PART 1

THE TAXES AFFECTING SMALL BUSINESS

CHAPTER I

PROVISIONAL TAX

Definition

1 Provisional tax is anticipatory in come tax payable before the end of the current year on the non-salary (or wages) income of that year. It is -ought forward and credited against ordinary tax assessed on the year's come after deductions. Excess provisional tax is credited or offset against any provisional tax already notified for the following year or any provisional tax instalment already due and payable for the following year. However, under new arrangements announced by the Tax Office, excess tax paid by taxpayers who are not subject to the quarterly instalment system (that is: with tax liabilities of less than $8,000) will now receive full refund rather than have a credit offset against their provisional tax liability.

1.2 Provisional tax may be imposed on salary or wages income from which insufficient tax instalments have been deducted.

1.3 This tax is payable by every taxpayer and trustee on all assessable income except salary and wages, except by'.

(a) a company;

(b) a trustee of a superannuation fund or an Approved Deposit Fund;

(c) a trustee of a Pooled Superannuation Trust;

(d) a trustee of a corporate unit trust or public trading trust; and

(e) a trustee on trust income to which a beneficiary who was a non-resident at the end of the relevant year of income was presently entitled.

1.4 Provisional tax is payable in lump sums or instalments if the previous year's provisional tax was $8000 or less, or taxable income includes primary production income, or where there is an entitlement to be taxed at concessional rates under the averaging rules for authors, artists, sports-persons, performing artists etc, provisional tax is payable as a lump sum in the last quarter of the income year. It is otherwise payable by quarterly instalments which commence on 1 September of the year of income.

1.5 in many circumstances, a likely start for a small business would be for it not to show a profit for the first year or more, and for a low level of profit and hence taxable income to manifest in the early years of operation. Under the current system, this would keep it in the lump sum tax payment regime until it reached the $8,000 tax liability threshold which would propel it into the quarterly instalment regime. The same double impost in year 2 that is discussed below will occur in the second year of a business's liability for provisional tax, unless the business lodges an early return under subsection 221YC(4) of the ITAA.

1.6 Depending on the fluctuations in a business's income, and in particular its tax liability, the business could alternate between lump sum tax payments and quarterly payments regimes as its tax liability fluctuates around the $8,000 threshold. This adds to the complications facing such small businesses.

The Provisional Tax System

1.7 The application of provisional tax can be quite complicated as the level of tax payable has an impact on the level of tax payable in the following year. The following exercise has been chosen to illustrate the complexities of provisional tax, and to demonstrate the types of issues commonly confronting small businesses at various stages of their development.

1.8 The scenario consists of a five year time line starting from 1 July 1994 and charts the course of the business's income and tax liabilities for a period of five financial years ending on 30 June 1999 (Figure 1). For the purposes of this exercise the following assumptions have been made:

- the new business operator starts out on 1 July 1994 without a provisional tax carryover from any previous employment or enterprise, expands in his/her first three years of operation before suffering a moderately severe reduction in income in year four;
- the tax rates for each year are assumed to remain at 1994/95 rates throughout,
- the provisional tax uplift factor is 8% throughout; and
- the Medicare levy, rebates, other taxes and imposts, for example: PPS, RPS, PAYE, WST, SG, and so on are not included in the calculations.

1.9 The new business will probably not pay provisional tax within its first year of operation. This is in spite of subsection 221YC(4) of the ITAA, which requires a new business (or more precisely, a taxpayer who did not earn more than $1,040 other than from salary or wages in the previous year of income), which has earned assessable income in excess of $1,040 up to 31 March in the year of income, to furnish a return estimating its income for the first year of income. The *Australian Federal Tax Reporter* comments in this regard that as a matter of practice, the Commissioner does not require such returns to be furnished.'

1.10 If the new business pays no provisional tax in its first year of operation, the tax assessment for that year arrives sometime in late 1995 or early 1996, depending upon when the tax return was lodged and how long it has taken the Tax Office to process. It is accompanied by a notice informing the new business operator of an impending liability for provisional tax which will become payable no earlier than 31 March 1996.

