BTR/Section17 -

17

SMALL BUSINESS INITIATIVES

A simplified tax system for small business

Recommendation

17.1 *Simplified Tax System* (STS) for small business

That in order to reduce the compliance costs faced by small businesses, a small business

- **with an annual turnover or annual receipts of less than $1 million, exclusive of Goods and Service Tax, and**
- **which derives less than 5 per cent of its income from a leasing activity,**

be able to elect to be taxed under the *Simplified Tax System* (STS), consisting of:

(i) a cash accounting regime — for recognising business income and day-to-day expenditure as an alternative to an accruals based regime;

(ii) a simplified depreciation regime — including a small business depreciation pool for most tangible depreciable assets, as an alternative to an individual asset regime based on effective life; and

(iii) a simplified trading stock regime — as an alternative to an annual requirement for stocktaking and stock valuation.

A major concern of small business is the cost incurred in complying with their obligations under the various taxation and other laws. Studies have shown that the burden of compliance with taxation laws is regressive (that is, compliance costs relative to firm size are higher for small businesses than for large businesses) and fall with particular severity on the smallest business sector.[1]

Labour time spent on taxation activities by owners, employees and helpers is the most significant component of tax compliance costs.[2] There are substantial opportunity costs associated with this, as time spent on compliance reduces the time available to invest in business growth.

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

2 Evans C, Ritchie K, Tran-Nam B and Walpole M (1997), *A report into taxpayer costs of compliance*, Commonwealth of Australia, Canberra, page 53.

Small business is calling for the additional compliance burden they face to be recognised and for a simpler and more certain system to be introduced.

Against this background, the Review is recommending the STS as a package of measures to assist small business. The STS will consist of:

- a cash accounting regime as an alternative to accrual accounting;
- a simplified depreciation regime for tangible depreciable assets, providing immediate write-off for items costing less than $1,000 together with a pooling arrangement treating as a single asset all other tangible depreciable assets with an effective life of less than 25 years; and
- a simplified trading stock regime, so that where the value of trading stock is less than $5,000, or the change in value from the base year value is less than $5,000, changes in the value of the physical stock on hand need not be accounted for. This will avoid the need for many small businesses to take stock on an annual basis.

Eligible businesses

Over 95 per cent of businesses (representing over 850,000 businesses) have annual turnover of less than $1 million.[3] Table 5 in the Overview shows the percentages of selected industries accounted for by businesses falling into this category. Much of this group consists of family businesses and many have few or no employees. Around 60 per cent operate as individuals or partnerships. The potential burden of taxation compliance falls most heavily on this group. Research has shown that small business primarily prepare financial statements for tax purposes.[4] Generally they do not need to prepare more detailed statements of the kind required by accounting standards, except where such accounts may be needed for finance or overdraft considerations.

To ensure that larger businesses do not separate their operations into several smaller businesses with less than $1 million turnover, and thus gain access inappropriately to the STS, safeguarding provisions will be required. One model for such legislation could be the 'grouping provisions' of the States' payroll tax legislation. Another model could be based on the capital gains tax grouping rules.

The legislation will ensure that, in calculating whether the $1 million turnover test has been met, the turnovers of all associated taxpayers are taken into consideration. For example, all company subsidiaries would be included in

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3 Based on data obtained from ABS publication *Small Business in Australia* (1993), adjusted for turnover level from ATO data.

4 Evans C, Ritchie K, Tran-Nam B and Walpole M (1997), *A report into taxpayer costs of compliance*, Commonwealth of Australia, Canberra, pages 3 and 4.

the grouping calculations, as well as unincorporated businesses sharing a common or associated controller (widely defined). However, small businesses which are carried on by different taxpayers, and which a reasonable person would conclude are substantially independent of each other, may still be permitted access to the small business concessions in certain situations, even if they failed the basic grouping tests. Safeguarding measures of this sort require some flexibility in implementation if they are to appropriately target genuine small businesses.

Election to participate in simplified tax system

The election to participate in the STS is available to businesses with an annual turnover of less than $1 million. Once in the system, a business will continue within that system until it elects to leave the system or until its turnover exceeds $1 million.

Some small businesses may face fluctuations in their turnover around $1 million from year to year. These businesses will be able to remain in the simplified regime until such time as their average turnover for the current and preceding two years exceeds $1 million. In such circumstances, these businesses will be required to convert to an accrual system of reporting.

Those businesses who elect to leave the STS, or are required to leave the system because of an increase in their turnover, may later apply to the Commissioner of Taxation to return to the STS. In making this application a business in the former category will need to make a case on commercial grounds for the reversal and a business in the latter category will need to demonstrate a substantial change to the nature of their business that would lead to an ongoing reduced level of turnover.

