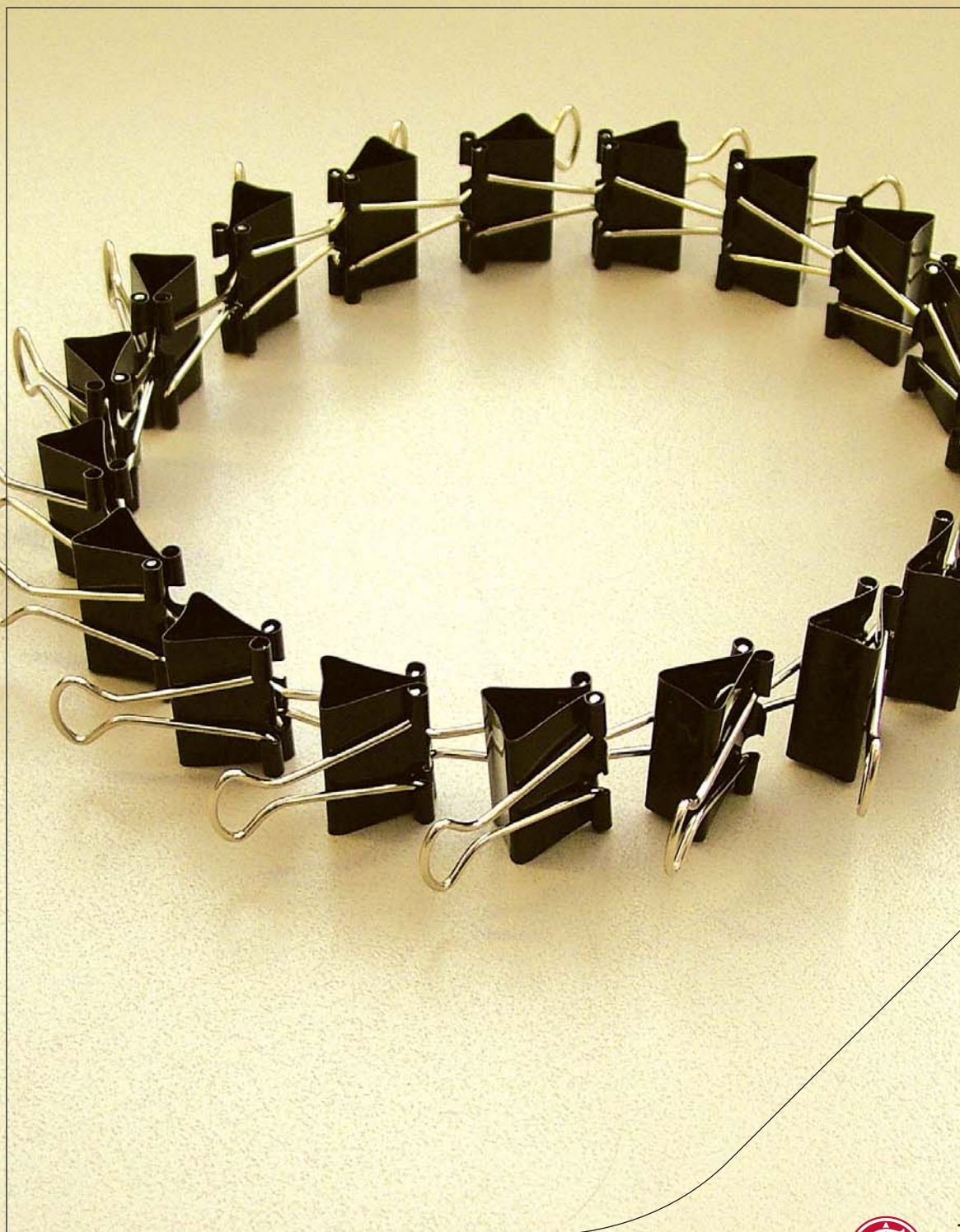


The Institute of Chartered Accountants in Australia

Research and recommendations on definition of small business



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**The Institute of
Chartered Accountants
in Australia**

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About this report

Associate Professor Neil Warren, Senior Lecturer Garry Payne and Senior Lecturer Helen Hodgson of Atax, Faculty of Law, the University of New South Wales in Sydney, Australia have prepared this report.

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Research and Recommendations on Definition of Small Business

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Foreword

Small businesses constantly identify the complexity of the taxation system, and the cost of compliance associated with it, as one of their main causes of concern.

The complexity of the taxation system for this sector lies historically in Commonwealth governments providing concessions for small business that are implemented through the taxation system. This has resulted in different definitions being used to identify small businesses on a provision-by-provision basis for a variety of purposes.

The Institute commissioned Atax, Faculty of Law, University of New South Wales, to develop a definition of small business that, within the constraints of policy aims and provisions, can be used consistently throughout Australia's income tax (including capital gains tax (CGT)), fringe benefits tax (FBT) and goods and services tax (GST) legislation.

The report, written by Associate Professor Neil Warren, Senior Lecturer Garry Payne and Senior Lecturer Helen Hodgson, covers the current definitions of small business, simplifying the definition, recommendations, sample legislation and the impact of proposals.

The Research and recommendations on definition of small business is part of the Institute's thought leadership initiatives. It provides the basis for lobbying for the reduction of the regulation and compliance burden on business and the accounting profession.



Stuart Black FCA

President 2005

The Institute of Chartered Accountants in Australia

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Executive summary

The manner in which tax laws identify small business on a provision-by-provision basis adds considerably to the complexity of the law and the compliance burden on small business.

This report focuses on a key aspect of increasing simplicity in relation to small business tax concessions — improving access and reducing compliance costs through consolidating and simplifying the definition of small business, to the maximum realistic extent, in Australia's income tax (including capital gains tax (CGT)), fringe benefits tax (FBT) and goods and services tax (GST) legislation.

The report does not debate whether concessions should exist or new concessions should be introduced. It is solely concerned with making access as consistent as possible.

Australian research

Detailed research was conducted to identify all main concessions in Australian tax laws that depended to any degree upon the size of a business. For each concession identified, size-related access criteria and any supporting anti-avoidance provisions were isolated and government or quasi-government published material examined to learn whether any official rationale was provided for the criteria or thresholds adopted.

The results clearly demonstrated the variety, complexity and inconsistency of the tests used. It emerged that very little policy rationale is ever publicly given for choice of particular criteria and there is no 'magic' involved with the choice of a particular threshold, as many were altered a number of times during the consultation process or passage through parliament.

The report also examined data collected by the Australian Taxation Office (ATO) and the Australian Bureau of Statistics (ABS) on small businesses and small business clients of a number of accounting practices to gain some insight into how many businesses are likely to be impacted by any legislative changes and the possible consequences for other stakeholders.

Overseas comparison

In considering potential definition options, comparative research was undertaken on three overseas jurisdictions with similar market-driven economies, legal systems and business philosophies to Australia. Identification of small business for non-tax purposes was also considered.

It was found that the problems faced by Australia were not unique. A list of potential criteria on which to base a simplified definition of small business was compiled and evaluated. A further outcome of the international study was to raise the possibility of more beneficial treatment where a simpler structure has been used by a small business.

Key findings

A key finding was that the current myriad definitions of small business, with multiple inconsistent criteria, definitions and thresholds, appears to be in large part a result of the process that takes place when concessions, preferences or other small business provisions are introduced.

It was also found that some concessions are of such a vastly different nature that valid reasons can exist for using different criteria, using more than one criterion or using different thresholds.

Reducing the problem of inconsistency and complexity therefore needs to involve two steps:

1. Consolidating and simplifying criteria and their meaning (to the extent possible)
2. Addressing the process of definition (to minimise future deviations).

The essential elements of any simplified definition of small business must include:

- > The criterion (or criteria) that is to be used
- > The meaning of that criterion (or criteria)
- > The threshold for the criterion
- > Grouping provisions — to avoid manipulation
- > Flexibility — to allow for new concessions or departures from the norm.

Key recommendations — technical criteria

Minimum upheaval from the existing position, advantages and disadvantages of each possible criterion, desirability of marrying the income tax and GST systems as much as possible, and the number of concessions to which it can be applied and ease of application, lead to the conclusion that turnover should be the main criterion for access to small business concessions. In some cases, policy reasons dictate that this be supplemented or replaced with an assets test.

Precise thresholds for turnover and assets are a policy decision and do not impact upon, nor should they be used as a diversion from, the prime goal of a simplified definition. Hence, while the report suggests and uses a basic turnover threshold of \$2m and an assets threshold of \$6m in drafting a sample proposed new definition, the suggested form of this definition allows for deviations and perhaps higher thresholds for other concessions where justified.

Key recommendations – grouping

After examining a number of potential approaches to drafting a grouping provision intended to have universal application, it was concluded that the preferable approach was to review the current grouping measures and reflect the tests used, but in a simplified manner. This simpler approach incorporates the following features:

- > Easy readability – use of clear, commonly understood terminology
- > Succinctness
- > A logical arrangement and progression
- > Use of general concepts that can, nevertheless, be readily applied and that a court could easily interpret if required
- > Prima facie rules that give certainty as to how to apply the general concepts – but being prima facie rules, they are capable of being overturned in an appropriate situation to reflect the underlying substance of the primary tests.

Key recommendations – process of definition

There are three key points for achieving simplification through the process of definition, despite allowing for some deviation:

1. Consolidate all the relevant access definitions in a single area, so that business or their advisors can easily view all the concessions for which they will or will not potentially qualify (subject to any non-size-based criteria that remain in the individual operative provisions) and be aware of different access criteria. As the definition is to have effect for a number of Commonwealth tax laws, a separate Act is proposed.
2. If there is to be deviation, treat it as such – in other words, commence with the basic definition and use it to the maximum extent possible, rather than writing completely separate and different definitions.
3. Focus parliamentary attention on the fact that there is deviation – this is very important when introducing new concessions, as it means any deviations from the basic definition would need to be justified.

Sample new legislation

A preliminary draft of a ‘Small Business (Definition) Act’ has been provided that demonstrates the methodology and uses the uniform criteria recommended in the report.

This preliminary draft is not meant to be ‘perfect’ or final legislation, nor does it attempt to detail every small business concession that can be brought within its format. It is simply sample legislation that demonstrates and implements the approach and criteria recommended.

If, after wider distribution, the approach suggested in this report is accepted, this draft legislation may, with appropriate feedback, form a suitable base for fine-tuning to finalise a new definition.

Part 1 – Introduction

1.1 Background

Atax has been commissioned by The Institute of Chartered Accountants in Australia to develop an alternative definition of small business, capable of consistent application, to the maximum extent possible, throughout Australia's income tax (including CGT), FBT and GST legislation.

Small business is often described as the engine room of the Australian economy. Using the Australian Bureau of Statistics criterion of a business that employs less than 20 people, Australia has around 1.2 million small businesses. In the private, non-agricultural sector, the vast majority of businesses (over 95 per cent) are described by the Commonwealth Government as small businesses. Their importance to the economy is demonstrated by the fact that they account for almost half the employment in that sector and around a third of Australia's total economic activity.

It is not surprising, therefore, that all Commonwealth Governments, of every political persuasion, have, for both political and economic reasons, sought to support and encourage small business. It is equally not surprising, given that it is one of the Commonwealth's most important constitutional powers, that this support has often been implemented through the taxation system.

It is often stated that there are three criteria by which a good tax system can be judged:

1. Equity – horizontal and vertical
2. Neutrality (or efficiency)
3. Simplicity.

Small business tax concessions will usually, by their very nature, inherently breach the first two criteria. The desirability or otherwise of that is a matter for political judgment as to the offsetting benefits to the country as a whole and is not the subject of this report, which accepts the concessions (or sometimes restrictions) that do exist.

Simplicity, however, is usually the poor relation to other criteria when tax legislation is being drafted. The myriad of different size-based criteria that determine which businesses can access the various small business concessions proves this point.

Nevertheless, the complexity of the tax system and the compliance costs associated with it are constantly referred to by businesses of all sizes, but particularly small business, as one of their major causes of concern.

This report focuses on one key aspect of simplicity in relation to small business tax concessions – the desirability of consolidating and simplifying the definition of small business. The primary aim is to improve access to the concessions that do exist and consequently reduce compliance costs, although adoption of a more uniform definition should also have flow-on benefits for the equity and neutrality criteria.

1.2 Scope of report

The focus of this research report is to review the manner in which small business is defined, explicitly or implicitly, in Commonwealth income tax (including CGT), FBT and GST legislation, with the aim of meeting the following objectives:

- > Identify current tax concessions for small business and examine their eligibility criteria
- > Propose consistent criteria (wherever possible) for access to and application of the identified concessions
- > Draft the proposals in a format suitable for presentation to policy makers, including draft legislation where appropriate
- > Apply the draft proposals to a series of hypothetical business case studies so as to determine the effect on compliance costs of the business and any flow-on economic impacts.

This report is **not** concerned with whether small business concessions should exist, whether the existing concessions are meeting their aims or whether new concessions should be introduced. It is solely concerned with access to the concessions, in particular trying to make access as consistent as possible.

1.3 Research methodology

The methodology adopted in carrying out the above tasks was as follows:

1. Identify all existing provisions (primarily concessions) in the income tax (including CGT) GST and FBT law that directly or indirectly, explicitly or implicitly, in whole or in part, depend upon size of a business as a qualifying criterion for their application.
2. Isolate the qualifying criteria within these provisions that could be described as depending on a business as being of a smaller size (without limiting the parameters of that concept) than other businesses for their satisfaction.
3. Classify the isolated criteria into those that:
 - > Constitute the prime tests for access
 - > Support the prime tests or ensure they are not avoided, manipulated or abused.
4. Describe these criteria in sufficient detail to enable comparison of the different criteria being used to access the identified provisions, both in terms of whether:
 - > The criteria themselves are fundamentally different
 - > Their definition is fundamentally different.
5. Research government published material to see if it provides any official reasons as to why certain size-dependent criteria were or were not used as the basis for access to identified concessions, why specific thresholds were adopted for those criteria, or why the chosen criteria were defined in the way they were, such as:
 - > Explanatory memoranda
 - > Second reading speeches
 - > Parliamentary debates
 - > Government announcements
 - > Government commissioned reports.

