to the design of those expenditures. This would entail compliance with item 5 in the preceding list;
3. careful consideration be given to whether competitive disadvantages experienced by small business might more efficiently be overcome by means such as tax system reform or regulatory reform rather than by tax expenditures. This would entail compliance with items 3 and 6 in the preceding list;
4. on-going review of any tax concessions resulting from this process be implemented, and this review to entail consideration of the validity of the policy

¹⁰² OECD, *Citizens as Partners*, OECD, Paris, 2001, 15.

¹⁰³ See, for example, European Commission, *The Commission's contribution to the period of reflection and beyond: Plan-D for Democracy, Dialogue and Debate*, COM(2005) 494 final, Brussels, 2005; European Commission, *European Governance: White Paper*, COM(2001) 428 final, Brussels, 2001; European Commission, *Towards a reinforced culture of consultation and dialogue – general principles and minimum standards for consultation of interested parties by the Commission*, COM(2002) 704 final, Brussels, 2002.

¹⁰⁴ OECD, *Citizens as Partners*, OECD, Paris, 2001.

- underpinning the legislation as well as the effectiveness of the legislation in achieving the stated policy; and
5. the entire process of considering small business tax concessions would be subject to evaluation.

4.3 Are these norms adopted in Australia?

I have considered the failure to adopt these norms, within the requirements for Regulation Impact Statements applicable to taxation legislation, elsewhere.¹⁰⁵ The preceding discussion of express substantive small business tax advantages suggests that the process by which the Australian small business tax concessions are created and maintained is critically flawed. There are substantial shortcomings with respect to the information upon which those measures are based, the process by which the community is engaged in developing these measures and also the nature and process by which the measures are reviewed and evaluated after their introduction. In particular:

1. the purpose of these measures is expressed in vague and/or unverifiable terms, such as ‘lowering small business taxation’, ‘promoting small business entrepreneurship’ or ‘lowering compliance costs’ (without any data regarding the baseline compliance costs being available). The failure to identify key strategic outcomes when introducing these measures is reflected in the poor targeting of the measures. For example, these measures do not differentiate ‘lifestyle’ businesses – businesses which the proprietor has little/no intention to expand – from entrepreneurial small businesses which may truly be an engine room for economic and jobs growth;
2. little or no effort is expended in identifying existing systemic tax advantages available to small business ie income splitting, income sheltering;
3. despite the scale of this tax expenditure program, it is characterized by an absence of any convincing evidence justifying the introduction of small business tax concessions and of the particular form of small business tax concessions;
4. similarly, there has been apparently no effort to examine small business tax advantages in other jurisdictions;
5. the procedures adopted in introducing these measures exhibit an ad hoc and non-inclusive approach to consultation with the wider community, while small business lobbyists appear to gain special access to government. For example, with respect to the entrepreneur tax offset measures it is clear that the government consulted intensively with the small business sector, without apparently engaging in wider consultation with respect to the merits of these measures;
6. there is an absence of a whole of tax system approach, as no study has been undertaken with respect to small business tax advantages provided by all levels of government;
7. there is an absence of a whole of government approach as no study has been undertaken with respect to small business advantages provided across all government programs (spending, regulatory and taxation) and across all levels of government;

¹⁰⁵ Mark Burton, ‘Tax citizens as partners? Foundations for an effective tax system in the new democratic era’, (2006) *Law in Context* (forthcoming).

8. when introducing small business tax concessions, little regard is paid to the cost of overlaying another layer of tax complexity upon an already complex tax system, despite the government's rhetoric to the contrary. For example, the cost of accessing the small business capital gains concessions is considerable and may be greater than the cost of 'complying' with similar antecedent provisions, despite the fact that the government indicated that a purpose of the new provisions was to lower compliance costs;¹⁰⁶
9. no credible justification has been provided for why tax expenditures should be preferred to outright spending programs. The small business sector as a group might pride itself on its self-reliance, and so might spurn direct government assistance. To overcome this problem, governments might provide subsidies through the tax system which are not perceived as 'welfare'. However, the literature regarding small business tax expenditures makes no reference to this.

When one considers the parlous state of Australian tax policy design reflected in the Australian small business tax concessions, the justifications put forward in *A Guide to Regulation* for not engaging in comprehensive critical review of tax policy measures¹⁰⁷ seem particularly flimsy. At no point in the legislative process are the Australian small business tax concessions subjected to a credible process of open and transparent critical scrutiny and public consultation. Moreover, the conduct of post implementation reviews by the Board of Taxation does little to redress this shortcoming. The Board of Taxation interprets that part of its Charter which states that it will advise the Treasurer 'on the quality and effectiveness of tax legislation' in a quite limited fashion. Rather than taking the opportunity to conduct a broad 'tax expenditure analysis' akin to that envisaged by Surrey,¹⁰⁸ the Board restricts the scope of its post implementation reviews by merely examining the technical aspects of legislation, viz the extent to which the legislation:

- 1) gives effect to the government's policy intent;
- 2) is expressed in a clear, simple, comprehensible and workable manner;
- 3) avoids unintended consequences of a substantive nature;
- 4) takes account of actual taxpayer circumstances and commercial practices;
- 5) is consistent with other tax legislation; and
- 6) provides certainty.¹⁰⁹

Most importantly, the merits of the Government's policy are not open to question during the course of a post implementation review.¹¹⁰

4.4 The need for further research

The Australian government does not systematically follow norms of good governance with respect to public policy making in formulating its tax legislation, and in particular in formulating its small business tax concessions. The preceding discussion of the Australian small business tax concessions suggests that such norms should be followed,

¹⁰⁶ Commonwealth of Australia, above n 84.