Arrangements to apply where a business enters or leaves the simplified system are discussed later.

Income from leasing activities

The 5 per cent threshold for income derived from leasing activities will exclude businesses deriving substantial income from leasing. It is intended to prevent businesses participating in the STS from being able to transfer the benefits of higher rates of pooled depreciation to lessees outside that system.

The level of the threshold has been set so that businesses using assets in their operations and leasing them out on a temporary basis are not excluded from participating in the STS — for example, a farmer who owns and leases out equipment on an ad hoc basis.

Recommendation

17.2 Cash accounting for small business

That as part of the simplified tax system, an eligible taxpayer electing to use that system adopt a cash basis to account for their business income and their day-to-day expenditure, except in relation to:

(i) depreciable assets subject to write-off for taxation purposes — covered by the simplified depreciation regime (see Recommendation 17.3);

(ii) trading stock on hand where the change in the value from the opening stock value in the initial base year (or a substituted base year) exceeds $5,000 — covered by the simplified treatment for trading stock (see Recommendation 17.4);

(iii) all assets and liabilities (including prepayments) relating to participation in a project or arrangement, managed by another person or entity, in which a number of taxpayers individually participate;

(iv) prepayments where the payment relates to the provision of services or products over a period:

- **exceeding twelve months; or**
- **ending after the next income year;**

(v) assets in which a gain or loss is taxed on realisation;

(vi) financial assets and liabilities that would be taxed on an accruals basis in accordance with Recommendation 9.2 and that have a term of one year or more where the rate of return applicable to any effective discount or premium is more than 1 per cent per annum, compounded annually;

(vii) financial assets and liabilities subject to market value election in accordance with Recommendation 9.1; and

(viii) non-routine leases and rights (see Recommendations 10.1 to 10.13).

The cashflow/tax value approach to determination of taxable income underpinning this report is consistent with the general principle in the current income tax law that income is recognised when 'derived' and deductions for expenses are recognised when 'incurred'.

For small businesses, the cash accounting regime will prove a more straightforward and a less costly accounting method than the accruals approach. The basic principle behind the cash basis is relatively easy to understand and will apply in respect of receipts and expenditure resulting from flows of funds such as sales and purchases and the payment of expenses. For income tax purposes, the cash basis will provide that income is recognised when it is actually received and expenses when they are actually paid.

Under the current law, the courts have determined that some taxpayers may use a 'cash' basis for income recognition, although expenses have generally retained their 'accrued' basis of recognition. The application of this current form of cash basis accounting is not well founded and is subject to considerable uncertainty. Its asymmetric application results in mismatches of cash and accrual recognition in a variety of situations.

Benefits to small businesses of being able to elect to use the cash accounting regime, as proposed, will include:

- clarity in the law associated with the timing of income receipts;
- the introduction of a symmetrical treatment of receipts and payments; and
- the ability to relate the tax liability to the cash flow of the business.

Some eligible small businesses which currently employ the accruals approach will enjoy compliance cost savings by electing to switch to a cash system. Additionally, taxpayers with a turnover of less than $500,000 can elect the cash accounting method for GST purposes but under current income tax arrangements many would be required to use the accruals method for income tax purposes. Further costs would be incurred in maintaining both accounting approaches.

Taxpayers who employ a 'hybrid' system, with a cash approach for income and an accruals approach for expenses, will be required to choose between the standard basis of income taxation and the STS, as this 'hybrid' basis will not continue. The cost of this change will largely depend upon the sophistication of their present accounting practices. Those with fairly rudimentary systems who elect a cash basis should benefit through reduced compliance costs.

Implementing the cash basis

Small business taxpayers who opt to use the simplified tax system must account for their income and their expenditure on a cash basis.

The major elements of the cash accounting system will be as follows:

- debtors at year end will no longer be brought to account as income (income will equate to amounts received);
- amounts owing to creditors at year end in respect of expenditure will no longer be allowable (deductions will only be recognised when payment actually occurs);

- work in progress will be treated on a cash basis when payments are received;
- tangible depreciable assets (which are the subject of Recommendation 17.3) will be subject to depreciation from the time they are installed ready for use; and
- trading stock will be treated under a simplified regime (which is the subject of Recommendation 17.4).

Prepayments

The proposed approach removes the obligation of small businesses, accounting on a cash basis, from having to account for those assets where the payment does not relate to the provision of services or products over more than twelve months and the payment does not relate to a period which ends beyond the next income year. This approach is consistent with that adopted for individual taxpayers — see Recommendation 4.4.

Tax shelter arrangements

Small businesses may be conducted by entities who prepay expenditure (and incur advance expenditure) in respect of participation or investment in arrangements or projects, sometimes referred to as 'tax shelter schemes'. Consistent with the treatment for individual taxpayers proposed in Recommendation 4.4, such small businesses will be unable to treat this under the cash basis despite an election to access the STS for their business activities.