6. Tabulate the information gathered in Steps 1 to 5 in order to:
 - > Clearly demonstrate the variety, complexity and inconsistency of the tests used in defining small business in Australian tax laws
 - > Form the basis of the analysis in Step 7, as a prelude to recommendations for a consolidation and simplification of these tests.
7. Analyse the information from Steps 1 to 6 to determine:
 - > Criteria that have been treated as important or most important
 - > Reasons these criteria were treated as important
 - > The extent to which common threads exist between provisions
 - > The degree of thought given (or at least made public) to the choice of particular thresholds for individual criteria
 - > Whether reasons exist for adopting different criteria
 - > Whether reasons exist for adopting different thresholds for the same criteria
 - > Whether reasons exist for applying/defining the same criterion in a different manner when used in different provisions.
8. Identify and examine other provisions, within the same tax laws, that primarily affect smaller businesses, even though capable of application to larger businesses, to see if they:
 - > Should be included in the consolidation or simplification process
 - > Contain tests or rationale that may be useful in that process.
9. Identify criteria used in other countries that provide tax concessions based to some degree on size of business, particularly countries that have similar economies, philosophies or modes of doing business to Australia, to see if:
 - > The same problems exist
 - > Any solutions have been found
 - > Criteria not presently being used in Australia should be considered.
10. Identify criteria used for non-tax purposes to define small business to see if they could potentially be applied in a tax environment (this has been limited primarily to criteria used for government statistical reporting at this stage, as endeavouring to create consistency across all business laws is beyond the scope of the present report).
11. List potential candidate tests for defining small business for tax purposes as derived from both those presently being used (see Steps 1 to 8) and those used elsewhere that could be considered (see Steps 9 to 10).
12. Evaluate the advantages and disadvantages of each potential criterion in the light of:
 - > The analysis in Step 7 (i.e. existing criteria and their justification)
 - > The goal of simplification
 - > Other relevant considerations.
13. Recommend, in the light of the full research and analysis process:
 - > The best criterion or criteria to identify small business for tax purposes
 - > The most appropriate manner in which to define that criterion or those criteria
 - > The most appropriate thresholds to adopt for a particular criterion
 - > Other matters it may be essential to include in any simplified definition, such as:
 - Anti-avoidance provisions
 - Permissible departures from the norm.
14. Prepare draft legislation to implement a simplified definition that:
 - > Incorporates the simplified criteria (as recommended in Step 13)
 - > Is located in a manner that reflects its relevance for a range of purposes across a range of tax statutes
 - > Facilitates its interaction with individual concessions
 - > Is flexible enough to deal with the introduction of new concessions
 - > By its nature, minimises departures from the norm, now and in the future.
15. Test the appropriateness of or any problems with the proposed new definition by evaluating its impact on a range of hypothetical business scenarios, undertaking stakeholder consultation and analysing any available ATO and ABS data.

Part 2 – Current definitions

2.1 Current position – overview

An overview of broad criteria and thresholds currently used to limit access to tax concessions, or to provide preferential treatment in relation to tax obligations, based on size of a business, is provided in Table 1. A more detailed description is provided in Table 2, later in this report (see 2.3).

Table 1: Overview – Major small business tax concessions – access criteria

Item ¹	Concession	Size-based criteria and thresholds		
		Turnover ² \$	Assets ² \$	Other criteria \$
1.	Simplified tax system (STS)	1,000,000	3,000,000	–
2.	STS taxpayer – entrepreneurs' tax offset	75,000	<i>Per STS</i>	–
3.	STS taxpayer – prepayments (< \$1,000)	<i>Per STS</i>	<i>Per STS</i>	–
4.	CGT small business concessions	–	5,000,000	–
5.	R&D tax offset	5,000,000	–	1,000,000 (R&D spending)
6.	Debt/equity rules – at-call loans	20,000,000	–	–
7.	PAYG remittance – medium withholder	–	–	1,000,000 (amts withheld)
	PAYG remittance – small withholder	–	–	25,000 (amts withheld)
	PAYG instalments – annual	–	–	8,000 (notional tax)
8.	GST – non-compulsory registration	50,000	–	–
9.	GST – annual tax periods	50,000	–	–
	GST – quarterly instalments (estimates)	2,000,000	–	–
	GST – quarterly tax periods	20,000,000	–	–
	GST – non-electronic lodgment	20,000,000	–	–
10.	GST – cash accounting	1,000,000	–	–
11.	GST – ITCs – financial acquisitions	–	–	50,000 (input tax credits)
	GST – ITCs – annual apportionment	2,000,000	–	–
12.	GST – simplified accounting methods	2,000,000	–	–
	GST – business norms method	1,000,000	–	–
13.	FBT – car parking	–	–	10,000,000 (ord + stat inc)
	FBT – record-keeping	–	–	5,000 + index (agg FB amt)
	FBT – annual payment	–	–	3,000 (FBT previous year)

¹ Refer to Table 2 under same Item number for more detail (see 2.3).

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

Table 1 clearly demonstrates the lack of consistency in adoption of criteria and thresholds. Nevertheless, Table 1 is still only a very condensed summary that belies the true complexity of the situation.

Greater inconsistency and complexity arises from the fact that the thresholds indicated for individual concessions or preferences are not directly comparable, even when based on the same broad criterion, as each criterion is itself invariably defined or applied in a different manner for the purposes of each provision.

Table 1 also does not demonstrate complexities associated with determining exactly what business the thresholds are applied to, namely individual business entities or overall business group structures, and how the limits of the latter are to be determined.

Table 2, under the heading 'Qualifying criteria and policy rationale – detailed description' (see 2.3), more fully indicates the existence of these other complexities.

2.2 Small business tax policy – major reports

As a prelude to a detailed examination of the myriad of qualifying criteria currently being used for small business tax concessions or preferences and their expressed rationale (if any), it is desirable to briefly document the broad development of small business tax policy over recent years.

The following major reports or reviews all considered to some degree what should be regarded as a small business.

Senate Committee: A question of balance – 1995

Various small business definitions for different purposes were noted:

- > The ABS used different definitions for non-agricultural and agricultural sectors:
 - for the non-agricultural sector, small business was defined by reference to number of employees:
 - < 20 employees (non-manufacturing industries)
 - < 100 employees (manufacturing industries)
 - for the agricultural sector, small business was defined by reference to value of agricultural operations: between \$20,000 to \$399,000 estimated value (*ABS Small Business in Australia 1993*)
- > Small businesses, according to the combined ABS definitions, were estimated to account for about 96 per cent of all businesses in Australia
- > The ATO defined a small business as one returning business income of < \$10m.

Bell Report – 1995

The task force defined a small business as having the following characteristics:

- > Independently owned and operated
- > Most, if not all, capital contributed by owners and managers
- > Closely controlled by owners/managers who make principal decisions
- > Turnover less than \$10m.

Most small businesses have fewer than 20 employees in non-manufacturing industries and fewer than 100 employees in manufacturing industries.

The report determined that taxation was one of the two main sources of compliance burden, with industrial relations (IR) being the second.

Reform recommendations emerging from this report included:

- > FBT simplification
- > PAYG simplification (incorporated as part of A New Tax System (ANTS))
- > CGT record-keeping simplification
- > Uniform provisions across taxation legislation.

The government responded to the Bell Report in March 1997 with a response entitled *More Time for Business*, accepting many of the report's recommendations.

Ralph Review of Business Taxation – 2000

Small Business was not defined as such, but the small business chapter refers to:

- > Businesses with a turnover of less than \$1m as representing over 95 per cent of business (this figure was later queried – see CPA Australia submission).

Reference was also made to the need for grouping as an integrity measure.

2.3 Qualifying criteria and policy rationale – detailed description

Table 2, below, provides a full description of the size-based criteria that must be satisfied to qualify for access to all of the current major small business tax concessions identified in Table 1 (see 2.1).

Table 2 looks at the exact criteria used, the amount chosen as the threshold to measure satisfaction or non-satisfaction with each criterion, and any additional tests that have been employed in conjunction with these basic size-based access criteria to support their operation (as opposed to rules that are merely part of the technical operation of the concession unrelated to size-based access).

Corresponding with this analysis, Table 2 also details results of research into the policy behind the introduction of each concession, focusing on the reasons (if any) publicly expressed as to why the criteria used were selected and in particular why the specific threshold adopted was chosen.

A detailed overall analysis of the information in Table 2 is located in segment 2.4 of this report, immediately following Table 2.

Table 2: Major size-based business tax concessions

Basic tests	Additional tests	Policy rationale
1. Simplified tax system (STS)		(Div 328 ITAA 1997)
<p>Any business entity:</p> <ul style="list-style-type: none"> > Individual, company, partnership or trust <p>Eligible if:</p> <ul style="list-style-type: none"> > Carry on business in current year > Average turnover any three of four preceding years < \$1m pa <ul style="list-style-type: none"> – Alternative test — projected average turnover in current and following two years < \$1m pa > Depreciating assets at year end < \$3m 	<p>Grouping rules apply to determine average turnover:</p> <ul style="list-style-type: none"> > 'Group turnover' for year is total value of all business supplies made by taxpayer and 'grouped entities' during year <ul style="list-style-type: none"> – Value of business supplies is determined using GST concepts – Turnover is not, however, identical to GST turnover > 'Group turnover' is calculated after making certain 'reductions' <ul style="list-style-type: none"> – Major reduction is for intra-group supplies 	<p>Introduced following the Ralph Review.</p> <p>There is no discussion in the report in relation to the selection of \$1m threshold, although it does suggest that 95 per cent of small businesses would qualify. A table indicates the proportion of small business in various industry groupings that are within the target group. There is no discussion in parliamentary documentation as to what should be considered a small business.</p> <p>The depreciable assets test was included to limit access by big business with large capital outlay and correspondingly low profits in early years. Note that the depreciable assets threshold was raised from \$2m to \$3m following the exposure draft. This was apparently based on the fact that if a business acquires assets during the year, the depreciation claim is halved under the STS, therefore a higher asset threshold was applied.</p> <p>The explanatory memorandum states that the grouping provisions are 'to ensure that ineligible businesses cannot structure or restructure their affairs to take advantage of these benefits. These measures reinforce that the STS is designed for small businesses with straightforward and uncomplicated affairs.'</p> <p>It was originally proposed that the grouping measures be on the same basis as CGT grouping rules, but during consultation on the exposure draft it was modified to refer to STS affiliates — requiring affiliates to act together rather than co-owning assets. The change to an active role, rather than an ownership role, reflects the different purpose of the legislation.</p>
	<p>Grouped entities include those where:</p> <ul style="list-style-type: none"> > Taxpayer controls the entity in the prescribed manner > Entity controls the taxpayer in the prescribed manner > Both are controlled in the prescribed manner by the same entity > An entity could reasonably be expected to act in accordance with taxpayer's directions or in concert with taxpayer (STS affiliate) 	
	<p>Prescribed control tests include:</p> <ul style="list-style-type: none"> > Discretionary trusts are controlled by a person if, broadly: <ul style="list-style-type: none"> – The person has the power to determine how the trustee exercises the power to distribute income or capital to beneficiaries, or – Distributions to the person have exceeded a set threshold > Partnerships have special control tests that basically involve a 40 per cent interests test 	
2. STS taxpayers – 25 per cent entrepreneurs' tax offset		(Subdiv 61-J ITAA 1997)
<p>Any business structure:</p> <ul style="list-style-type: none"> > Sole trader, company, partnership or trust <ul style="list-style-type: none"> – Concession applies to entity that pays tax on business income derived in structure <p>Eligible if:</p> <ul style="list-style-type: none"> > STS taxpayer (so must meet STS criteria and elect to be STS taxpayer) > Annual turnover as measured under STS < \$75,000 	<p>Grouping rules apply to determine annual turnover</p> <ul style="list-style-type: none"> > Same as for STS 	<p>This most recent development was announced during the election campaign, in a policy named <i>Promoting an Enterprise Culture</i>. The reason given for the initiative was to foster the entrepreneurial spirit of small businesses where the turnover is low because the business is in establishment phase.</p> <p>The concession is not limited to businesses in the start-up period. It is available as long as the turnover is below the threshold.</p> <p>It specifically targeted micro-businesses and home-based businesses.</p> <p>There is no reason given for the particular level of \$50,000 (at which the maximum tax offset applies), nor the \$75,000 threshold that arises from the shading-out formula.</p>
3. STS taxpayers – prepayments (< \$1,000)		(s 82KZM ITAA 1936)
<p>Any business entity:</p> <ul style="list-style-type: none"> > Individual, company, partnership or trust <p>Eligible if:</p> <ul style="list-style-type: none"> > STS taxpayer (so must meet STS criteria and elect to be STS taxpayer) 		<p>Refer to policy rationale for STS as discussed in (1.) above.</p>

Table 2: Major size-based business tax concessions (continued)

Basic tests	Additional tests	Policy rationale
<p>4. CGT small business concessions (Div 152 ITAA 1997)</p>		
<p>Any business structure:</p> <ul style="list-style-type: none"> > Sole trader, partnership, company or trust <ul style="list-style-type: none"> – Applies to disposal of asset of entity (or other CGT event) – Individual may also be able to claim for disposal of shares in company or interest in trust <p>Eligible if:</p> <ul style="list-style-type: none"> > Net assets ≤ \$5m > Asset is 'active asset' <ul style="list-style-type: none"> – Shares in company or interest in trust only qualify if entity's own active assets (or proceeds from CGT events relating to them) meet specified tests 	<p>Grouping rules apply to \$5m net assets test – group net assets (with some exclusions) of:</p> <ul style="list-style-type: none"> > Person/entity making disposal > Connected entities > Small business CGT affiliates <ul style="list-style-type: none"> – Spouse (of individual) – Child under 18 (of individual) – Person/entity who acts in accordance with directions, wishes or in concert (other than as a partner) with person/entity making disposal > Connected entities to small business CGT affiliates <p>Partnerships:</p> <ul style="list-style-type: none"> > Partner seeking to access concession must satisfy net assets ≤ \$5m > Net assets of partnership must also be ≤ \$5m <p>If dispose of shares in company or interest in trust:</p> <ul style="list-style-type: none"> > 'controlling individual' must exist <ul style="list-style-type: none"> – Company – individual with ≥ 50 per cent interest in voting, dividend and capital rights – Fixed trust – individual with ≥ 50 per cent interest in income and capital – Discretionary trust – individual has received ≥ 50 per cent of distributions during income year > Concession can only be claimed by 'CGT concession stakeholder' <ul style="list-style-type: none"> – Controlling individual – Spouse of controlling individual <ul style="list-style-type: none"> • Provided has some interest or has received some distributions (any amount) <p>15-year asset concession:</p> <ul style="list-style-type: none"> > Individual – additional tests <ul style="list-style-type: none"> – ≥ 55 years and retire (or permanently incapacitated) – If disposing of company shares or trust interest, 'controlling individual' must have existed for entire period owned > Company or trust – additional tests <ul style="list-style-type: none"> – 'Controlling individual' must have existed for entire period owned – 'Controlling individual' at time of CGT event is ≤ 55 years and retires (or is permanently incapacitated) <p>Retirement (lifetime limit) concession:</p> <ul style="list-style-type: none"> > Individual – additional tests <ul style="list-style-type: none"> – ≥ 55 years <ul style="list-style-type: none"> • No additional tests • No requirement to retire – < 55 years — deemed ETP amount must be rolled over into superannuation fund or ADF <ul style="list-style-type: none"> • No requirement to retire, but gain effectively preserved for retirement > Company or trust — additional tests <ul style="list-style-type: none"> – 'Controlling individual' must exist – ETP (non-deductible) must be paid to 'CGT concession stakeholders' <ul style="list-style-type: none"> • 'CGT concession stakeholder' if < 55 years must roll over ETP into superannuation fund or ADF <p>Replacement asset roll-over concession:</p> <ul style="list-style-type: none"> > If replacement asset is company shares or trust interest, taxpayer (or connected entity) must immediately be 'controlling individual' of that company or trust 	<p>These concessions have evolved from the initial introduction of the former goodwill concession in the CGT legislation.</p> <p>1985 – Australian Democrats negotiated a goodwill concession of 20 per cent discount on the capital gain related to goodwill, where the value was less than \$1m (former s 160ZZR ITAA 1936). No detail is available as to how that figure was selected. The basis of the concession was to recognise that goodwill would have a negligible cost base, and therefore indexation would not assist, and to ensure that there was no disincentive to investment in small business.</p> <p>1992 – One Nation Economic Statement extended to a 50 per cent concession, and was based on \$2m indexed annually 'in recognition of the unique circumstances facing small business owners'.</p> <p>1995 – Bell Report identified that paying CGT on exit from one business restricted capital available to expand/take on new business. It also recognised anomalies between businesses operated through closely held entities and those owned by taxpayers. Investment in business as a form of retirement savings was recognised. A \$5m threshold was first introduced in government response.</p> <p>1997 – Small business exemptions appeared in former Divs 18A and 18B ITAA 1936. They were designed to ensure that a lack of capital does not constrain the growth of small business (explanators memorandum). Roll-over was allowed where active assets were disposed of and replaced within 12 months. Small business was not defined, but a concession was available where the value of all assets was less than \$5m (Press Release No 64 of 1997). Retirement roll-over relief was also introduced for small business – up to \$500,000 could be rolled into a superannuation fund CGT free. The new provisions coexisted with former s 160ZZR.</p> <p>1999 – Ralph Review recommended amalgamating the concessions. It removed the goodwill concession and replaced it with a 50 per cent reduction on active asset gains, and retained the principle behind roll-over and retirement concessions. It applies to 'active assets' used in a 'small business'. It retained the \$5m value threshold from former Divs 18A and 18B.</p> <p>Neither the Ralph Review nor the parliamentary documents give any basis for the criteria used for the grouping provisions.</p>