1.11 The income tax assessment for 1994/95 turns out to be $9,802, payable no earlier than 31 March 1996, and the actual provisional tax assessment for 1995196, based on an 8% uplift of the previous year of income, amounts to $11,178. Because there was no provisional tax paid in 1994/95 in relation to 1993194, provisional tax for 1995196 becomes payable as a lump sum, regardless of the amount payable. The provisional tax owing is also payable no earlier than 31 March 1996.

1.12 In year two, 1995/96, income rises slightly to $41,500. The tax liability payable within that year of income is $9,802 + $11,178 = $20,980, just over 50% of the taxable income for that year. The tax liability of $20,980 which becomes payable in year two is entirely a result of the $40,000 of taxable income in year one, which would be payable regardless of the level of taxable income in year two. Had the business's taxable income for year two been $20,980, then the tax liability would have been 100% of the taxable income for that year, unless the taxpayer had lodged a request for a variation for that year.

1.13 When the tax liability exceeds $8,000 for a financial year, the provisional tax for the following year becomes payable by quarterly statements, commencing no earlier than 1 September of that (the flowing) year. Liability to pay an instalment does not arise unless the 3x Commissioner serves an instalment notice on the taxpayer.

1.14 Year three will be the first year in which the new business is drawn into quarterly instalments because the amount of provisional tax paid in year two was greater than $8,000. Each of the first three instalments in this case amounts to 25 per cent of $11,178, which is $2795.

1.15 Because taxable income for year two, 1995/96, did not increase by the 8% predicated by the provisional tax uplift factor, the income tax assessment for that year will result in a refund in year three (1996/97) of $731. Nevertheless, the tax uplift factor applied to the taxable income in year two results in the final instalment for year three rising to $3,490 in order to discharge the actual provisional tax liability for year three.

1.16 Year three is successful and taxable income for that year is assumed to be $65,000.

1.17 The business suffers a moderately severe decline in income in year four (1997/98) to $45,000. from the previous year's high of $65,000. The income tax assessment for year three, based on a taxable income of $65,000 is $21,152 less provisional tax already paid ($11,875) , leaving $9,277 owing by no earlier than 1 February 1998. The taxpayer also receives a notice of a forthcoming provisional tax liability for 1997/98 of $23,596. Assuming that the first three instalments of $2969 each (one quarter of $11,875) have been paid, the final instalment for year four, due on 1 June 1998, will be $14,689. The total amount of tax payable within year four, based on taxable income for year three, is $9,277+$23,596=$32,873, and will be payable out of the taxable income of $45,000.

1. 18 The first three instalments for year five (1 998199) will be no more e actual provisional tax for 1997/98 than $5,899, or 25 per cent of the actual provisional tax for 1997/98 Income tax for year four is assessed at $11,95. Because of the large amount of tax paid in the previous year, the business will now receive a refund of $11,644 ($23,596 - $11,952). Assuming that the tax assessment for the previous year and the notice for the third instalment are received shortly after the second instalment has been paid, the instalment notice for the third quarterly payment will be calculated on the basis of actual provisional tax for yearfive, $13,500.

1.19 The third instalment must be calculated on the basis of actual provisional tax rather than estimated provisional tax, unless the former results in an instalment that is greater than $5,899. In this

case, the amount to be paid in the third instalment must be 75 per cent of the actual provisional tax liability for year five, less any amount already paid, hence:

($13,500 x 75%) - ($5,899 x 2) = $10,125 - $11798

= - $1,673

1.20 Accordingly a refund of $1,673 will eventuate from the third instalment. The final instalment on 1 June 1999 will be the amount outstanding for that financial year, ie**:** $13,500 - $10,125 = $3,375. Taxable income for the year is assumed to be $50,000**.**

1.21 A summary of the business's taxable income for each year vis a vis the tax liabilities that became payable within those years of income is shown in Table 1.1.

Table 1.1 - Summary of taxable income for each year and provisional tax liabilities due within each of those years.

