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Tax and small business

We measure small business income tax performance, estimate their income tax gap and use research to reduce the tax gap.

Small business random enquiry program findings

The ATO conducts a random enquiry program to estimate the small business income tax gap.

QC 59955

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Last updated 27 October 2026

Summary of findings

For the purposes of estimating the Small business income tax gap, we examine the income tax affairs of a sample of small business taxpayers. This is called the random enquiry program.

Our latest completed sample comprises of 2,024 small business taxpayers across the 2020–21, 2021–22 and 2022–23 financial years.

We refer to this as our 2023 bundled sample.

For the 2023 bundled sample, we found that:

- 50% reported correctly
- 37% tried to report correctly but made mistakes – these were usually caused by one or more of the following
  - poor record keeping
  - lack of reconciliation processes
  - carelessness (for example, transposition errors or small one-off omissions)
  - complexity (business owners not understanding the law or how their tax obligations apply for their chosen business structure).
- 6% under-reported income or exaggerated expenses and were considered to be engaging in opportunistic behaviour. While there was no clear evidence the behaviour was deliberate, these taxpayers often made little effort to keep records or substantiate claims.
- 7% were deliberately under-reporting income or overclaiming expenses and deemed to be operating in the shadow economy. This group was responsible for around 54% of the missing revenue identified in the sample.

Behaviours observed in the random enquiry program

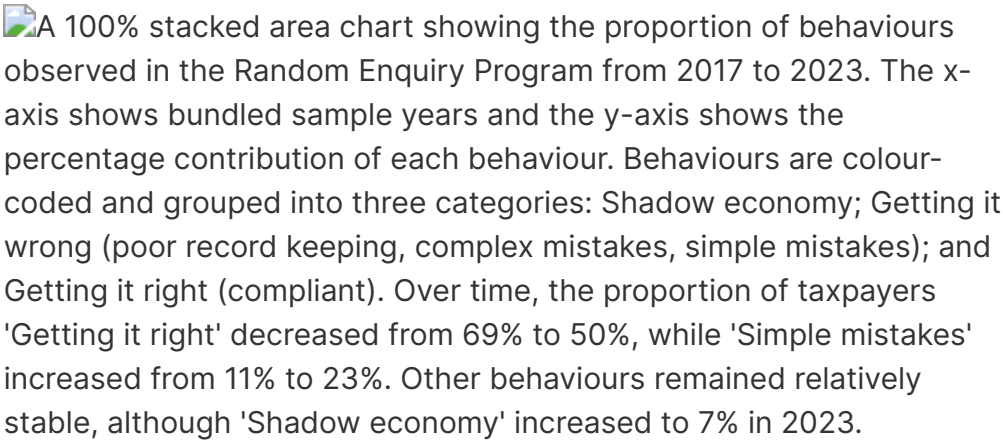
The random enquiry program has been operating for 10 years. Over this time, we have analysed the behaviour of small business taxpayers and gained some key insights into how we can better assist taxpayers to lodge and pay the correct amount of tax.

The observed behaviours can be broken down into 3 broad categories for small businesses:

- getting it right
- getting it wrong (as a result of mistakes, complexity, poor record keeping or opportunistic behaviour)
- operating in the shadow economy.

Figure 1 shows behaviours observed in the random enquiry program since its inception. Over time, there has been a decrease in small business taxpayers getting it right, particularly in the 2023 bundled sample. This follows a similar trend of an increase in small business taxpayers getting it wrong, notably those making simple mistakes and to a lesser extent, those engaging in shadow economy behaviour.

Figure 1: Proportion of bundled sample population by behaviour, 2017–2023


A 100% stacked area chart showing the proportion of behaviours observed in the Random Enquiry Program from 2017 to 2023. The x-axis shows bundled sample years and the y-axis shows the percentage contribution of each behaviour. Behaviours are colour-coded and grouped into three categories: Shadow economy; Getting it wrong (poor record keeping, complex mistakes, simple mistakes); and Getting it right (compliant). Over time, the proportion of taxpayers 'Getting it right' decreased from 69% to 50%, while 'Simple mistakes' increased from 11% to 23%. Other behaviours remained relatively stable, although 'Shadow economy' increased to 7% in 2023.