Table 2: Major size-based business tax concessions (continued)

Basic tests	Additional tests	Policy rationale
5. Research and development tax offset		
<p>Companies only:</p> <ul style="list-style-type: none"> > Includes partnership of companies <p>Eligible if:</p> <ul style="list-style-type: none"> > Annual turnover < \$5m > Annual R&D spending < \$1m 	<p>Grouping rules apply to determine annual turnover:</p> <ul style="list-style-type: none"> > Turnover defined by reference to GST concepts 	<p>(s 73J ITAA 1936)</p> <p>R&D concessions have been in the legislation for many years. The overall policy objective is to encourage innovation in Australia. In 2001 a small business concession was added to the existing regime. The package was based broadly on the recommendations contained in the Innovation Summit report, which assessed the strengths and weaknesses of Australia's innovation system, and the report of the chief scientist who reviewed the effectiveness of Australia's science, engineering and technology base in supporting innovation.</p> <p>One of the findings of that review was that smaller companies involved in R&D were often not able to access the accelerated deduction, as the company was not earning sufficient assessable income to utilise the deduction. The offset option was introduced to assist such companies. The offset is calculated at a rate equivalent to the deduction that would otherwise be available.</p> <p>To be eligible, a company must have R&D expenditure of \$20,000, and any group it is part of must have a total R&D expenditure less than \$1m. Group turnover must be less than \$5m. There is no documentation as to how those thresholds were selected. This was estimated to assist some 600 to 700 companies.</p>
6. Debt/equity rules — at-call loans		
<p>Companies:</p> <ul style="list-style-type: none"> > Annual turnover < \$20m 		<p>(Div 974 ITAA 1997)</p> <p>The original proposal to cut compliance costs was to exclude related party at-call loans from debt/equity rules if CGT net assets were not greater than \$5m and annual deductions were \$100,000 or less.</p> <p>The rationale for the change to a turnover of less than \$20m was consultation with industry and greater simplicity.</p>
7. PAYG — Timing of remittances		
<p>Any taxpaying entity:</p> <ul style="list-style-type: none"> > Individual, company or trustee <p>PAYG withholding:</p> <ul style="list-style-type: none"> > Small withholder – amounts withheld ≤ \$25,000 > Medium withholder – amounts withheld ≤ \$1m <ul style="list-style-type: none"> – Provided not small withholder <p>PAYG instalments:</p> <ul style="list-style-type: none"> > Annual instalments – notional tax < \$8,000 	<p>Grouping rules apply to determine whether amounts withheld ≥ \$1m:</p> <ul style="list-style-type: none"> > Only apply to companies <ul style="list-style-type: none"> – Must be members of same wholly-owned group > Do not change small withholder to medium withholder <p>Commissioner has discretion to change status:</p> <ul style="list-style-type: none"> > Downwards without restriction > Upwards after considering specified matters <p>Grouping rules apply to determine whether a company qualifies for annual instalments:</p> <ul style="list-style-type: none"> > Must not be part of instalment group <ul style="list-style-type: none"> – Majority control of another company or majority controlled by another company – Regardless of combined notional tax 	<p>(Sch 1 Subdivs 16-B, 45-E TAA 1953)</p> <p>The current regime for collection of taxes has evolved through two key developments. The 1995 Bell Report highlighted tax collection systems as one of the key problems facing small business. It recommended simplification of the PAYG system. The 1995 Senate Committee report <i>A Question of Balance</i> also recommended that small business be allowed to opt into a PAYG system.</p> <p>The government accepted the recommendations of the Bell Committee in its March 1997 response <i>More Time for Business</i>, which led to the incorporation of some of the recommendations in the New Tax System reforms.</p> <p>Prior to 2001, company tax was payable on a different basis from other taxpayers. Individuals, including those operating a business through an unincorporated structure, were subject to provisional tax; while companies were able to pay tax after the end of the financial year.</p> <p>In the 1993 election, the ALP released an election statement <i>Investing in the Nation</i> that proposed a shift in the timing of company tax collections.</p> <p>Under the legislation, introduced in 1993, the timing of the instalments was based on the 'notional tax' payable by the company (i.e. based on the tax payable in the previous year).</p>

Table 2: Major size-based business tax concessions (Continued)

Basic tests	Additional tests	Policy rationale
7. PAYG – Timing of remittances (continued)		
(Sch 1 Subdivs 16-B, 45-E TAA 1953)		
		<p>Following the expiry of the transitional period, companies were classified as follows:</p> <p>Small</p> <p>Notional tax < \$8,000</p> <p>Installments 100 per cent of likely tax – 15/12 of calendar year including 30/6</p> <p>Balancing payment Balance of actual tax – 15/3 following year</p> <p>Medium</p> <p>Notional tax \$8,000–\$300,000</p> <p>Installments 25 per cent of likely tax – 1/6, 1/9, 1/12 of calendar year including 30/6</p> <p>Balancing payment Balance of actual tax – 1/3 of following year</p> <p>Large</p> <p>Notional tax > \$300,000</p> <p>Installments 25 per cent of likely tax – 1/3, 1/6, 1/9 of calendar year including 30/6</p> <p>Balancing payment Balance of actual tax – 1/12</p> <p>The figure of \$8,000 notional tax became the basis for the PAYG system that was introduced as part of the New Tax System in 2001.</p> <p>Following the introduction of the BAS reporting system, there was significant unrest as small business started to comply with the new reporting system. Two core problems were that the PAYG payment and the GST payment were required to be calculated on a quarterly (or monthly) basis. However, in February 2001 the government announced the introduction of an instalment basis for taxpayers with a PAYG income of less than \$1m and a GST turnover of less than \$2m and net GST payers. Note that payment is still required at least quarterly, but the calculation is based on notional income/turnover instead of actual income/turnover.</p> <p>Again, no specific reason is given for the selection of these turnover figures, although the explanatory memorandum indicates that they were nominated after extensive discussion with small business and were estimated to be available to 95 per cent of quarterly GST payers.</p>
8. GST – non-compulsory registration		
(Div 23 GST Act)		
<p>All entities carrying on an enterprise:</p> <ul style="list-style-type: none"> > Includes activities in form of a business <p>Registration not compulsory if:</p> <ul style="list-style-type: none"> > Annual turnover ≤ \$50,000 	<p>Individuals must have reasonable expectation of profit or gain:</p> <ul style="list-style-type: none"> > Also partnership if mostly individuals <p>Non-profit bodies have higher threshold:</p> <ul style="list-style-type: none"> > Annual turnover ≤ \$100,000 	<p>This threshold was proposed in the original policy document <i>Not a New Tax, A New Tax System</i>. There is no basis given for the selection of this figure.</p>
9. GST – remittance (tax periods/returns)		
(Divs 27, 31, 151, 162 GST Act)		
<p>Annual tax periods:</p> <ul style="list-style-type: none"> > Annual turnover ≤ \$50,000 <p>Quarterly instalments (estimates):</p> <ul style="list-style-type: none"> > Annual turnover ≤ \$2m <p>Quarterly tax periods:</p> <ul style="list-style-type: none"> > Annual turnover < \$20m <p>Non-electronic lodgment:</p> <ul style="list-style-type: none"> > Annual turnover < \$20m 	<p>GST groups:</p> <ul style="list-style-type: none"> > Thresholds that allow annual or quarterly tax periods apply to group as a whole > Every member of group must meet threshold to allow payment by estimated quarterly instalments 	<p>Originally, unlike PAYG, GST had to be remitted at least quarterly. Original GST measures required any business with a turnover of \$20m to remit GST monthly and use electronic remittances. Again, no reason was given for the nomination of this threshold. Annual lodgment and payment was intended to reduce compliance costs for businesses that would not be required to register but had registered for other reasons (a variation on proposals from accounting and professional bodies).</p>
10. GST – cash accounting		
(Div 29 GST Act)		
<p>Cash accounting:</p> <ul style="list-style-type: none"> > Annual turnover ≤ \$1m <ul style="list-style-type: none"> – No threshold if receipts method used for income tax 		<p>The threshold below which a tax basis can be used was originally proposed to be \$250,000. It was increased to \$500,000 during public consultation, then a \$1m threshold was adopted following submissions by CPA Australia that New Zealand experience suggested it should be higher. The CPA Australia submissions also addressed the issue of using a cash basis where income was accounted for on a cash basis.</p>

Table 2: Major size-based business tax concessions (Continued)

Basic tests	Additional tests	Policy rationale
11. GST – Input tax credits		
<p>Financial acquisitions threshold:</p> <ul style="list-style-type: none"> > Annual input tax credits for acquisitions used in making financial supplies ≤ \$50,000 <ul style="list-style-type: none"> – Provided also ≤ 10 per cent of total annual input tax credits <p>Annual apportionment:</p> <ul style="list-style-type: none"> > Annual turnover ≤ \$2m 	<p>GST groups:</p> <ul style="list-style-type: none"> > Financial acquisitions threshold is applied both individually and on a group basis > Every member of group must meet threshold for annual apportionment of input tax credits 	<p>(Divs 11, 131, 189 GST Act)</p> <p>The financial acquisitions threshold allows a small finance provider to claim input tax credits in relation to financial supplies.</p> <p>A de minimis concession was originally included, to limit the concession to cases where the turnover of financial supplies was the lesser of \$50,000 or five per cent of annual turnover. This exemption was subsequently amended to be based on the input tax credits related to supplies, rather than the value of supplies. The value of \$50,000 remained unchanged, but the proportion was increased to 10 per cent of the total input tax credits on acquisitions.</p> <p>The purpose of the concession is to ensure that a business that makes financial supplies incidentally to taxable supplies is not denied access to the input tax credits. The explanatory memorandum to the amendment notes that the original thresholds had the effect of denying input tax credits to many entities with small levels of financial supplies.</p> <p>Annual apportionment of input tax credits was intended to reduce compliance costs, without undue risk to the revenue. No basis was given for the \$2m threshold, but it is consistent with the simplified accounting methods.</p>
12. GST – simplified accounting methods		
<p>Simplified accounting methods:</p> <ul style="list-style-type: none"> > Annual turnover ≤ \$2m <ul style="list-style-type: none"> – One optional method is only available if annual turnover ≤ \$1m – Thresholds at discretion of Commissioner 		<p>(Div 123 GST Act)</p> <p>Division 123 authorises the Commissioner to develop simplified accounting systems for businesses that supply both GST-free and taxable supplies, provided they, to some extent, supply food (or are charities that make non-commercial supplies).</p> <p>The Division was introduced following consultation with the retail industry, which was concerned that members would be unable to track different categories of supplies.</p> <p>The methods are available if a business does not have appropriate accounting systems to track categories, and where turnover is less than \$2m.</p> <p>These methods were agreed and introduced administratively and are not enshrined in legislation or regulations.</p> <p>The threshold for the 'Business Norms' method is \$1m. Thresholds for the other methods were set at \$2m. It was proposed that these thresholds would be lowered to \$1m in the second year, but this did not occur.</p> <p>Although these were designed in consultation with the relevant industry group, there is no information on how the levels were set.</p>
13. FBT – Car parking, records and remittance		
<p>Car parking:</p> <ul style="list-style-type: none"> > Ordinary income + statutory income < \$10m <p>Record-keeping exemption:</p> <ul style="list-style-type: none"> > Aggregate fringe benefits amount ≤ \$5,000+ <ul style="list-style-type: none"> – \$5,000 indexed annually (since 1997) — \$6,223 for 2005–06 FBT year <p>No instalments:</p> <ul style="list-style-type: none"> > FBT previous year < \$3,000 	<p>Car parking:</p> <ul style="list-style-type: none"> > Not a public company 	<p>(s 58GA, Pt XIA, s 111 FBTA)</p> <p>The car parking exemption was adopted following the Bell Committee report. There was no discussion of the basis for the \$10m threshold.</p> <p>The record-keeping exemption was also a recommendation of the Bell Committee. There was no discussion as to the basis for nominating \$5,000.</p> <p>The original threshold for not having to pay FBT by instalments was notional tax (based on previous year's FBT payable) less than \$1,000 (s 111). This was increased by gazettal to \$3,000 from the 1991–92 year. Again, there was no discussion of the basis for the nominated threshold in either initial or amended legislation.</p> <p>Each of these exemptions is a de minimis style exemption intended to ease the record-keeping burden on small business.</p>

2.4 Analysis of existing criteria

The existing criteria used for restricting access to a business concession on the basis of size, as described in Table 2 (see 2.3), can be analysed from two different points of view:

- > Tests used and application
- > Policy rationale for selection and application.

Analysis – tests used

The following points emerge from an analysis of the existing criteria used:

- > A myriad of different tests are used – with very little, if any, consistency
- > Tests concentrate on the business itself, its activities and assets – as opposed to people tests such as ownership or employees (ownership is generally only relevant for grouping: see below)
- > Turnover is the most frequently used criterion – but inconsistently defined
- > Assets is the next most frequently used criterion – but inconsistently defined and used for different reasons in different concessions
- > Group application of tests is widely used as an anti-avoidance measure – to prevent qualification for a concession by artificially splitting activities
- > A myriad of different grouping tests are used – with very little, if any, consistency.

Analysis – policy rationale

The following points emerge from an analysis of the expressed policy rationale for using different tests, defining them differently or adopting different thresholds for the same criteria:

- > Very little policy rationale is ever publicly given for choice of a particular criterion as the access test or the threshold used to measure qualification with the test – industry consultation is often expressed to occur, but rarely detailed
- > There is no ‘magic’ involved with choice of a particular threshold – it is apparent that many thresholds were altered a number of times during the consultation process or passage through parliament – a different ‘number’ could easily have been the final choice.

Scope for consolidation/simplification

It is clear from the above analysis that there is a pressing need to step back and evaluate the overall or ‘bigger’ picture with access to small business concessions to determine if variances are justified, with a view to simplifying and/or consolidating the position.

However, such a review, while using the current criteria as a starting point, also needs to consider whether there may be other options that would be better approaches.

This report will therefore consider a range of other possible relevant considerations or options, before proceeding to recommendations.

2.5 Quasi-small business provisions

Apart from the major small business concessions summarised in Table 1 (see 2.1) and described in more detail in Table 2 (see 2.3), which are the main focus of this report, a number of other provisions exist within the same tax laws that could be described as quasi-small business provisions.

These quasi-small business provisions primarily affect smaller businesses, even though the criteria used mean they are technically capable of application to any sized business. While some still offer concessions, others treat small businesses more harshly than other taxpayers, to protect against tax avoidance.