Year of Income	Taxable income	Tax payments due within the Year of income
Year one (1994/95)	$40,000	Nil
Year two (1995/96)	$41,500	$20,980
Year three (1996/970	$65,000	$11,144
Year four (1997/98)	$45,000	$32,873
Year five (1998/99)	$50,000	$1,856

1.22 Other factors affecting the operation of provisional tax include:

- Late payments may be subject to late payment penalty tax plus interest.
- Quarterly payments of provisional tax are calculated on the basis of estimated provisional tax, ie: provisional tax liability of the previous year, unless actual tax is known. Any revised quarterly instalment amounts will not exceed the instalments due on the basis of the previous year's provisional tax. If actual provisional tax is less than estimated provisional tax, quarterly instalments can be reduced. The final instalment for a year of income will be the balance of the total provisional tax payable for the year.
- A taxpayer can request one variation at any time during the year of income, based on estimated income for the year. Should the taxpayer underestimate taxable income by more than 15 per cent, additional tax may apply. The taxpayer may request a remission of that additional tax. Non-payment of additional tax may result in penalty tax plus interest.

C*onclusion*

1.23 A number of important issues emerge from this exercise. Unless a new business takes advantage of an unenforced requirement in the ninth month of the first year to furnish a return estimating its income for he first year of income, and to pay the liability resulting from the Subsequent assessment, a lump sum tax liability arising from the combined taxable income for both the first and second year of operation mill be incurred. This was cited in numerous submissions to the Committee as a major factor for the failure of new businesses.

1.24 Another issue which emerges is that the current system accrues tax liabilities at a rate which is unrelated to current cash flows. Notwithstanding a final assessment and the option to lodge an

application to vary provisional tax, cash flow problems generated by a decline in income will be compounded by provisional tax which is related to previously higher incomes. Conversely, cash flow in a year in which income rises will be assisted for the main part of the year, before the fin assessment is received, by lower levels of provisional tax resulting from lower taxable income in the previous year.

1.25 The establishment of parity between wage and salary taxpayers and other taxpayers through the provisional tax system is, as the Beddall Committee points out, a legitimate objective which aims to limit the tax deferral advantages derived by non-salary income. It is questionable, however, whether this objective is fulfilled when cash flows and income are not aligned with tax liabilities. Incomes from wages and salaries are rarely subject to the volatile fluctuations which characterise much of the provisional taxpaying sector. In the PAYE sector tax is deducted very much in alignment with receipts whereas provisional tax is remitted in accordance with levels of income from two years prior.

Timing of Provisional Tax Payments Under The Existing System

1.26 In evidence to the Committee, SBP State Council Inc. and the Australian Earthmovers & Road Contractors Federation asserted that the timing of quarterly payments of tax instalments one month before the end of the quarter to which they relate means that in theory tax is payable on income earned in the quarter one month before the end of that quarter.

1.27 Since provisional tax is based upon the previous year's actual provisional tax, which in turn is based upon the income received in the preceding year, and since there is no guarantee that a small business will be able to maintain its income, let alone fund its liabilities, the Committee considers that some more leeway should be introduced into the current quarterly instalment regime.

1.28 As already noted, the provisional tax system was implemented as an equity measure to ensure parity with the PAYE system applying to salary and wage earners, and was intended to reduce the advantage perceived to accrue to earners of unincorporated business income by reason of the deferral of tax liabilities arising from earnings.

1.29 A number of submission advocated that the provisional tax system revert to payment of tax in arrears. Arguments used in support of this suggestion included the following points:

(a) For wage and salary earners, the earning and the receipt of income happens at the same time - this is not so for many small businesses who are taxed on income earned or derived, before money is actually received.

(b) Provisional tax takes effect in the second year of a new business when the business is expanding, thereby withdrawing large amounts of working capital when it is most needed, frequently forcing small business operators into debt financing or asset sales.

(c) Provisional tax, which is based on the previous year's taxable income, can place a severe strain on the cash flow of a small business which is experiencing a decline in income. The option of lodging a variation is fraught with danger in the early part of the year because of the penalties which apply if the revised self-assessment understates income by more than 15 per cent. The subsequent tax credits available to businesses which do not apply for a variation may come too late to be a useful remedy.