Small businesses getting it right

When we see businesses operating well and complying with their tax obligations, we see they have the basics right. As observed through the random enquiry program, we can see that these businesses:

- have good record keeping practices and undertake regular reconciliation processes (such as ensuring cash deposits are included in total sales)
- understand their tax obligations and seek advice when they need it
- have the support of someone who understands their business (for example, a registered tax or BAS agent, a bookkeeper or accountant)
- use technology that is appropriate for the size and scale of their business (such as point-of-sale software, cloud-based accounting systems or mobile apps).

Small businesses getting it wrong

We observed 4 main types of behaviour amongst small businesses getting it wrong:

- simple mistakes – generally doing the right thing but making a genuine, isolated error
- complex mistakes – demonstrating willingness and effort to comply with tax obligations, with errors arising from complex issues or a misunderstanding of how the law applies to their circumstances
- poor record keeping – being unaware of record keeping obligations or problems with record keeping systems, or having minimal controls in place to prevent errors
- opportunistic – appearing to take advantage of ambiguous circumstances or relying on social norms to justify actions (without exhibiting clear intent to avoid paying the right tax).

Simple mistakes

In the 2023 bundled sample, we can see a greater number of small businesses making low-value mistakes than in previous years. However, the reasons for these mistakes remain similar to previous bundled samples. These include:

- clerical errors – bookkeeping errors made during reconciliation processes, such as typographical errors, transposition errors, missing substantiation, apportionment issues or incorrect calculations
- non-deductible expenses – mistakenly claiming ineligible items in error, such as late superannuation payments or donations to non-deductible recipients
- immaterial variations – misreporting small amounts of income or expenses that are forgotten or not fully verified, such as omitted bank interest.

Complex mistakes

While complex mistakes were less common than simple mistakes in the 2023 bundled sample, they often resulted in higher value adjustments.

Complex mistakes often stemmed from issues related to the taxpayer's business structure or incorrect application of the law. Complex mistakes observed include:

- fringe benefits – errors typically arising from the private use of motor vehicles
- personal services income – underreporting or misreporting income from personal services, often due to misunderstanding specific provisions
- Division 7A – businesses failing to consider loan implications for personal use of assets, missing loan repayments or using the incorrect interest rate in non-arm's length loan arrangements
- business structure – misunderstanding how tax obligations apply to the chosen business structure or changes to that structure, including the tax treatment of franchise purchase costs, and difficulties managing complex reporting structures involving multiple entities
- capital gains – mistakes made on how to correctly calculate a capital gain or loss, including the sale of a business, property, shares, or crypto assets
- income – misreported foreign or rental income, complex errors related to loan income, or cash and accrual entries
- expenses – for example, confusion surrounding capital works depreciation, the deductibility of entertainment expenses, and incorrectly claiming non-deductible life insurance premiums as business expenses.

Poor record keeping

Poor record keeping can be the result of a lack of business acumen, however, it can also be a tax avoidance strategy. When taxpayers deliberately avoid keeping the right records to hide income, they are taking part in the shadow economy.

Unintentional record keeping issues observed in the 2023 bundled sample include:

- no source records kept, in these instances bank account statements were often used to determine income and expenses (instead of being reconciled against)
- poorly maintained documentation, including poor storage, partially completed logbooks, faded receipts or no digital backups

- expenses claimed without the necessary substantiation, such as motor vehicle, travel and home office expenses
- manual recording or transposing of figures resulting in errors
- limited or no reconciliation practices in place
- failing to separate business and personal transactions.

Digital record keeping solutions are the ideal way to keep records, but care is required to ensure they are fit for purpose and set up correctly. In the random enquiry program, we saw coding and software errors primarily caused by accidental miscoding of transactions or software limitations that did not allow for business-specific transactional coding.

Opportunistic

These businesses don't exhibit a clear intention to avoid their tax liabilities like those operating in the shadow economy; however they appear to take advantage of the self-assessment system. Observed errors could easily have been avoided by the business owner or tax professional, with proper due diligence.

Our analysis of the 2023 bundled sample found that small businesses engaging in opportunistic behaviours were typically:

- taking advantage of ambiguous circumstances
- relying on social norms to justify their actions
- claiming private expenses that could not be linked to business operations
- exaggerating the apportionment of business use for services or assets that were also privately used.