Private companies

The criterion of being a private company is frequently used as the basis for a different application of income tax law. In a few instances this is to the benefit of the taxpayer, but more often it is associated with imposition of additional tests designed to negate tax avoidance opportunities that the closely held nature of such companies may otherwise provide.

These special rules not only differentiate between conduct of a business through a private company as opposed to a public company, but may also impose additional hurdles on doing business through a private company as opposed to another entity (often justified on the basis of tax deferral opportunities private companies may provide).

Provisions that provide different or extra rules for private companies include:

- > Deemed dividend rules for disguised distributions to shareholders or associates (including payments, loans, debt forgiveness and property transfers) (Div 7A ITAA 1936)
- > Excessive remuneration or excessive retirement or termination payment rules for payments to shareholders, directors or associates (s 109 ITAA 1936)
- > Preferential rules for timing of franking of dividends (Subdiv 202-E ITAA 1997)
- > Less concessional tracing/measurement rules for satisfaction of carried forward loss deduction tests (Divs 165 and 166 ITAA 1997)
- > Less concessional rules for determining if an asset ceases to be a pre-CGT asset (Div 149 ITAA 1997)
- > Different treatment of off-market and on-market share buy-backs (Div 16K ITAA 1936).

Determination of whether a company is a public or private company is primarily by virtue of stock exchange listing (Div 7 ITAA 1936 – note some of the provisions listed above do not use this Division, but separately apply a public listing criterion). Stock exchange listing requirements invariably mean small businesses would not satisfy those requirements. However, public listing can be overruled if a 20/75 test (relating to shareholder numbers/ownership, control or dividends) is breached.

Family trusts and non-widely-held fixed trusts

Restrictions on use of carried forward trust losses apply differently from ordinary fixed trusts and widely held fixed trusts.

Of more widespread importance for small business, however, is that family trusts (as defined – family trusts will usually be discretionary trusts, but could be fixed trusts) are granted an exception from application of most of the trust carried forward loss restrictions.

Qualification as a family trust involves identification of a specified individual and their family group, a family control test, possible inclusion of interposed entities and a penalty for distributions outside the nominated family group.

It would be difficult to apply tests that require an election and nomination by a taxpayer, for a concession, as the basis for anti-avoidance grouping tests that require compulsory amalgamation of turnover, assets, etc for small business threshold test purposes. Nevertheless, the tests were examined as part of looking for possible alternatives to existing control and quantity of distribution tests in the STS and CGT small business measures for grouping of discretionary trusts.

Minimum activity level tests

A number of specific anti-avoidance provisions operate to deny or modify the otherwise generally applicable tax treatment where a business is, essentially, 'too small' to warrant treatment as a business at all.

These provisions can be said to introduce, at least in certain respects, an additional measure to qualify as a small business. While a business must be operating below the relevant turnover or asset thresholds for access to concessions, it must nevertheless be operating at least at a minimum level of activity (often related to turnover, income or assets employed) to avoid other, potentially adverse, consequences.

These de facto filters on qualifying as a small business include:

- > Personal services business tests for avoiding application of the alienation of personal services income rules (the 'contractor rules') – if the results test is not satisfied, reliance must be placed on quantity of business from various sources, extent of advertising, use of employees or a business premises test that is biased against home-based businesses (Div 87 ITAA 1997)
- > Non-commercial loss rules that restrict deductibility of business losses for individuals or partnerships unless annual assessable income has reached \$20,000, a pattern of positive taxable income has been established, or business real property of \$500,000 or other business assets of \$100,000 are used in the business (Div 35 ITAA 1997)
- > Enterprise exclusion tests for GST that require individuals, or partnerships comprised mostly of individuals, to have a reasonable expectation of profit or gain (s 9-20(2)(c) GST Act).

Miscellaneous other provisions

Other quasi-small business tax provisions include:

- > The tax exemption which small credit unions receive on certain interest income and the benefit of a phased-in tax rate which medium credit unions receive (ss 23AG and 6H ITAA 1936)
- > CGT advantages of use of discretionary trusts (e.g. non-applicability of CGT event E4)
- > Closely held trusts beneficiary disclosure provisions
- > Concessions to encourage establishment of new SMEs or portfolio type investment in SMEs, such as the pooled development fund (PDF) provisions or CGT venture capital exemptions – although not directly affecting the SME, limits on the size of companies in which investments can be made make the concessions of a quasi-small business nature.

For the most part these provisions merely provide further differing thresholds for particular taxpayers or circumstances that offer little scope for wider application as part of a uniform small business definition.

Also, because of their restricted or specialist application, and often limited number of affected taxpayers, it is considered that there is no need to attempt to specifically cater for these taxpayers or concessions within the overall small business definition which it is the aim to develop.

Part 3 – Simplifying the definition

3.1 Possible criteria for defining small business

A list of the potential criteria on which to base a simplified definition of small business, alone or in combination, is provided below.

1. Turnover (or gross receipts)
2. Gross income
3. Taxable income
4. Net assets
5. Concentration of ownership
6. Equity
7. Employees
8. Stage in life cycle of business
9. Industry-based size relativity.

The list has been compiled from a review of present Australian tax, overseas tax and administrative practice.

The list does not include criteria only relevant for a specific purpose that is intertwined with the concession itself. For example, amounts withheld (used for withholding remittance) or R&D spending (used for the R&D concession). Use of such criteria does not assist the goal of simplification. Whether they need to be or can be accommodated in a simplified system is discussed under 'Part 4 – Recommendations'.

The analysis of existing Australian tax criteria in Part 2 of this report revealed that turnover was the most commonly used criterion, followed by assets. Some of the major Australian small business policy reports indicated that for non-tax administrative purposes, number of employees was more common (this is also the overseas experience).

Although this report has not yet discussed overseas criteria that were considered in compiling the list, it was preferable to set out the list first to provide a logical framework under which to consolidate a discussion of the overseas position. This report will now briefly consider the overseas position in the context of this framework.

Analysis of the advantages and disadvantages of using each of the above potential criteria as the basis of a simplified system of access to small business concessions follows the overseas discussion.

3.2 Comparison to other countries

Comparative tax treatment of small business was examined in three other countries: the United States of America, South Africa and Ireland. All have predominantly market-driven economies, with tax and legal systems heavily influenced by or derived from English law, meaning there is a similar operating environment to Australia. Any apparent solutions to the problem of defining small business should, therefore, be capable of implementation in Australia.

All three countries offer small business tax concessions, but to markedly differing degrees. This report focuses on the manner in which the tax system of each country defines or identifies small business, as well as on any anti-avoidance provisions used to prevent unintended access to concessions.

The following is an Atax-prepared summary for each country, drawing heavily on joint work of Atax personnel and tax experts in each country, specifically:

- > United States of America – Professor Stewart Karlinsky (Graduate Tax Director, San Jose State University)
- > South Africa – Jackie Arendse (Project Director of Tax, South African Institute of Chartered Accountants)
- > Ireland – Dr Sheila Killian (Lecturer, University of Limerick).

United States of America

The United States has no single definition of small business for tax purposes. More than 40 different qualifying criteria apply for access to what can implicitly be considered small business tax concessions. Not surprisingly, the range of criteria used covers most of the possibilities listed in this report as potential small business qualifying criteria (see 3.1).

Major United States small business tax concessions include lower corporate tax rates, the ability to use cash accounting, immediate expensing of otherwise depreciable assets, exemption from alternative minimum tax rules (a separate parallel system to the regular tax that applies to individuals and, with modified rules, to some corporations) and ordinary loss as opposed to capital loss treatment for investment losses. Other concessions are too specialised to require reference in this report.

Gross receipts

Gross receipts is a commonly used criterion in the United States, but is generally not defined. Many different thresholds are used.

Average gross receipts for the prior three years of not more than US\$5m is the most common test (used in at least five different provisions). The same calculation method is also used in two other provisions, but with a US\$10m threshold.

Gross receipts of less than US\$1m in the previous year allow a business to automatically use cash accounting.

A significant simplification concession for small business is that if average gross receipts are less than US\$7.5m over all three-year periods since introduction of the particular provisions, a C corporation (distinguished from an S corporation – see below) is exempted from the complicated 'alternative minimum tax' rules.

Although gross receipts are not specifically defined, associated regulations do give some examples of their calculation. The examples indicate that gross receipts are calculated before cost of goods sold (reasonably obvious). More specifically, they include investment income, tax-exempt interest and imputed interest income. They also include proceeds from sale of investments, but after subtracting the cost of the securities. Loan repayments are logically excluded, as is state sales tax.

Grouping rules apply to prevent manipulation. These rules include a requirement to include a proportional share of gross receipts of pass-through entities (partnerships and S corporations invested in) in the calculation.

Taxable income

The basic United States corporate tax rate (a flat 34 per cent for the year examined) is phased in for businesses with taxable income less than US\$335,000. This effectively gives qualifying smaller businesses a progressive, rather than flat, corporate tax rate scale. Corporate taxable income less than US\$100,000 is taxed at an average 22.25 per cent (the first \$50,000 at 15 per cent, the next \$25,000 at 25 per cent and the next \$25,000 at 34 per cent). Between US\$100,000 and the US\$335,000 threshold at which the concession ends, the rate is 39 per cent, thus phasing in to the flat 34 per cent that applies to all taxable income (including the first US\$335,000) once that threshold is exceeded.

There are exclusions from this scale. Personal service corporations (commonly used by doctors, dentists, lawyers, accountants and engineers) are subject to a flat 35 per cent rate to encourage them to distribute income in the form of salaries. Businesses operating through the concessional S corporation structure (see 'Concentration of ownership' below) effectively have individual owner progressive tax rates applied to their taxable income (putting them in a similar position to sole traders or partnerships).

Level of taxable income is also used as the criterion for a small business concession with regard to advance collection of corporate tax (the United States equivalent to Australia's PAYG system). If taxable income did not equal or exceed US\$1m in any of the three prior years, estimated taxes for the current year may be based on the previous year's liability, rather than on actual tax liability for the current year.

Cost of assets acquired during year

Immediate deductibility, to a maximum of US\$100,000, is available on a combined basis for selected, otherwise depreciable assets, where the total cost of tangible assets (excluding real property) placed in service during the year does not exceed US\$400,000. The US\$100,000 maximum immediate deduction phases out on a dollar-for-dollar basis above the US\$400,000 threshold, meaning no immediate deduction at all is available if total cost of assets acquired for the year exceeds US\$500,000.

Strictly speaking, this concession is not limited to small business, as it is available on a year-by-year basis and any size business could qualify in a particular year if it did not acquire many new assets in that year. Nevertheless, as grouping rules apply to prevent artificial splitting into multiple entities to access the concession, small businesses are more likely to qualify. The grouping rules that apply are, however, much easier to avoid than Australian grouping rules.

Concentration of ownership

The United States uses number or concentration of shareholders as the criterion for several concessions, but in particular one very important small business concession. Effective concentration of ownership is also used, in a different form, as a criterion for anti-avoidance provisions.

The S corporation is one of the most important United States small business concessions. It provides significant incentives to use a simple corporate structure with relatively few or a concentrated shareholder structure. The required structure

includes having just one class of stock, no more than 100 shareholders and no foreign investors. The current 100-shareholder limit is the result of occasional increases from an original limit of 10 about 50 years ago. Also, interestingly, the test now allows six generations of ancestors or lineal descendants to be considered as one shareholder for purposes of the count.

An S corporation is only taxed at the shareholder level on income earned and assets sold, income retains its character on flow-through to owners, losses can be passed through to owners, and more lenient rules apply to be able to use the cash method of accounting.

With regard to concentration of ownership as an anti-avoidance criterion, a C corporation that essentially holds investment assets and has a concentrated ownership (five or fewer shareholders owning more than 50 per cent of the stock – but with grouping of certain family members and partners in a partnership in applying this test) is subject to a number of anti-avoidance provisions. First, punitive personal holding company rules apply to prevent excess cash that has been taxed at lower corporate tax rates from being retained at the corporate level, rather than being distributed as dividends (if breached, 15 per cent tax is due in addition to the regular corporate tax). Second, onerous and complex passive activity loss rules apply (which punish ownership of investments not actively managed by the business).

Similarly, if a C corporation accumulates investment assets from the profits of the business, rather than using them to expand the business or distribute the proceeds to shareholders, accumulated earnings tax rules exist to force dividends to be paid. However, a de minimis rule exempts small businesses with less than US\$250,000 of accumulated earnings and profits from the extra tax.

To discourage reducing the overall tax rate between owners and the various entities they own, if the same five or fewer shareholders own too much stock in two companies, the companies are treated as one for many tax benefits, a distinct tax disadvantage imposed on small businesses. Similarly, sales of assets between owners and their related entities may be treated as ordinary income rather than capital gains and, if a loss is realised, it may be postponed or disallowed. Another anti-avoidance provision is that, if a company that is substantially owned and worked in by its owners performs services for a related party, it may have its income, deductions or credits re-allocated if tax avoidance is a principal motive.

Size of equity raised or assets accumulated

There are two United States tax concessions that assist in encouraging investment in or growth of corporate small businesses.

The first concession uses equity raised as the criterion, and converts losses from capital to ordinary loss treatment for the first US\$1m of equity raised. The ordinary loss is limited to an annual cap of US\$100,000 (US\$50,000 for single taxpayers). This recognises that many new businesses fail and seeks to alleviate some of the risk by reducing the tax liability or allowing for a refund through the net operating loss carry-back claim mechanism. Anti-avoidance provisions prevent

contribution of under-appreciated assets from leading to ordinary loss treatment. The rules apply to investments in C or S corporations, but not sole proprietorships, partnerships or certain other vehicles. They do not apply to debt financing.

The other concession allows a 50 per cent reduction in gains from the sale of certain 'qualified small business' C corporations (but the taxable half is taxed at 28 per cent, rather than the usual 15 per cent or 20 per cent). The criterion for this concession is quite generous, being no more than US\$50m in gross assets. It was enacted to help high technology, low technology, manufacturers, wholesalers and retailers to organise and grow. Certain industries are, however, excluded, such as personal or professional services (defined as health, law, accounting, consulting, financial or brokerage services and even actors and athletes), banking, insurance, farming, mining and hotel, motel or restaurant businesses. Owners of an eligible small business corporation may defer their tax liability arising out of the sale of the stock by re-investing the proceeds in another qualified small business within 60 days after the sale (with the tax base of the new stock reduced by the deferred gain).

Type of activity

A number of small business concessions exist within specified industries.

Small business farmers (Small Business Administration test: under 500 employees or under US\$750,000 in sales) operating a nursery, sod farm or the raising or harvesting of most trees (but not fruit or nut trees) may use cash accounting. An S corporation engaged in farming can use cash accounting, as can family farms with gross revenue of less than US\$25m or farming C corporations with less than US\$1m of gross receipts.

In some industries, notably natural resources and energy, specially tailored rules define small business. For example, in one provision, small is defined based on the number of barrels (1,000) or cubic feet (six million) of natural gas produced per day. For small independent producers, a more favourable depletion allowance is available. Another provision uses 50,000 barrels a day as the demarcation for favourable treatment of a small producer. A fuel credit is available to a 'small ethanol produce', defined as one that produces less than 30 million gallons per year.

Compliance relief

There are a number of other ways that United States income tax law differentiates small business treatment from large business, most aimed at simplifying the compliance burden.