¹⁰⁷ Commonwealth, *A Guide to Regulation*, Office of Regulation Review, Canberra, 1998 (2nd edn), B9.

¹⁰⁸ Stanley Surrey, *Pathways to Tax Reform*,

¹⁰⁹ Commonwealth of Australia, above n 84,

¹¹⁰ Id.

and in particular those concessions should be subjected to a rigorous, transparent and open tax expenditure analysis.

At the least, such an analysis would entail:

- 1) clear identification of, and justification for, the desired outcome. Here there is a considerable amount of work to be undertaken in terms of ascertaining whether a problem exists and, if there is a problem, the extent of the problem in terms of the 'undesirable' competitive disadvantages borne by small business; and
- 2) assessment of options for achieving the desired outcome. Are tax measures the most appropriate and, if so, might systemic changes be more effective than specific tax concessions?

4.4.1 Defining objectives of small business taxation expenditures

It was noted earlier in this paper that small business tax concessions are generally justified upon the following grounds:

1. compensating small business for regressive tax compliance costs;
2. to promote neutrality by compensating for market failures which disadvantage small business;
3. to promote a relative form of tax neutrality, in the sense of ensuring that small businesses are treated comparably to other economic units;
4. promoting entrepreneurial endeavour;
5. achieving macroeconomic objectives such as securing economic stability by promoting the small business sector which possibly exhibits countercyclical growth by comparison to other sectors of the economy;
6. reducing small business taxes.

Underlying the first three of these objectives is the desire to level the playing field by compensating small business for actual or perceived competitive disadvantage. The fourth and fifth of the objectives listed above express the desire to generate small business growth. The last objective may be little more than providing government largesse to a favoured sub-community without requiring any broader community benefit. Although the legislature has referred to the first five objectives, there is little evidence to suggest that these objectives have been taken seriously. For example, the preceding discussion indicates that no serious effort has been made to identify and quantify the competitive disadvantages suffered by small business, let alone ascertain whether the various small business tax concessions represent the most effective means of redressing those disadvantages.

The first step in addressing the dysfunctional legislative process enveloping small business tax concessions is for the government to identify what the objectives of the small business tax concessions are, and make a commitment to identifying the best means of achieving these objectives. Assuming that some or all of the first five objectives in the above list are identified, it is then possible to undertake a tax expenditure analysis with respect to any existing/proposed small business advantage. A central aspect of identifying the objectives of small business tax concessions is to define the class of 'small business' taxpayers – only then can the significance of these objectives for the specified small

business taxpayers be assessed. For example, it may be the case that the specified group of 'small business taxpayers' experience little competitive disadvantage, and so there is no need to consider small business tax concessions to redress such disadvantage. In this regard, there is no consensus regarding the definition of 'small business,'¹¹¹ and this is reflected in the various measures used for legislative and statistical purposes. Turnover,¹¹² gross income,¹¹³ business income,¹¹⁴ net value of capital assets¹¹⁵ and number of employees¹¹⁶ are the measures generally applied. However, in applying any of these measures the identification of the upper threshold is essentially arbitrary. Thus, for example, in the Budget 2006-07 it was announced that the STS maximum annual turnover threshold would be increased from \$1 million to \$2 million.

The absence of a consensus definition of 'small business' is most probably attributable to the heterogeneity of 'small businesses'. Ranging from 'lifestyle businesses'¹¹⁷ to substantial commercial enterprises, there are a number of variables which make the targeting tax concessions upon small business, and upon particular kinds of small business, extremely complex. These variables include:

1. number and type of entities within the 'management unit';
2. number and type of taxes borne by the business unit, and the number and type of rules with respect to each tax which apply to the unit;
3. number of 'employees' (ie self employed sole proprietor vs 19 full time employees vs 50 part-time employees);
4. industry sector (manufacturing, mining, services);
5. number of transactions (ie consultant providing services under several contracts vs corner store with hundreds of transactions per day);
6. type of transactions (ie cash or invoice);
7. situs of business activity (ie dispersed or localized);
8. value of assets;
9. class of assets held (ie depreciating assets vs other capital assets such as real property); and
10. degree of risk assumed by proprietor.