1.30 Despite these arguments, the Committee considers that it would :)t be appropriate to revert to a system of paying all tax in arrears because of the deferral of a large amount of revenue to the ATO and because such a system is inequitable vis a vis PAYE taxpayers.

1.31 However, the Committee does believe that a significant problem as in the fact that the existing deadlines for quarterly remittances, which commence one month before the end of the quarter in which they are aid, place undue strain on small businesses because the tax liabilities become due and payable not only before income is received but, for the ninth of September, before it is earned/derived.

1.32 When asked about the reason for the 1 September deadline, treasury gave evidence that it may have been designed to ensure that over a 12 month period there were four instalments that roughly fitted into a financial year. In addition, Treasury commented that since the instalment was based on income two years prior, and if income were generally rising, the instalment represented a quarter of the income for two years prior, which may compensate the taxpayer for not having received some of the income for the current quarter.

1.33 Neither argument appears sustainable. The Committee believes that the fact that a quarterly regime commencing on 1 September fits into a financial year is not a relevant consideration. Quarterly company tax payments have been brought forward to straddle years of income, now commencing toward the end of the year of income to which they relate, conforming with the Government's policy to improve the equity of the tax payments system vis a vis provisional taxpayers, amongst others.

1.34 The assumption that incomes will generally rise seems unjustified. During a recession the entire economy contracts and this is reflected generally in reductions in business income. Information supplied by Treasury (summarised in Tables 2.1 and 2.2, pages 26 & 27), demonstrates that the entire provisional tax paying sector has experienced a number of downturns in the last 6 years. This tendency is even more pronounced within the provisional tax sector, particularly within primary production which is subject to the vagaries of climate.

1.35 Accruals based accounting is now an integral part of the tax accounting system. Whatever deadlines for the quarterly provisional tax instalments are chosen will therefore result in the payment of tax before all relevant income is actually received, notwithstanding a minor tax deferral advantage which is gained vis a vis salary and wage earners who pay as they receive their income. The Committee considers that this deferral advantage should not be overstated, as it is more than offset in many instances by the uncertainty in the source, quantum and regularity of business income. A more appropriate deadline would allow for income to be derived, and for a standard term of credit to elapse, before tax becomes payable.

Recommendation 1.1:

The Committee recommends that where provisional tax is payable in quarterly instalments, the earliest due dates be 30 October, 30 January, 30 April of the year of income, and 30 July immediately following the year of income.

Tax office Proposal - PAYG

1.36 in response to many requests made by small business representatives for alternative payment arrangements to provisional tax, the Tax Office issued a discussion paper proposing a pay-as-you-go (PAYG) system (Appendix 111). PAYG would apply to all unincorporated non-salary/wage earners. Under the Government proposal a taxpayer could choose to come under the PAYG arrangements, enabling self assessed payments to be made, the pattern (monthly, quarterly, biannual) for which would be chosen by the taxpayer as long as it was also suitable to the ATO. Payment patterns would be tailored to suit the taxpayer's income stream, and payments would be calculated on actual tax payable in the period. There will also be an option to switch payment patterns and between systems of payment. Most, if not all of tax payable within a year of income must be paid. within the year of income, although the ATO has indicated that 90 per cent may be sufficient payment within the year of income with the shortfall being paid by 30 November.

1.37 Reactions to this proposal have been generally favourable. The South Australian Economic Development Authority supported the PAYG proposal, principally because the proposal would enable a small business to deal with cashflow problems more effectively (Table 1.2). As illustrated, the advantage of the PAYG system is that tax liabilities fluctuate in line with cash flow. This is in contrast to the unsynchronised accrual of liabilities evident in the current provisional system.

Table 1.2 - Comparison of timing of tax payments under the provisional tax system and under the proposed PAYG system.

Year of Income	**Taxable Income**	**Tax Payments Current System**	**Tax Payments PAYG System**
Year One	$40,000	Nil	$8,822
Year Two	$41,500	$20,980	$10,383
Year Three	$65,000	$11,144	$20,082
Year Four	$45,000	$32,873	$12,872
Year Five	$50,000	$1,856	$13,887

1.38 PAYG has been endorsed by the Australian Society of Certified Practising Accountant, and the Taxation Institute of Australia (TIA), both of whom were appreciative of the response by the ATO to submissions put to it by various professional bodies.