South Africa

South Africa provides a range of small business tax concessions, although nowhere near as extensive as in Australia or the United States. The main concessions relate to rate of tax, immediate deductibility of otherwise depreciable assets and other depreciation concessions, CGT relief on disposal of assets, value-added tax (VAT) registration and frequency of VAT returns.

However, South Africa is much more restrictive on the form in which small business can operate to qualify for the

concessions, using an extremely narrow definition that severely limits eligibility.

Qualifying as a small business corporation

Most of the tax concessions for small businesses in South Africa apply only if the business operates in corporate form (whether as a company or close corporation) and qualifies as a 'small business corporation' (SBC).

The primary requirement to be an SBC is that gross income must not exceed R6m during any year of assessment. This is a strict threshold, with no phase-out provisions.

The small business tax incentives are targeted largely at manufacturing operations to try and reduce the country's huge unemployment rates. Small corporations having too high a proportion of personal service or investment activities are excluded from qualifying as an SBC (see 'Excluded activities' below).

Grouping restrictions

A different, simplified, but very restrictive, approach is taken to grouping (effectively eliminating involvement in multiple entities if it is desired to qualify for small business concessions).

First, the entire shareholding of an SBC must be held, at all times during the year of assessment, by shareholders or members that are natural persons.

Second, none of the shareholders or members at any time during the year may hold any shares or have any interest in the equity of any other company (other than certain specified companies, such as listed companies, traded portfolios in collective investment schemes and companies exempt from tax under certain provisions).

These grouping restrictions would not, however, prevent individual family members from separately owning 100 per cent of different SBCs.

Concessions

As with the United States, qualifying small businesses enjoy a progressive, rather than flat, corporate tax rate scale. The first R35,000 of taxable income is tax-free, the next R215,000 is taxed at 10 per cent and any excess over R250,000 is taxed at 29 per cent (which is the flat rate that applies to the entire taxable income of other companies).

Small business corporations are allowed a 100 per cent write-off on manufacturing assets in the year first brought into use. Non-manufacturing assets may be written off over three years, with a 50 per cent allowance in year one, 30 per cent in year two and 20 per cent in year three.

Similar to Australia and Ireland, but not the United States, an individual disposing of certain small business assets is granted relief from capital gains tax (CGT) on the first R500,000 of capital gains arising on disposal, provided certain requirements are met.

South Africa has a value-added tax (VAT) and small businesses with taxable supplies (similar to turnover) not exceeding R300,000 over a 12-month period are not required to register. Certain small businesses that have registered are permitted to submit VAT returns every four months, instead

of the normal monthly or bi-monthly requirement. In addition, small businesses may elect to pay VAT on the cash basis, rather than the accrual basis, if their turnover is less than R2.5m per year.

Excluded activities

A service-related entity can qualify as an SBC provided it does not breach two particular exclusions in the definition of an SBC.

First, it must not be an 'employment company' (defined as including certain labour brokers and 'personal service companies').

Second, not more than 20 per cent of the total receipts and accruals (including capital gains) of the company during the year of assessment may be derived from rendering a 'personal service'. 'Personal service' is defined in a very wide manner to include almost all types of services, which therefore excludes many small businesses. However, in 2005 the definition was amended to exclude businesses with at least four full-time employees who were not connected persons in relation to the shareholders of the company and who were engaged full time in rendering the company's services, enabling more businesses to qualify as an SBC.

If an incorporated business is classified as a 'personal service company', apart from not qualifying as an SBC, almost all of its expenses are disallowed as deductions. It is taxed at the highest corporate tax rate (34 per cent in the current year) on its taxable income, which, with the denial of most deductions, will closely resemble turnover.

Investment companies will not qualify as an SBC as the definition excludes companies that derive more than 20 per cent of their total receipts and accruals in the form of investment income (which includes dividends, interest, royalties and annuities).

Ireland

Ireland's treatment of small business is vastly different from that of Australia or the United States, and even narrower than South Africa's. Ireland has minimal small business tax concessions, but a wide array of anti-avoidance provisions aimed at smaller businesses.

The lack of concessions appears to be partially the result of a successful policy for attracting direct foreign investment. Near-full employment available in multinationals means there has been less incentive for individuals to set up small firms or for the government to foster entrepreneurship.

Irish small businesses used to enjoy a significant corporation tax rate advantage. However, since 2003, all trading income arising in Ireland, regardless of the size of the firm, has been subject to a low flat tax rate of 12.5 per cent (a higher rate of 25 per cent applies to investment income).

Tax liability as a criterion

The primary test of a small company for a given year is a tax liability of €50,000 or less in the previous year. This is a simple test and use of this criterion is connected to the fact that the concession it applies to relates to tax payment (see below).

At the comparatively low Irish tax rates in the year examined, it allows all firms with taxable income of €200,000 or less

(where a greater proportion of income is taxed at the 25 per cent investment income rate) to be defined as small businesses, or firms with higher taxable incomes if they have a greater proportion of trading income.

There are no grouping provisions.

Tax payment and other concessions

The main concession for companies that qualify as small on the basis of their prior year tax liability is the purely administrative and cash flow benefit of a less onerous system of tax payment and filing. The preliminary corporation tax paid by smaller businesses can be calculated as 100 per cent of the prior year's liability, saving the expense of estimating the current year profits and tax liability before the year is ended and reducing the risk of penalties and interest for underpayment.

There is also some relief for small firms in the areas of retirement and succession. Where the consideration for disposal of a business is less than €500,000, and the vendor is an individual over the age of 55, the disposal will not trigger any charge to CGT. Phase-out provisions apply.

Ireland has a value-added tax (VAT) and a small business registration threshold exists. In addition, annual VAT filing applies for small firms (as opposed to the normal bi-monthly filing).

Anti-avoidance

Significant anti-avoidance provisions apply to closely held companies controlled by five or fewer participators. In this case, connected groups form one participator for tax purposes.

These rules are mainly designed to dissuade distribution of corporate profit to shareholders or connected persons otherwise than as dividends and to avoid unnecessary retention. First, certain benefits in kind, or interest in excess of a specified rate, are taxed as distributions. Second, tax has to be deducted from loans to participators. Third, penal provisions apply to writing-off of loans. Finally, a non-deductible surcharge of 20 per cent applies to undistributed income, to discourage the abuse of a dominant shareholder position to control payments from the company and reduce the tax base.

Overseas comparison – conclusion

The three countries selected provided a good basis for comparison as they ranged from a situation of offering even more concessions than Australia and even more differing access criteria (the United States), to slightly fewer concessions but much more restrictive access criteria (South Africa) and finally very limited concessions and access criteria (Ireland).

The Irish situation also demonstrated that, even if the benefits of small company status are largely withdrawn, the burden of the classification could still exist for anti-avoidance purposes.

The summary of concessions, access criteria and anti-avoidance provisions for each country demonstrates that the problems faced by Australia in defining small business and ensuring access to concessions is not abused are not unique. The more concessions, the more that different access criteria apply. Grouping rules only become simpler where the policy is not to allow access unless simple structures are adopted.

The United States examination was particularly useful in building the list of criteria that could potentially be used to define or distinguish small business identified by this report (see 3.1). It also served to demonstrate, however, that even within the same potential criterion, there can be great inconsistency in definition or thresholds (e.g. gross receipts), which the study of the existing Australian position had already made clear. Even with very restrictive criteria as in use in South Africa, there were a large number of special rules to exclude certain activities.

The other major element to be derived from the international study was the possibility of more beneficial treatment where a simpler structure has been used by a small business (the United States S corporation or the South African small business corporation), generally placing restrictions on shareholders and thus resulting in less likelihood of tax avoidance. In the United States this was an alternative, whereas in South Africa it was compulsory to obtain concessions. Australia currently does not do either and it will be considered further in the recommendations segment of this report (see Part 4).

3.3 Advantages and disadvantages of each criterion

Each of the criteria listed under 'Possible criteria for defining small business' (see 3.1) will now be compared to determine their advantages and disadvantages, if they were to be used as the sole criterion (regardless of threshold) for that purpose.

1. Turnover (or gross receipts)

Turnover is the most commonly used test in Australia and throughout the world for distinguishing business on the basis of size. It therefore has the advantage that it is reasonably well known and understood, albeit not consistently defined.

The fact that it is so often used also means that it is generally consistent with government policy for access to and granting of a size-based concession.

Surprisingly, it was little utilised in Australia prior to the introduction of GST. The very close, but theoretically narrower, substitute of income was more prevalent, if a measure was required for a concession (whether small business or otherwise).

However, the introduction of GST significantly changed that position. Turnover is a universally accepted measure in most GST or VAT systems. Therefore, given that it has to be measured anyway for application of GST (not just initial access), utilising it for all tax purposes has the considerable advantage of requiring less additional work. This is why it has already started to be used for many business-oriented income tax purposes in Australia, as Table 1 (see 2.1) demonstrates. Hence, basing a simplified definition of small business around its more consistent application would require the minimum amount of change and be less disruptive to the operation of the system as a whole.

Turnover would also appear less open to manipulation than measures based on income or taxable income, due to not having to narrow its base to accommodate the meaning usually associated with those concepts.

Its disadvantage, however, is that it can be unreliable as an access measure, when used in its widest sense, if it includes infrequent large capital asset sales. This could cause business compliance with thresholds to widely fluctuate in certain years that would not be representative of the true size of the business on a long-term basis. This can, of course, be easily fixed by excluding such sales from turnover for threshold purposes even though, for example, GST or CGT may still apply to the particular sale. This has already been recognised in many of the existing applications of the criterion for income tax purposes, as demonstrated in Table 2 (see 2.3). This moves the concept much closer to that of income.

There is the issue, however, even allowing for these modifications, of whether turnover should be measured for comparison to thresholds on a GST-inclusive or GST-exclusive basis. While GST itself obviously has to be calculated on the GST-inclusive price, most businesses would need to exclude the GST component from the amount received when determining their liability to income tax or CGT (not as relevant if capital asset sales are excluded for threshold purposes) on the same sale. This means that both GST-inclusive and GST-exclusive figures would be available from their books.

While using GST-inclusive figures for turnover-based thresholds would have the advantage of simplicity, in that overall sales quantum would not need to be adjusted, it would appear to lack equity if the purpose is to grant business a concession on the basis of size of turnover. A registered business would be treated differently from an unregistered business simply because of the GST component in their sales, which is not retained. It would also be inconsistent with having a criterion that can be applied uniformly for income tax and GST purposes, given that compulsory GST registration, for example, obviously depends on value of supplies before GST is added.

Hence, any equitable and uniform application of turnover as a small business criterion should be on a GST-exclusive basis.

2. Gross income

The discussion of turnover, and in particular the modifications suggested if it were to be used as the basis of a simplified definition, indicates that for many businesses there would be little variance between that concept and gross income. However, there could be some differences, and the concept of gross income does require an extra judgment as to the nature of an item than that required for turnover.

For this reason, it would add an extra layer of complexity for no apparent benefit, and is therefore not recommended. Nevertheless, for many small businesses there would be no difference, assuming that they conceptually understand that the GST component of sales is more correctly treated as a liability, rather than as income.

3. Taxable income

Taxable income, the third of the three possible criteria based around notions of turnover, receipts or income, is generally a less reliable measure of true size than turnover or gross income, due to its greater propensity for fluctuation, in particular large fluctuation.

Its other major disadvantage, compared to the other two 'income' criteria, is that it requires two measures rather than one, given that it is effectively a net concept of assessable income less deductions. There is the added problem of businesses that earn large amounts of exempt income.

Its major advantage, however, is that it also has to be calculated for other purposes and the reliability of its accurate measurement is backed up by the threat of detailed ATO audit or scrutiny. As most small business concessions are for income tax, based on an income year qualification, there is also significant or exact timing symmetry between its measurement and its use.

4. Net assets

A net assets test may operate as a test in its own right (as it does with the CGT small business concessions) or as a back-up test to avoid allowing essentially large businesses to qualify as small when they are in their start-up phase (as it does with the STS system).

The problem of the measurement base of net assets is a significant one, with possibilities being cost, depreciated value or market value. Each basis has its own particular advantages and disadvantages from policy, equity and cost of compliance perspectives. Cost is simple but static and may not be representative of true value, depreciated value fluctuates even though the size of the business may not and does not cover all assets, and market value may be difficult and costly to ascertain.

Liabilities may include private liabilities for smaller businesses, and it is inappropriate to treat such liabilities as a reduction in value of the business, creating apportionment problems.

Extending current STS asset value thresholds to match CGT asset value thresholds, assuming a uniform measurement basis can be achieved, may not be as large a problem as anticipated, as it is unlikely that truly larger businesses would be particularly worried about qualifying for the STS concessions.

5. Concentration of ownership

While it may be true to say that most small businesses will have fairly concentrated ownership and control, whether directly or indirectly, the opposite is not true and some quite large businesses may be owned or controlled by a limited family group.

Thus, this criterion is not suitable as the sole criterion for defining a small business. However, as mentioned in the conclusion to the overseas comparison (see 3.2), there may be scope for its use in restricting access to concessions as an alternative to complex grouping rules.

6. Equity

Capital employed is a possible test, but discriminates against capital-intensive businesses as opposed to other businesses.

In theory it is a more philosophically accurate measure of small businesses than net assets, which may have been financed with debt.

However, the existence of the extremely complicated debt/equity rules demonstrates how difficult it may be to truly identify in the modern business environment, with much more sophisticated and varying financial instruments being increasingly developed and used.

7. Employees

Number of employees is very rarely used as a small business criterion for tax purposes, although it is often used for government statistical purposes.

The problem in the modern world of using employees as a basis for identifying size of operations is the increasing movement towards use of contractors, rather than employees, which could lead some businesses to qualify as small that really should not.

It would not be feasible, nor satisfy the goal of simplicity, to group contractors with employees to determine size, as it would require quite complicated provisions to distinguish employee-like contractors from truly independent suppliers.

8. Stage in life cycle of business

Encouraging the establishment of small business and providing assistance in the start-up phase was expressed as the main rationale behind the entrepreneurs' tax offset, but no test of this nature has actually been used in the legislation.

Adoption of such a test as a uniform qualifying criterion for small business would require a policy decision that small businesses are only going to be assisted in their start-up phase, which is inconsistent with virtually all current concessions.

Some existing concessions, such as the CGT small business concessions, are actually targeted at the termination phase of a business, although their existence is also meant to encourage small businesses throughout their life cycle by making investment in the business a viable alternative savings vehicle to superannuation.

Hence, while concessions may operate at different stages in the life of a small business, they do not provide scope for more uniformly defining small business.

9. Industry-based size relativity

This test would take an industry-by-industry approach rather than a one-size-fits-all approach to defining small business.

A business would be measured as small relative to its industry, rather than in absolute terms.

Such a test would, however, be difficult to determine and police. It could result in multiple definitions and be inconsistent with the goal of simplicity.

Part 4 – Recommendations

4.1 Solving the problem

The current myriad definitions of small business, with multiple inconsistent criteria, inconsistent definitions of each criterion and differing thresholds to receive concessions, appears to be in large part a result of the process that takes place when concessions, preferences or other small business provisions are introduced.

The current position has been built up over a long timeframe, with many individual concessions or preferences introduced on an ad hoc basis by various governments to address particular needs or desired outcomes at the time.

Although there was some attempt to redress this position when the CGT small business concessions were modified and the simplified tax system was introduced, by having a centralised definition provision that applied to a number of concessions, each was still narrowly focused on its own individual concessions, without being consistent with the others, nor recognising the wider range of small business provisions across all tax laws.