This is by no means a complete list of small business variables but it suffices to make the point that if the government wishes to pursue any of the first five objectives of small business concessions listed above, gathering relevant data in order to ascertain the nature of net competitive (dis)advantage experienced by various types of small business, having

¹¹¹ OECD, above n 3, ch 3; Stewart Karlinsky, 'How does U.S. Income Tax Law Define a Small Business? Let me count the ways' in Neil Warren, above n 5, 45ff.

¹¹² ITAA97 s 328-365(1)(b).

¹¹³ With respect to the classification of companies, the Australian Taxation Office uses the total gross income of the company as the basis for comparison: Australian Taxation Office, *Taxation Statistics 2003-04*, Australian Taxation Office, Canberra, 2006, 54.

¹¹⁴ With respect to the classification of trusts, the Australian Taxation Office uses total business income as the basis for comparison, Australian Taxation Office, *Taxation Statistics 2003-04*, Australian Taxation Office, Canberra, 2006, 88.

¹¹⁵ ITAA97 s 152-15.

¹¹⁶ Australian Bureau of Statistics, *Small Business in Australia 2001*, Commonwealth of Australia, 2002, 1-2.

¹¹⁷ Freedman, above n 86, 15.

regard to the range of small business tax advantages outlined earlier in this paper, is a lengthy and difficult task which has hitherto been ignored.

For example, if public expenditure in promoting entrepreneurship is a worthy objective (as opposed to leaving entrepreneurship to the private sector), there is a range of qualitative data which would be extremely useful in framing appropriate public programs. It would be fruitful, for example, to know the extent to which entrepreneurs are aware of the existing small business tax concessions and the extent to which these concessions influence entrepreneurial behaviour. Further, research might also explore a number of themes, including the 'marketing' of existing small business tax concessions to consideration of how those concessions might be simplified with a view to making them more marketable. Moreover, the research might indicate that small business tax concessions are less significant than other factors in promoting entrepreneurial endeavour ie access to finance/protection from oppressive conduct, in which case the justification for small business tax concessions would have to be questioned.

Even within the more developed literature regarding taxation compliance costs, the data is deficient in terms of identifying the particular industries, entity categories, transactions and stage of the business lifecycle most affected by regulatory compliance burdens. Such data is essential, however, if the introduction of small business tax concessions is to be justified. Moreover, this data is critical to successfully targeting any proposals for small business tax concessions which emerge from the first, justificatory, stage of critical review. If the government genuinely wishes to achieve any or all of the objectives for small business concessions listed above, it is necessary to either:

- 1) identify common competitive disadvantages/common characteristics of all small businesses such that a 'one size fits all' small business tax concession can be developed – an extremely difficult task given the heterogeneity of small businesses; or
- 2) identify different subcategories of small business and develop a more complex array of interlocking or contiguous tax concessions which collectively provide appropriate levels of assistance to the different categories of small businesses. It is possible that this is the overarching purpose behind the array of Australian small business tax concessions, although no such logic is expressly referred to in the relevant extrinsic materials. Given the heterogeneity of small businesses, such a program of independent tax concessions will encounter the problem of magnifying tax complexity.

4.4.2 Considering options

The difficulties of targeting tax concessions are not necessarily a good reason to desist from providing such concessions, however they are cause to critically reflect upon whether there are more efficient means of fostering small business growth and entrepreneurship. For example:

- 1) might non-tax strategies such as the public provision of loan guarantees be more effective in providing leveraged assistance to small business?
- 2) might any such expenditure programs be effectively combined with targeted tax system reform?; and

- 3) whether a tax compliance dividend can be reaped from tax reform which reduces compliance costs for small businesses. In this regard the possibility of introducing a presumptive taxation regime with respect to Australian small businesses ought be explored.¹¹⁸

Only after such issues have been explored and the information is publicly available will it be possible to inform all stakeholders and commence a process of active engagement in policy making.

5 Conclusion

In the recent past the discourse regarding small business taxation has come to be dominated by the perception that small business, the engine room of the Australian economy, has been sorely dealt with at the hands of oppressive government regulation. In response to this perceived crisis, tax concession has been piled upon tax concession apparently in the hope that this will right the wrong. What is striking is the apparent disinterest in ascertaining, on a holistic basis, whether or not this portrayal of small business competitive disadvantage is supported by evidence. Certainly, there is a growing body of literature regarding the regressive compliance costs borne by small businesses, but the literature is remarkably silent when it comes to recognizing the ‘hidden’ tax advantages which afford small businesses substantial advantages. Until such tax advantages are comprehensively listed and quantified, and other forms of government assistance provided by all levels of government identified and quantified, it is impossible to determine whether or not small business should receive compensation in the form of tax expenditures. Further, until some effort has been made to identify the types of small businesses which are net losers as a result of the operation of Australian taxation laws, the targeting of small business tax concessions is more an act of faith than an act of public finance ‘science’. There is, then, clearly a need for much more stringent research in relation to small business taxation and the suggested definition of small business tax advantage proffered in this paper is but a first step in this direction. Failing to ground small business taxation policy upon such rigorous application of good governance norms will only foster public cynicism which will undermine the legitimacy of the Australian tax system.

¹¹⁸ See section 3.1 above.