The shadow economy

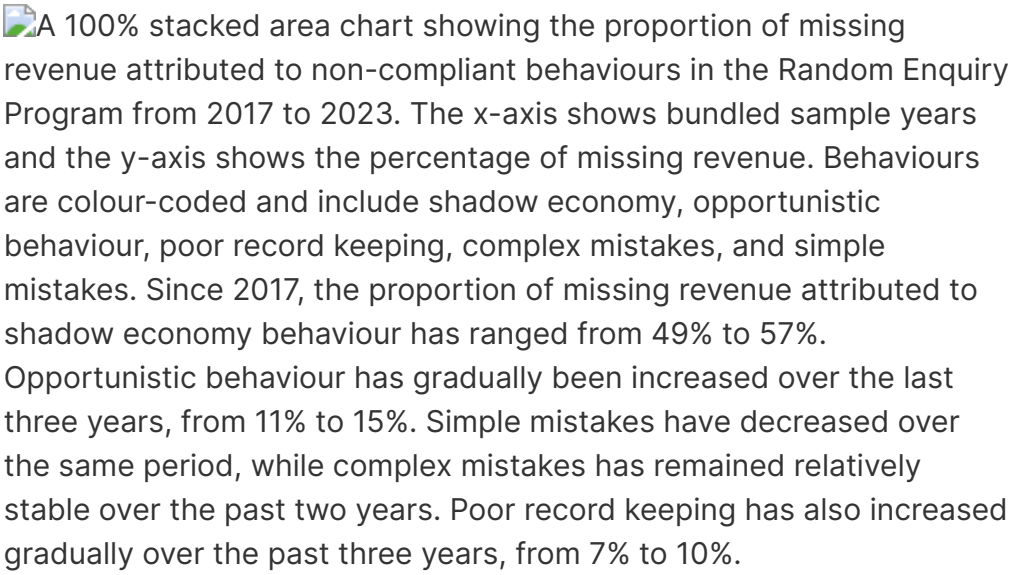
The shadow economy refers to economic activities that are unrecorded and untaxed, but the behaviour isn't limited to tax issues. Activities include deliberate behaviour carried out to misuse or abuse government systems, as well as criminal activities. Shadow economy activity accounts for around 60% of the gross small business income tax gap (around $22.0 billion).

Common shadow economy activities for small businesses include:

- deliberately hiding income or overclaiming expenses to not pay the right amount of tax
- underpaying wages or paying cash wages to evade a range of government obligations
- not meeting reporting obligations for payments to contractors and others
- liquidating and reforming a business to avoid obligations (known as 'phoenixing').

Through our analysis of the 2023 bundled sample, we have observed that 7% of the entities in the sample engaged in shadow economy behaviour. This behaviour contributed around 54% of the overall tax shortfall amount across the sample. Figure 2 shows the percentage of missing revenue attributable to each non-compliant behaviour.

Figure 2: Percentage of missing revenue attributable to behaviour 2017–2023


A 100% stacked area chart showing the proportion of missing revenue attributed to non-compliant behaviours in the Random Enquiry Program from 2017 to 2023. The x-axis shows bundled sample years and the y-axis shows the percentage of missing revenue. Behaviours are colour-coded and include shadow economy, opportunistic behaviour, poor record keeping, complex mistakes, and simple mistakes. Since 2017, the proportion of missing revenue attributed to shadow economy behaviour has ranged from 49% to 57%. Opportunistic behaviour has gradually been increased over the last three years, from 11% to 15%. Simple mistakes have decreased over the same period, while complex mistakes has remained relatively stable over the past two years. Poor record keeping has also increased gradually over the past three years, from 7% to 10%.

Examples of shadow economy activity observed in the random enquiry program included:

- business owners deliberately hiding income in personal accounts (including mortgages and foreign accounts) or not declaring cash income, which was then used to finance their lifestyle
- intentionally claiming private expenses that had no link to business activities

- paying staff, contractors or directors in cash and not reporting it
- not reporting income received from an associate entity (for example director's fees).

Undeclared business income can be unintentional or deliberate. When it's deliberate, the amounts involved are usually larger.

QC 59962

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