Solving or at least reducing the problem of inconsistency and complexity therefore needs to involve two steps:

1. Consolidating and simplifying criteria and their meaning (to the extent possible)
2. Addressing the process of definition (to minimise future deviations).

4.2 Essential elements

It is apparent from the analysis in preceding segments of this report that simplifying the definition of small business is not as straightforward as saying, for example, that 'you will be a small business if your turnover is under \$x'.

The reality is that some concessions are of such a vastly different nature that valid reasons can exist for using different criteria, more than one criteria or different thresholds. This does not mean, however, that the search for greater simplicity should be abandoned or that there cannot be a significant improvement over the present position. It just means that this reality needs to be taken into account in the final recommendations and itself built into the process. Simplification will be a question of degree, rather than absolute.

Other realities are that, even with such a simple statement as 'you will be a small business if your turnover is under \$x', this raises further questions that then need to be addressed, such as who is the 'you' it refers to, recognising that different entities with different flow-through characteristics may be used, and what is meant by turnover.

Finally, the possibility of artificially splitting activities between entities to achieve compliance with a threshold must be addressed (this is another aspect of the 'you' question).

Therefore, the essential elements of any simplified definition of small business must include:

1. Criterion (or criteria) that is to be used
2. Meaning of that criterion (or criteria)
3. Threshold – for the criterion
4. Grouping provisions – to avoid manipulation
5. Flexibility – to allow for new concessions or departures from the norm.

This report's recommendations on the criteria to use to define small business, their meaning and associated thresholds (elements 1 to 3) are located under 'Recommended criteria' (see 4.3).

The recommended approach to drafting the grouping provisions (element 4) for use in conjunction with the thresholds is explained under 'Grouping provisions' (see 4.4).

Providing flexibility as part of the process (element 5) is addressed as part of the discussion on 'Form and location of definition' (see 4.5).

4.3 Recommended criteria

Recommendations as to qualifying criteria to be applied as part of the essential elements (see 4.2) of a new definition of small business are discussed below.

1. Criteria to be used

Simplification requires that the minimum number of criteria be used to define a small business that may suitably be used for accessing the maximum number of concessions.

Minimum upheaval from the existing position, advantages and disadvantages of different criteria (as discussed – see 3.3), desirability of marrying the income tax and GST systems where possible to reduce compliance costs and increase familiarity, number of concessions to which it can be applied and ease of application lead inescapably to the conclusion that **turnover** should be the main criterion for access to small business concessions.

Nevertheless, the two most significant concessions, the simplified tax system and CGT small business concessions, currently also use an **assets** test (in the case of STS, in conjunction with turnover). This must also be accommodated to facilitate the simplification of that test, as the policy reasons for the existence of an assets test mean it is unlikely to be abandoned.

2. Meaning of criteria

Turnover

Turnover needs to be linked to its GST meaning and calculated on a GST-exclusive basis (see 3.3).

Turnover should exclude infrequent large capital asset sales (see 3.3 for reasons).

It is also suggested, to increase simplicity, that input taxed supplies be specifically excluded from the basic definition. These are already excluded in calculating GST turnover. They would be implicitly excluded for most small businesses under the current definition of value of business supplies because of the requirement that they be made in the ordinary course of carrying on a business. The exception would be true moneylenders and, for the majority of small businesses, this could be catered for with a special subsection without obscuring the meaning.

The period over which it is to be measured also requires a decision. Income tax law uses income years (which for most taxpayers would be a financial year, but some may use substituted accounting periods), GST law uses a range of possible sequential periods, only some of which are annual (but which can generally be accumulated for any annual

period), and FBT uses FBT years which commence 1 April. For this reason, the financial year is suggested as the simplest alternative for the measurement period.

It must also be decided whether only the current financial year should be used or a rolling average either backward, forward or both, as either sole or alternative tests. It is recommended that the basic test be a single year test to increase simplicity. However, as this may not always be equitable, it is also recommended that it be supplemented by a three-year backwards-rolling average test where the current year test is not satisfied.

Assets

The main concessions that currently use an assets test use different bases.

STS is based on written-down value (adjustable value) of depreciable assets (with modifications) and CGT is based on market value of CGT assets (with exclusions), net of liabilities related to those assets.

Simplification is not achieved by selecting the same threshold if the measurement base is different.

Depreciable assets have the disadvantage of not including all assets and also leading to the possibility of a business falling in or out of a threshold as its assets wear or it replaces them.

Market value requires an additional valuation procedure and for some assets it may be a difficult process or information may not be readily available.

Original cost of all assets (whether depreciable or not) would at first glance appear a simplistic alternative to solve all of the preceding problems of lack of comprehensive coverage, fluctuating values and ease of ascertainment.

Original cost also has the advantage, if the STS threshold is to be lifted to match the CGT threshold (or both lifted higher), that it reduces the effect on the revenue, as depreciable values of those assets would still be lower, so there would not be a floodgate of new applicants.

While use of original cost would open the possibility of more CGT taxpayers qualifying if market value is higher than cost, this is balanced by the fact that the CGT threshold has been static for a number of years and in theory should increase over time anyway.

However, the CGT assets most likely to have a higher market value, land and buildings, may for some businesses have been acquired many years earlier and the discrepancy in value could be very significant.

A separate complication with the current CGT test is the meaning of the 'related to the assets' requirement for deducting liabilities. It should be clarified that all business liabilities can be deducted even if there is not a direct relationship to specific assets.

There is the added problem, in trying to meld the two existing tests, that CGT includes the requirement to value goodwill. While this is treated as a separate CGT asset, it is inappropriate to use an original cost concept, except for purchased goodwill.

It therefore seems inescapable that market value will need to be retained as the main CGT test. Some simplification could, however, be achieved by allowing written down value of depreciable assets to be treated as a proxy for market value, unless there were a substantial difference.

The issue then becomes, would a potential STS taxpayer be disadvantaged if the same test were to be applied for STS purposes or, alternatively, would a taxpayer currently in breach of the STS test now qualify. The inclusion of extra assets may create a risk of the former and the adoption of a net basis could create a risk of the latter.

The overall position is, therefore, that two different tests may have to be lived with unless a fundamental policy decision is made to completely change current policy in either or both areas.

This may not be disastrous for simplification, as the current STS test is not complicated and the adoption of a proxy for market value (see above), clarification on liabilities and centralised location (see 4.5) may still have some benefits. The current exclusions and inclusions in the CGT assets test can also, to an extent, be consolidated.

The final aspect of an assets criterion that needs to be dealt with is point of measurement. End of a financial year would seem the simplest and most logical.

3. Thresholds

Turnover

Although the precise threshold is a policy decision and does not impact upon the prime goal of a simplified definition, the suggested turnover threshold is \$2m. This would apply as the base threshold for a number of significant concessions, but the suggested form of definition allows for deviations for other concessions where justified (see 4.5).

It is recommended that a number of thresholds currently below \$2m be raised to that amount, namely the STS, GST cash accounting and GST business norms method thresholds.

In other areas, higher thresholds may be more appropriate, particularly where the concession is compliance related and has less potential impact on revenue (for example, the existing \$20m threshold for exclusion of at-call loans from the debt/equity rules – see Item 6 in Table 1 at 2.1).

Assets

The suggested assets threshold is \$6m for CGT (once again, the precise threshold is a matter of policy and does not impact upon the goal of simplification of the definition). This is an increase from the existing \$5m threshold to reflect that it has not been reviewed in some time. However, from the point of view of simplification principles, this is not critical.

Given that the conclusion was that two different definitions may have to be retained, the STS assets threshold would remain at its present level.

Other thresholds

To increase consistency, the R&D spending limitation could be dropped. In any event, it is unlikely that businesses which have a turnover below the R&D turnover threshold would exceed that spending.

There may also be an argument, to increase efficiency benefits for government and revenue authorities, that the GST electronic lodgment threshold be dropped to the new basic turnover threshold. Once again, businesses with assets exceeding \$6m, or which have a turnover exceeding \$2m, will invariably be using electronic information systems and should not have a problem with electronic lodgment.

Indexation

Automatic indexation of thresholds would generally be considered desirable by small business. Governments tend to overlook the option of regularly increasing non-indexed thresholds to take account of inflation.

However, the current goal is simplification and automatic indexation suffers from the problems that it requires extra provisions (albeit not necessarily complex). It would also mean that the current thresholds would not appear on the face of the legislation and would result in thresholds that are awkward numbers and not easy to remember. Nevertheless, feedback from small businesses suggests that this would be a small inconvenience that they would be willing to bear in return for automatically adjusted thresholds to allow for inflation.

While indexation has not been included in the sample legislation, it would be easy to do so. If it is not considered appropriate to provide for automatic indexation, it is, of course, nevertheless recommended that the government regularly increase thresholds by rounded million or half million dollars. The recommendation for a separate legislative scheme (see 4.5) would result in thresholds being less buried and therefore, hopefully, the subject of greater ongoing attention and would also make it a simpler task both to amend them and for that to apply across a range of provisions.

4.4 Grouping provisions

Grouping measures are an essential integrity test to ensure that access to the small business concessions is limited to businesses that genuinely meet the tests. The aim is to prevent larger businesses from gaining access simply by splitting activities or asset holdings into multiple entities, whether artificially or for genuine commercial reasons.

Grouping provisions add to the complexity of defining small business. Achieving a simpler and more uniform definition of small business also requires achieving a simpler and more uniform set of grouping provisions.

Compulsory grouping to prevent unintended access, when measuring against thresholds, is the only grouping that the definition of small business needs to address.

Voluntary grouping, such as by forming a GST group, has a different aim unrelated to size of entities, normally being to reduce administrative burdens for closely related entities with high interconnectivity (e.g. through trade or accounting). Grouping for those reasons usually requires far greater common ownership and it is inappropriate to attempt to achieve uniformity between it and small business grouping. Grouping rules of that nature should continue to be dealt with in the relevant specific legislation.

A review of Table 2 (see 2.3) shows that a grouping test is commonly used as an additional test. The main small business concessions, the STS and CGT concessions, contain the major small business grouping rules. Although established as two separate sets of rules, there is a high degree of commonality (possibly around 90 per cent in terms of similar concepts and tests). Nevertheless, there is no consistency in the way in which the tests are constructed, with different language being used, together with a different organisation and approach, often without any real difference in substance.

This was acknowledged at the drafting stage of the rules, with the STS rules being originally based on the CGT concession rules. However, the tests were modified to a format that seemed more appropriate to the specific policy underlying the STS.

Problems with grouping

The logical starting point for a grouping test is to review ownership of the business, and aggregate a group based on common ownership. While this approach works in relation to companies, unit trusts and partnerships, it is problematic in relation to discretionary trusts where the only interest may be a right to be considered for a distribution.

In particular, in relation to discretionary trusts, some of the problems that arise include:

- > Beneficiaries may be within a class, but may not benefit in the relevant period, in particular where a charity has been included
- > There may be potentially different capital and income rights
- > If a trust has no income, and capital rights are discretionary, it may not be possible to apply standard tests.

While each of these issues has been addressed by recent amendments in particular contexts, the issues need to be addressed in considering a definition of global application.

A further consideration in relation to grouping is that two businesses may act in concert although there is no formal ownership relationship. This is particularly relevant when a turnover test is to be applied, as decisions that are taken together could be used to distort turnover figures. The STS measures have an emphasis on business acting in concert, rather than just on ownership, for this reason.

When applying an assets test, however, it is appropriate to base the test mainly on ownership and to include the value of other business assets that are owned by each party.

Possible approaches to grouping

There are three potential approaches that could be adopted when drafting a grouping provision intended to have universal application:

1. The current grouping measures could be reviewed and the tests used reflected in the new definition, but in a simplified manner
2. An entity could be required to nominate its related entities, in a similar manner to the current family trust elections, and access to the concessions would depend on the members of that group meeting the requirements. This approach would require the development of sanctions that would apply if a person outside the group received a benefit
3. Where a business uses interposed entities, access to the concession would be dependent on being able to trace natural persons as the owners of the business within a limited number of tracing steps.

Approach 2 would seem more suited to a situation where a concession is sought to be gained (such as qualification as a family trust), rather than where the provision is an anti-avoidance provision to prevent splitting. It is currently used in that context within the CGT small business concessions to secure active asset status where a discretionary trust has made a loss, with the trustee being permitted to nominate 'notional' beneficiaries for the purpose of identifying a pattern of distributions.

Approach 3 was the approach used in the sufficient distribution requirements formerly imposed on private companies for income tax purposes, prior to the introduction of dividend imputation. It is also similar in philosophy to the United States 'S corporation concession' or the South African 'small business corporation rules' (see 3.2). It could, however, result in many small business structures that currently qualify for concessions losing that status, and that would be a policy decision that is not the focus of this report, which is to simplify rather than restrict access to the concessions. Limitations on structures could, however, be considered as a possible supplementary aspect of any new definition of small business, with higher thresholds applying to simplified structures where there is less risk of tax avoidance.

Recommended approach to grouping

For the reasons outlined above, approach 1 to new grouping rules has been taken.

Sight should not be lost, however, of the possibility of supplementing this with approach 3 by giving a more generous threshold for simplified small business structures. This would be easy to implement, but has not been included in the sample legislation drafted, as it is a policy decision going beyond the major focus of this report, which is simplification of the definition.

Under approach 1, to achieve greater uniformity and simplicity, it is recommended that there be a move away from trying to spell out every single detail in the legislation, often a major cause of complexity in modern tax legislation. At least in part, a return is recommended to use of more general concepts that are easily understood and which a court would be able to readily interpret.

It is, however, also recognised, that actually having to go to court should be extremely rare, and small business requires a high degree of certainty in being able to apply the provisions, particularly in a self-assessment environment. The revenue authorities also require that the ability to take advantage of 'loopholes' should not be created.

It is therefore recommended that a simpler approach to drafting the grouping provisions be adopted that incorporates the following features:

- > Easy readability – use of clear, commonly understood terminology
- > Succinctness
- > A logical arrangement and progression
- > Use of general concepts that can, nevertheless, be readily applied and that a court could easily interpret if required
- > Prima facie rules that give certainty as to how to apply the general concepts – but being prima facie rules, they are capable of being overturned in an appropriate situation to reflect the underlying substance of the primary tests.

The actual content of the grouping rules in the sample legislation is based on the existing policy criteria including levels of ownership – the aim of this report is simplification.

Incorporating the opportunity to revert to the underlying substance of the primary general tests should offer protection against loopholes. Yet this would not be dependent on the Commissioner's discretion, but rather on a reasonable interpretation (to be confirmed by the court if need be). It is considered that a private ruling, with its objection rights, could satisfy the need in any areas of real ambiguity. If a case did go to court, the principles laid down could guide future interpretation.

Nevertheless, it is considered highly unlikely that the prima facie rules would not cover almost all situations or that there would be many areas of real doubt with application of the general concepts, which should give a small business confidence that it could determine with a reasonable degree of certainty and simplicity the entities with which it must be grouped.

Using the general concepts approach, it is not considered necessary to refer to methods applicable to different entities for every test. The concept of control, for example, would obviously be interpreted in a company situation to include control by means of voting power, without the need for that to be specified. Similarly, where an unrelated entity controls 60 per cent, compared to only 40 per cent by the entity under consideration, it is not considered necessary to specify that this is a situation in which the general concept of control would not be satisfied, as the 40 per cent rule is only a prima facie rule. However, any special widening of a general concept, such as the extension to acting in accordance with directions or wishes, would still be specified.