1.39 However, Mr Paul Greenwood, recently of COSBOA**,** told the Committee that he was disappointed with the proposal:

... because it is trying to collect the tax within the year of income and allow flexibility within the year of income when the problem is that the payment should be after the year of income ... It has not recognised the fag between earning and receiving ... The problem is that it is relying all the time on estimated income ... You cannot know your true income until after the end of the year, lots of things change. You are having to pre-estimate all the time. If you cannot pre-estimate then last year plus an uplift factor automatically applies. If your income is fluctuating, as it has been in the small business sector - it is a volatile area - how do you get to that 90 per cent figure?"

1.40 The Committee is concerned that the narrow margin of error in estimating taxable income within the year of income could impose additional compliance costs upon small business. This may happen because a small business may have to establish two or more sets of comparative accounts as a precaution against underestimating its PAYG liabilities. At the very least, record keeping would need to be meticulous and ongoing, and therefore probably more time-consuming than is currently required. Although this may increase compliance costs, it may also encourage 'small businesses to get a better handle of their finances. In order to be able to pay tax as they go, they are going to need to understand their income as they go, so ... that is an important side benefit of this sort of proposal'.

1.41 However, while endorsing the concept of PAYG in principle, the Committee considers that a greater margin of error needs to be allowed in estimating projected income for the final quarter to allow for unfamiliarity which will occur with the transition to new tax payment arrangements and for the volatile cash flow situations which are endemic much of the provisional taxpaying small business sector.

Recommendation 1.2:

The Committee endorses the concept of PAYG as an option and recommends that:

(i) the proposed PAYG system be refined to enable maximum flexibility of voluntary payment arrangements to recognise the reality of the volatility of small business incomes and the difficulties encountered by small businesses in containing compliance and accounting costs; and to this end

(ii) the proposed PAYG system allow flexibility to small businesses in estimating their end of year instalment; and

(iii) small businesses be ensured of retaining any provisional tax credits upon electing to enter the PAYG system.

The Winegrape Growing Industry

1.42 As an example of the complexities of provisional tax, and its impact on a particular industry which is largely comprised of small businesses, the evidence received from the Winegrape Growers' Council of Australia (WGCA) is considered in detail as follows. 11

1.43 In the past, most of the grapes grown by small enterprises were purchased by major co-operatives and growers had few problems with the provisional tax system. For tax purposes, growers had accounted for their income on the basis of cash accounting (that is, when they were paid by the wineries). Two things then happened, there was a demise in co-operative wine purchasing and the ATO ruled that accrual accounting was more appropriate for income from grape sales.

1.44 While certain concessions w ere made by the ATO to facilitate this changeover, problems associated with the seasonal nature of grape and South growing were exposed. In New South Wales, Victoria Australia, wineries pay grapegrowers on 30 April, 30 June and 30 September following the purchase of grapes**.** As lump sum provisional tax is payable on 31 March, the problem occurs that none of the payments have been made for the income which has accrued to the grower. The tax liability for payments outstanding must therefore be paid before receipt of that income, often through debt financing.

1.45 Although the ATO was willing to grant extensions of time for the growers to pay their tax liabilities, their request that their income be assessed on the basis of cash accounting was rejected by the Parliamentary Secretary to the Treasurer.

1.46 During evidence given to the Committee, the Council commented that:

> it is not just the normal situation of provisional tax being paid in advance of earning the income to which it applies. It is actually provisional tax being paid without the cash flow of the year befores income being available.

1.47 The main problem, therefore, is that the industry payment structure straddles the end of the year of income.

1.48 While there seems to be no problem in requesting dispensation for an extension of time in which to make tax payments, the Committee agrees that the unique seasonal nature of the industry combined with its move into accruals based accounting makes this an inappropriate remedy, particularly as virtually each grower would have to request an extension every year. The Committee considers that either the proposed PAYG system or a substituted accounting period would be more appropriate for the circumstances.