Some more specific rules would still be needed to cater for situations such as discretionary trusts, where interests in the normal sense do not exist, to ensure that there is certainty and a rule capable of application in that situation.

The draft grouping provisions included in the sample legislation reflect these principles. They demonstrate that such an approach is achievable and, even if minor variations to the draft grouping rules proposed are considered desirable, they can be accomplished within this framework.

4.5 Form and location of definition

The second element (see 4.1) for ensuring not only initial simplification, but also continued simplification, apart from using uniform criteria wherever possible, is to address the process of definition.

It has already been established that it would be impossible to have zero deviation. Nevertheless, it is important to minimise future deviations from the basic definition established and allow for any deviation in a manner that reduces as far as possible its effect on simplification.

There are three key points for achieving simplification, despite allowing for some deviation:

1. Consolidate all the relevant access definitions in a single area, so that business or their advisors can easily view all the concessions for which they will or will not potentially qualify (subject to any non-size-based criteria that remain in the individual operative provisions) and be aware of different access criteria
2. If there is to be deviation, treat it as such – in other words, commence with the basic definition and use it to the maximum extent possible, rather than writing completely separate and different definitions
3. Focus parliamentary attention on the fact that there is deviation – this is very important when introducing new concessions, as it means any deviations from the basic definition would need to be justified.

The above principles have been incorporated into the draft legislation proposed (see 5.1).

A single location has been suggested that can easily be located by small businesses and their advisers and is free from other statutory interference. As the definition is to have effect for a number of Commonwealth tax laws, a separate Act is proposed.

The proposed separate definition Act incorporates a basic definition that is used without modification to the maximum extent possible. It highlights any areas where there is deviation, but uses the basic definition as the starting point for any deviations. It can easily be amended if it is desired to increase a threshold in the future, without the need for multiple amendments to a range of statutes or provisions.

Most importantly, every time a new size-based concession is introduced, parliament will have to focus on whether to include it in the basic definition or create a deviation – this is considered vital to ensure that the simplification process does not unravel in the future.

Mechanics of introduction

It is proposed that two separate Acts be introduced at the same time.

1. Small Business (Definition) Act 2006

This Act is intended as a continuing new principal Act and will contain the new definition of small business,

drafted in accordance with the principles outlined above. A preliminary draft is provided (see 5.1) that **demonstrates** the methodology and uses the uniform criteria recommended in this report.

Note that the preliminary draft provided is not meant to be 'perfect' or final legislation, nor does it attempt to detail every small business concession that can be brought within its format. It is sample legislation that **demonstrates and implements the approach and criteria recommended in this report**

2. Small Business (Consequential Amendments) Act 2006

It is important that the new definition Act be kept as 'clean' as possible, consistent with the goal of simplification, not only of content, but also of access to and usability of the content.

This second Act is required to remove the existing definitions from their respective operative provisions and link the individual operative provisions to the new definition.

The link itself would be relatively simple, such as 'This section applies to a small business for the purposes of this section as identified in the *Small Business (Definition) Act 2006*.' Drafting of the individual removal provisions would be a task for the parliamentary draftsman and is beyond the scope of this report.

4.6 Advantages of proposal

This report has demonstrated that the existing manner in which tax laws identify small business differently on a provision-by-provision basis for a myriad of purposes adds considerably to the complexity of the law and the compliance burden on small business.

It is also recognised, however, that it would be virtually impossible, due to the different aims and policy intent behind various provisions, to adopt a complete one-size-fits-all approach.

Nevertheless, within that constraint, there are still considerable advantages for the government, revenue authorities and the small business community in attempting to address the situation to the maximum realistic extent by adopting the proposals in this report (possibly with refinements as it is considered on a wider basis), namely:

- > Recognition that the problem exists and an attempt is being made to solve it
- > Increased consistency across tax laws and considerable reduction in complexity in a large number of the existing rules
- > A one-stop shop for small business or their advisers to access the criteria that must be satisfied to obtain various concessions
- > Heightened awareness of the concessions that are available
- > Reducing future ad hoc variations in conditions and criteria through the need to build them into an existing framework and justify and identify any variations from that framework
- > A reduced compliance burden for small business as a result of the above.

Part 5 – Sample legislation

5.1 Draft legislation

Small Business (Definition) Act 2006

No. 126, 2006

An Act to define a small business for the purposes of various Commonwealth taxation laws

The Parliament of Australia enacts:

1. Short title

This Act may be cited as the Small Business (Definition) Act 2006.

2. Commencement

This Act commences on the day on which it receives the Royal Assent.

3. Object of this Act

The object of this Act is to provide a simplified and consolidated definition of small business for the purposes of the following Commonwealth taxation laws:

- Income Tax Assessment Act 1936* (ITAA 1936);
- Income Tax Assessment Act 1997* (ITAA 1997);
- A New Tax System (Goods and Services Tax) Act 1999* (GST Act);
- Fringe Benefits Tax Assessment Act 1986* (FBTAA); and
- Taxation Administration Act 1953* (TAA).

4. Small business

An entity is a small business for the purposes of a provision of a Commonwealth Act listed in section 3 if it satisfies the tests that this Act specifies apply for the purposes of that provision.

5. Turnover test

- An entity satisfies the turnover test if its **turnover** for a relevant period is less than \$2,000,000.
- Turnover** is the value of supplies that an entity makes in the ordinary course of carrying on business for a financial year as determined under subsections (4) or (5).
- If an entity is grouped with another entity under section 10, its turnover also includes the turnover of all other entities with which it is grouped, other than turnover consisting of supplies made between any of the entities.
- If an entity is registered for GST during all or part of a financial year, the value of supplies made while registered for GST is the sum of the:
 - Value (as defined by section 9-75 of the *A New Tax System (Goods and Services Tax) Act 1999*) of its taxable supplies; and
 - Prices (as defined by section 9-75 of the *A New Tax System (Goods and Services Tax) Act 1999*) of its GST-free supplies.

Input taxed supplies are not included.

- If an entity is not registered for GST during all or part of a financial year, the value of supplies made while not registered for GST is the sum of the prices (as defined by section 9-75 of the *A New Tax System (Goods and Services Tax) Act 1999*) of its supplies other than supplies that would be input taxed supplies (without the need for any election) if it were registered for GST.

- An entity that is a financial institution for any purposes within the meaning of the *Financial Transaction Reports Act 1988* must include input taxed financial supplies in addition to GST-free supplies in its calculation under subsection (4)(b).
- An entity that does not satisfy the turnover test under subsection (1) for a relevant period on the basis of its turnover for a financial year under subsection (2) may alternatively satisfy the turnover test if the average of its turnover for the financial year and the two immediately preceding financial years satisfies the test in subsection (1).

6. Assets test

- An entity satisfies the **assets** test if its assets at the end of a relevant period are less than \$6,000,000.
- Assets** at the end of a relevant period are calculated as the sum of the market value of all business assets owned by the entity or owned by entities with which it is grouped under section 10, at that time, less all business liabilities of those entities.
- The market value of a business asset that is a depreciable asset shall be taken to be its tax written down value (adjustable value for the purposes of Division 40 of the *Income Tax Assessment Act 1997*) unless its true market value would exceed its original cost.
- Business assets are CGT assets used for business purposes in a business of the entity or entities with which it is grouped under section 10, other than interests of an entity in another entity with which it is grouped.
- Business liabilities are liabilities related to the business affairs of a business the assets of which are business assets for the purposes of subsection (4).
- Assets or liabilities within the meaning of subsections (4) or (5) are apportioned if they are used only partially for business purposes.

7. Provisions to which tests apply without modification

- An entity is a small business for the purposes of a provision listed in column 1 of the table in subsection (2) if it satisfies the turnover test in column 2 as required and/or the assets test in column 3 as required.
- Table of provisions to which tests apply without modification:

Column 1 Provision	Column 2 Turnover test	Column 3 Assets test
Division 152 of ITAA 1997	No	Yes
Division 328 of ITAA 1997	Yes	No
Section 82KZM of ITAA 1936	Yes	Yes
Etc	Etc	Etc

8. Provisions to which turnover tests apply on a modified basis

1. An entity is a small business for the purposes of a provision listed in column 1 of the table in subsection (2) if it satisfies the turnover test in column 2 as modified by the modification listed in column 3.
2. Table of provisions to which tests apply on a modified basis:

Column 1 Provision	Column 2 Turnover test	Column 3 Modifications
Subdivision 61-J of ITAA 1997	Yes	Modification 1
Other provisions as considered appropriate	Yes	Modification 2

9. Modifications of turnover tests

1. The table in subsection (2) sets out the modifications that apply for the purposes of section 8.
2. Table of modifications:

Modification	How the turnover test is modified	
	Substitute turnover	Other modification
Modification 1	\$75,000	
Modification 2		Turnover includes input taxed supplies

9A Provisions to which assets tests apply on a modified basis

[Similar provisions to sections 8 and 9 would be inserted for assets test modifications]

10. Grouping rules

1. An entity is grouped with any other entity if it has a substantial connection with that entity.
2. An entity has a substantial connection with another entity if one entity has a substantial degree of:
 - a. Legal ownership of the other;
 - b. Beneficial interest in the other; or
 - c. Control over the other (whether through voting power or otherwise).
3. Without limiting the generality of subsection (2), legal ownership, beneficial interest or control (if related to voting power) of 40 per cent or more in an entity shall prima facie be taken to be a substantial degree.
4. Without limiting the generality of subsection (2), legal ownership, beneficial interest or control (if related to voting power) of less than 40 per cent in an entity shall prima facie be taken not to be a substantial degree.
5. For the purposes of subsection (2), an entity shall be taken to have a substantial degree of legal ownership, beneficial interest or control (if related to voting power) of another entity if it has a power or right to acquire a substantial degree of legal ownership, beneficial interest or control in that entity.
6. If two or more entities that have a substantial connection with each other hold any legal ownership, beneficial interest in or control (if related to voting power) over the same entity, then for the purposes of subsections (3) and (4), each shall be regarded as having their combined percentage interest in that other entity.

7. An entity is taken to have a substantial degree of control over another entity if the other entity acts in accordance with its wishes and directions.
8. Spouses are taken to act in accordance with the directions and wishes of each other.
9. A child under 18 of a person is taken to act in accordance with the directions and wishes of that person.
10. Partners in a partnership shall not be taken to act in accordance with the directions and wishes of each other merely because they make combined decisions in relation to the partnership.
11. A beneficiary of a non-fixed trust has a substantial beneficial interest in the trust if, and only if, in any of the last four income years for the trust the beneficiary:
 - a. Has received or been presently entitled to 40 per cent or more of any distributions of income or capital of the trust;
 - b. Has received or been presently entitled to any distributions, whether of income or capital or both, totalling \$100,000 or more; or
 - c. Would be entitled to a fixed interest of more than 40 per cent or more than \$100,000 in a distribution of the capital of the trust on a winding up.
12. In applying subsection (11), the receipts, present entitlements or entitlements of two or more entities that have a substantial connection with each other shall be combined, and each shall be regarded as having received or been or be entitled to the combined amounts or percentages.
13. Subsections (11) and (12) do not apply to an entity that is an exempt entity or deductible gift recipient as defined in the *Income Tax Assessment Act 1997*.
14. If an entity has a substantial connection with another entity, each entity is also taken to have a substantial connection with any other entity that has a substantial connection with either entity, whether directly under subsections (2) to (12) or through a previous application of this subsection.

11. Application

1. This Act applies for the purposes of a provision of the *Income Tax Assessment Act 1936* or the *Income Tax Assessment Act 1997* for the income year commencing 1 July 2006 and all subsequent years.
2. This Act applies for the purposes of a provision of the *A New Tax System (Goods and Services Tax Act) 1999* for the first GST period of an entity commencing on 1 July 2006 and all subsequent GST periods.
3. This Act applies for the purposes of a provision of the *Fringe Benefits Tax Assessment Act 1986* for the fringe benefits tax year commencing on 1 April 2006 and all subsequent years.
4. This Act applies for the purposes of a provision of the *Taxation Administration Act 1953* for the financial year commencing 1 July 2006 and all subsequent years.

Part 6 – Impact of proposals

6.1 Assessing impact – approach

As noted earlier, the small business sector is a vibrant part of the Australian economy and the intention of the changes proposed in this report is to simplify, in one very important respect, the operation of the small business tax provisions by making them more transparent, less complex and therefore more accessible.

To assess the broad impact of the proposed changes on the small business sector, it is important to first garner an understanding of this sector. This is not a simple task, since if there is one fact that distinguishes this sector from large business, it is the flexible way it seeks to maximise the returns to its owners from market opportunities.

To better understand this sector and how the proposed reforms will impact on it, three accounting practices were consulted and asked to identify the typical structures and key details of their small business clients.

Information was sought on a range of variables (see 6.2) on the basis that these identified the most important distinguishing characteristics of these small businesses and therefore provided an insight into how this sector would be impacted by the proposed legislative amendments.

Our original research methodology proposed taking the 26 case studies provided and using these as the basis for developing 10 hypothetical small businesses, analysing the proportion of small businesses that fell into each category identified and determining the impact on them of the proposed tax changes.

This data was then to be used to identify those areas that could be viewed as ‘pressure points’ when considering the potential impact on them of the proposed changes to the definition of what constitutes a small business.

6.2 Case studies – what was revealed?

Before discussing the results of the case study analysis, it is appropriate to describe the information that was collected.

Data collected

The data collected for each of the 26 case studies is detailed in Table 3, below.

Table 3: Case study data

1. Size

- a. Turnover
- b. Income
 - Taxable
 - Gross
- c. Asset base
 - Value: market — goodwill, market — other; cost — goodwill, cost — other; written down value
 - Profile of asset: depreciable, intangible, or other assets
 - Age profile of assets: < 5 yrs, 5–10 yrs, 10–20 yrs, > 20 yrs
 - Liabilities

2. Structure

- a. Sole trader; partnership; company; trust
- b. Is the entity part of a larger organisational group?
 - Entities with a horizontal relationship (e.g. owned by common parent entities);
 - Entities with a vertical relationship (e.g. having an ownership interest in the small business)

3. Industry

- a. Sector: service/manufacturing/agriculture
- b. Activity within sector (e.g. building construction where the business could be the prime contractor or a subcontractor)

4. Life cycle stage of business

- a. Start-up/mature

5. Capital funding

- a. Debt/equity
- b. Gross assets/net assets

6. Concentration of ownership

- a. Number of owners (1, 2, 3+)
- b. Age of owners (e.g. < 55 or not)
- c. Percentage interest of owners
- d. Relationship between owners (e.g. principal, spouse, immediate family, extended family or unrelated parties)

7. Pattern of distributions: principal, spouse, immediate family members, extended family members and unrelated parties.

Observations

The 26 case studies examined revealed the complex way in which many small businesses structure and operate their business activities. It also highlighted the importance of any grouping definition and the difficulty in ever generalising in relation to this sector.

In response, it was decided not to try to prepare the proposed 10 hypothetical small businesses from the case studies. Rather, the approach ultimately taken was to examine the case studies provided to assess more broadly how the proposed changes would impact on these businesses without revealing the specifics of their individual cases.

These observations can be made under a number of headings and will be discussed in turn below.

Turnover/income

The case study data revealed quite widely varying turnover, from just under \$100,000 to just over \$10m. It did, however, appear to confirm the comments made when analysing the possible criteria that could be used to identify small business (see 3.3) that in most cases there is very little, if any, difference between turnover and income. Taxable income, on the other hand, varied widely in comparison to turnover, also as expected.

Structure

While many businesses operate a simple structure, there are a number which have quite a complex structure, consisting of companies, partnerships and service trusts. Others operate combinations of unit trusts and companies, while some operate as sole traders with discretionary trusts. It was not unusual to therefore find small business structures that consisted of combinations and permutations of sole traders, partnerships, companies, service trusts, unit trusts and discretionary trusts.

Grouping

The data did not adequately reveal the other businesses the owners identified were involved in, in two respects: turnover/assets of grouped entities other than the business being examined and whether the owners might have had any other businesses that were not part of the particular group under consideration. This would have implications in trying to assess whether the business might be excluded from qualifying for small business concessions through application of the grouping provisions, even though as an individual entity they would qualify. This implies there is a need for more insight into grouping than provided by the data, to determine whether the proposed grouping definition might impact adversely on these owners.

Assets value

Data collected on asset values indicated how quite different outcomes can result from adopting different measures as the appropriate method for valuing assets (i.e. cost, market value or tax written-down value). The extent to which goodwill was a major asset of a high proportion of the businesses was also very apparent from the data.

Pattern of distributions

It was clear that the vast majority of the businesses identified distributed profits among immediate family members. Further information on other businesses in which the owners are involved may identify the business structures used when arm's length parties are involved in the wider business affairs, and the implications of the proposed definition on such structures.

Debt/equity

There were wide variations in the debt/equity ratios reported. This may to some extent result from the self-funding nature of many small businesses, and the manner in which owners' equity is reflected in the accounts. It became apparent that more information would be needed on loan funding, particularly from the owners and other grouped businesses, in trying to assess asset test application.

6.3 Other stakeholders – implications

Potential implications for other stakeholders are set out below.

Customers

The changes proposed in this report do not involve substantial policy change. As a consequence, impact on these businesses and ultimately on consumers will be infra-marginal.

Tax administrator

Simplifying the legislative provisions should reduce the cost of administering these tax provisions.

Government (politics/revenue)

The proposed changes do not involve a policy change and should have only a minimal impact on the revenue collected. In terms of the politics of the change, this will be determined by whether the changes reduce the scope for businesses currently defined as being small to retain that status. This can be achieved by ensuring that any change (such as to grouping) will still encompass those businesses.

Professional accountants/advisers

If the changes simplify the legislation, then this should act to reduce the task of and costs associated with the provision of professional advice from accountants and legal advisers.

Non-small businesses (competitive advantage)

The proposed changes should not impact on the non-small business sector because it is not proposed that the scope of the existing legislation be expanded.

6.4 ATO and ABS data – Businesses affected?

While the case studies approach is informative, it leaves unanswered the all-important question of how many businesses are likely to be impacted by the proposed legislative changes. While information was sought from the accounting practices providing the data on the case studies about how representative these businesses were of their small business clientele, it still does not provide detailed insight into the total number of businesses affected. Such a number is also important in any consideration of the revenue cost of the changes.

To gain some insight into this issue, we need to turn to data collected by the ATO and ABS on small businesses. The ABS traditionally defines a small business on the basis of the number of its employees. Agricultural and non-agricultural small businesses are subsequently defined as follows:

1. Non-Agricultural Businesses: Non-employing (0 employees), Micro (1-4 employees), Small (5-19 employees)
(Note: Medium 20-199, Large 200+) (See ABS 1321)
2. Agricultural Businesses: Estimated Value of Agricultural Operations (EVAO) of \$22,500 and \$400,000 based on:
 - The area of crops sown
 - The number of livestock, and
 - Crops produced and livestock turn-off (mainly sales) during the year.

However, this data is of little benefit to a study into small business that has its focus on the income, turnover and assets of small businesses.

The ATO *Taxation Statistics* is not much more helpful since it does not identify businesses per se but rather reports data on the basis of the structure of the taxpayer. This suffers from two problems in so far as usefulness for the focus of this report is concerned. First, some entities may not be active and not require an ABN. Second, and more importantly, no information is available on a group basis.

Table 4, below, presents the latest data on the total income and taxable income of companies, trusts and partnerships. However, a large proportion of the small business sector is unincorporated – especially micro-businesses. As of 30 June 2003, there were 4.1 million active ABNs (ATO *Taxation Statistics* 2001–02, Chapter 12, p 247), while the total of companies trusts and partnerships in the same period was 1.59 million (Table 4). Over 2.5 million ABNs are therefore issued to unincorporated taxable entities. The question is what proportion of this 2.5 million are small (or micro) businesses. The ATO 2002–03 *Taxation Statistics* shows that individuals with 'total net business income/loss' were some 0.86 million (2003PER5B.xls). This information, however, is not particularly helpful since these individuals could have received this business income from trusts or their share in a partnership and therefore overlap with the data in Table 4.

Table 4: Companies, trusts and partnerships – 2002-03

Number of Companies (private and public)			
Total income	Numbers	%	Cumulative %
Loss/nil	78,861	12.9	12.9
\$1–\$499,999	389,478	63.6	76.5
\$500,000–\$999,999	57,193	9.3	85.8
\$1,000,000–\$4,999,999	64,632	10.6	96.4
\$5,000,000–\$9,999,999	10,264	1.7	98.0
\$10,000,000–\$49,999,999	9,034	1.5	99.5
\$50,000,000–\$99,999,999	1,386	0.2	99.7
\$100,000,000 or more	1,592	0.3	100.0

Total	612,440	100.0
Other resident companies	50,048	
Total resident companies	662,488	
Non-resident	1,676	
Total companies	664,164	

Source: ATO 2002–03 Taxation Statistics: 2003COM8A.xls

Taxable income	Numbers	%	Cumulative %
Less than \$2,000	379,194	61.9	61.9
\$2,000–\$9,999	44,891	7.3	69.2
\$10,000–\$49,999	82,383	13.5	82.7
\$50,000–\$99,999	35,993	5.9	88.6
\$100,000–\$499,999	50,867	8.3	96.9
\$500,000–\$999,999	9,315	1.5	98.4
\$1,000,000–\$4,999,999	7,574	1.2	99.6
\$5,000,000 or more	2,223	0.4	100.0

Total	612,440	100.0
Other resident companies	50,048	
Total resident companies	662,488	
Non-resident	1,676	
Total companies	664,164	

Source: ATO 2002–03 Taxation Statistics: 2003COM2A.xls

Number of partnerships			
Net Australian income	Numbers	%	Cumulative %
Loss/nil	111,339	24.7	24.7
\$1–\$19,999	136,711	30.3	55.0
\$20,000–\$49,999	104,892	23.2	78.2
\$50,000–\$99,999	62,745	13.9	92.1
\$100,000 or more	35,693	7.9	100.0

Total	451,380	100.0
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Source: ATO 2002–03 Taxation Statistics: 2003PAR1A.xls

Number of trusts			
Net Australian Income	Numbers	%	Cumulative %
Loss/nil	78,041	16.6	16.6
\$1–\$19,999	193,831	41.2	57.8
\$20,000–\$49,999	77,125	16.4	74.2
\$50,000–\$99,999	52,367	11.1	85.3
\$100,000 or more	69,581	14.8	100.0

Total	470,945	100.0
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Source: ATO 2002–03 Taxation Statistics: 2003TRU1A.xls

The only comprehensive database capable of providing an insight into the number of small businesses corresponding to the above case studies is the ATO Business Income Tax (BIT) data base. The ABS has access to this information and Table 5, below, reports the number of small businesses for 2000–01 where small businesses are defined as those with income or expenses between \$10,000 and \$5m. This is in a period when the number of active ABNs was 3.5 million, the number of companies was 0.63 million, trusts 0.45 million and partnerships 0.47 million, and the number of persons receiving some 'net business income or loss' was 0.79 million. While the ABS data is drawn from a similar database to the ATO Taxation Statistics, it is superior to the ATO data because it includes all business activity, regardless of the business entity's structure. However, the data reported in Table 5 is only for 2000–01.

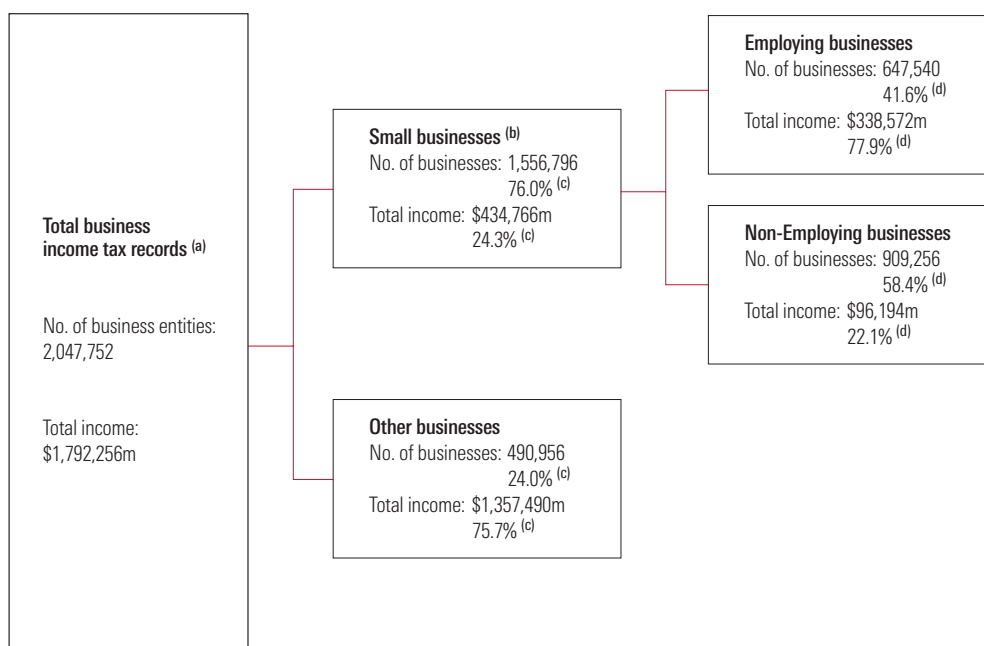
The ABS *Business Demographics* section (and in particular the Director, John Blanchette) assisted this project by preparing more up-to-date data using the ABSBR (ABS Business Registry) data as it relates to BAS information. Data for a range of turnover levels was prepared and the results are shown in Table 6, below. The number of businesses reported in Table 6 (3,015,318) contrasts with the 4,548,471 entities the ATO had registered for an ABN as at 2 July 2004.

The data in Table 6 shows that some 91.4 per cent of businesses have a turnover of less than \$1m and 98.1 per cent with less than \$5m, leaving only 57,554 businesses with a turnover greater than \$5m.

What this ABSBR data cannot tell us, however, is how many of these small businesses defined using a turnover test subsequently fail the assets test and are therefore ineligible for the current small business concessions. Equally, it cannot tell us how many businesses at the margin may be impacted by the proposed changes. However, this data source could be used to assess how sensitive the number of small businesses are to changes in the turnover test and in turn the cost of any such change. Nevertheless, once again, information is not available on a grouped basis and some holding entities do not require ABNs.

If identifying how many businesses are affected by changes in the turnover and assets tests is problematic given available data sources, then this inevitably means that costing the proposed reforms is not possible with the data available to this study. While it is reasonable to say that the 'no policy change' position taken in this study when seeking to simplify the small business tax legislation will not result in significant revenue impact, this cannot be said for changes that ultimately impact on policy.

Table 5: Data reported by the ABS when using the ATO BIT database



Note: Some government-owned Public Trading Enterprises are included.

(a) Excluding non-operating businesses, general government, some non profit institutions serving households and funds.

(b) Income or expenses between \$10,000 and \$5m.

(c) Percentage contributions to all businesses and total income.

(d) Percentage contributions to all small businesses and small business income.

Source: ATO files for companies, partnerships and trusts and individuals for 2000-01.

Source: ABS Experimental Estimates, Regional Small Business Statistics 1995–96 to 2000–01 (ABS 5675.0)

Table 6: ABSBR, counts of businesses – June 2004
Number of Businesses by BAS estimation turnover ¹ size ranges

Turnover range	< 20 employees ²			≥ 20 employees			Number of Businesses		
	Number	% of total based on:		Number	% of total based on:		Number	% of total	Cumulative total
		Turnover	Employees		Turnover	Employees			
< \$25k	260,589	99.7	9	791	0.3	1	261,380	9	8.7
\$25–99k	1,252,715	99.9	43	1,426	0.1	2	1,254,141	42	50.3
\$100k–\$499k	1,031,900	99.0	35	9,433	1.0	11	1,041,333	35	84.8
\$500k–\$999k	188,287	94.0	6	11,895	6.0	14	200,182	7	91.4
\$1m–\$4.999m	164,525	82.0	6	36,203	18.0	44	200,728	7	98.1
\$5m–\$9.999m	13,007	56.0	0	10,042	44.0	12	23,049	1	98.9
\$10m–\$14.999m	16,080	81.0	1	3,876	19.0	5	19,956	1	99.5
\$15m–\$19.999m	1,111	35.0	0	2,084	65.0	3	3,195	0	99.6
> \$20m	4,530	40.0	0	6,824	60.0	8	11,354	0	100.0
Total	2,932,744	97.0	100	82,574	3.0	100	3,015,318	100	

¹ BAS estimation turnover based on the latest available BAS turnover figures for that financial year for each business. Missing data (either missing months/quarters for sub-annual remitters or missing yearly figures for annual remitters) is imputed and, for larger, more complex businesses, statistical unit (the TAU) does not have direct ABN links and so full turnover figure imputed.

² < 20 employees includes non-employing.

Source: ABSBR data, specially prepared data.

6.5 Issues for further study

While the case studies provided us with some initial insight into the impact of the proposed changes on these small businesses, it has quickly become clear that some small business structures are quite complex and this raises issues that are beyond the scope of this study. One is that a study into the impact of tax changes must ultimately involve two distinct steps. The first is to focus on the policy approach that should be taken when taxing small business and the second is the nature of the data necessary to enable an informed assessment of any such policy on the small business sector.

In this study, it was assumed that there would be 'no policy change' so that the focus was on simplifying the current small business legislation. There is good reason, however, to review the approaches taken in other countries and consider whether they may or may not be superior to the Australian approach. However, this involves issues that are beyond the scope of this particular project and could be slated for further study in the future. Nonetheless, it is important to acknowledge that the current policy approach might not commonly be the preferred approach.

The second issue is access to data to enable an informed analysis of the impact of any proposed change to be undertaken. As noted above, the ABS and ATO data could not adequately provide us with this insight. This study instead sought to obtain detailed data on a range of small business case studies supplied by three accounting practices engaged to assist with this study. It was clear from this data that businesses operate using complex structures and that the case studies supplied did not provide adequate detail to enable all issues to be addressed. However, it was decided that the pursuit of additional data on these case studies was not necessary at this stage because our study has assumed a 'no policy change' position which is likely to have marginal impact on its businesses and not justified the substantial cost in collecting further data on each of the businesses on which data was initially provided.

This would, however, be justified if major policy changes were recommended. In this case, it would be essential to undertake such detailed analysis. Attention in the future should therefore be given to either: (a) circulating the proposed simplification for comment and seeing what industry should response occur; or (b) evaluating the adequacy of current policy and making alternative proposals. If the approach in (b) was adopted, there would be a good case for returning to the case study information, seeking greater detail on these individual businesses and combining this information where possible with that obtained from the ABS Business Demographics section which is accessing the ABSBR database to examine business related issues.

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