Financial assets and liabilities

In relation to financial assets or liabilities, small businesses will not be subject to accruals taxation unless those financial arrangements provide significant taxation deferral opportunities. This treatment is consistent with that proposed for individual taxpayers — see Recommendation 4.4.

Significant taxation deferral opportunities will be considered to exist where, to take the example of a financial asset, the asset has a term of one year or more, and the return applicable to any effective discount is more than 1 per cent per annum, compounded annually. A similar accrual requirement applies under the existing tax law. It means that, for example, if the annual return is wholly paid out during the income year, a small business does not have to apply accruals treatment to a loan.

The expression 'effective discount or premium' will cover deferred interest and similar situations — for example, where the capital is indexed to inflation.

Non-routine leases and rights

Taxpayers operating small businesses will be taxed, like other taxpayers, on a cash basis in relation to routine leases and rights. However, both significant deferral opportunities and excessive taxation may result if small businesses were taxed on a cash basis in relation to non-routine leases and rights.

Entry/exit rules

Measures are needed to address both the entry to and exit from the simplified cash system to ensure that there is no disadvantage to either the taxpayer or to tax revenue.

In the year of entry to the STS, it will be necessary to ensure income and expenses recognised in the prior year are not recognised a second time.

The following rules will deal with this situation:

- creditors and other expense accruals as at the end of the year prior to the year of entry will be subtracted from deductible cash outlays in the year of entry; and
- in the year of change, debtors and other income amounts receivable at the end of the year prior to the year of entry will be subtracted from cash inflows.

Where a business no longer qualifies for the STS, measures are required to allow a transition to an accruals regime in such a way as to ensure that income and expenses already recognised are not considered a second time.

The following exit rules will deal with this situation in the year of transition:

- deductions will be limited to deductible cash outlays plus closing creditors and other deductible amounts payable at year end; and
- income will include cash received plus assessable amounts receivable at year end.

Recommendation

17.3 Simplified depreciation regime for small business

That as part of the simplified tax system, an eligible taxpayer electing to use that system adopt a simplified depreciation regime consisting of:

(i) where the cost of a tangible depreciable asset is less than $1,000 — immediate write-off;

(ii) for all other tangible depreciable assets with an effective life of less than 25 years — a pooling arrangement, with

- **depreciation at the rate of 30 per cent (declining value basis);**
- **immediate write-off of the pool balance when less than $1,000; and**
- **streamlined arrangements for assets partially used for private purposes; and**

(iii) for tangible depreciable assets with an effective life of 25 years or more — effective life depreciation under the general depreciation regime (see Recommendation 8.2).

The simplified depreciation regime for small business will result in substantial savings in compliance costs because of the reduced record keeping requirements and reduced complexity in dealing with the disposal of depreciable assets.

Features of the proposal

In respect of each tangible depreciable asset with a life of less than 25 years (luxury cars will be included in the simplified system up to their cost limit), the simplified depreciation system will allow:

- an immediate write-off where the cost of an item is less than $1,000;
- pooling of tangible depreciable assets with lives less than 25 years (to be treated as a single asset);
- a simplified private use calculation;
- deduction of the net sale price of a tangible depreciable asset from the aggregated written down value of the pool; and
- prorating on a quarterly basis where tangible depreciable assets are acquired during a year of income, to allow the following percentages of annual depreciation, where the item is acquired:
  - in the first quarter: 100 per cent;
  - in the second quarter: 75 per cent;
  - in the third quarter: 50 per cent; and
  - in the last quarter: 25 per cent.

Savings in compliance costs from reduction in record keeping requirements

Because all qualifying tangible depreciable assets are pooled and treated for depreciation as a single item, the record-keeping requirements for each item are removed. The pool assumes the characteristic of a single asset, having a value that will increase with the purchase of additional items and decrease as other items are disposed of and by the amount of the annual 30 per cent depreciation allowance.

Disposal of assets

Under the simplified depreciation regime, the proceeds from the sale of any tangible depreciable asset included in the pool are deducted from the written down value of the pool. This effectively takes care of all balancing charge and capital gain consequences in one step. No further calculations are required by the taxpayer.

Where consideration is received which is greater than the total value of the pool or after the pool has been fully written-off, the negative value of the pool at the end of the year of income will be recognised as income.

Eliminating pool tails

Where the closing value of the pool after recording any purchases or disposals for the year, but prior to the calculation of the 30 per cent depreciation allowance for that year, is less than $1,000, the full value of the pool may be written off in that year.

This is consistent with the recognised view that the maintenance of an asset below a nominated value adds to the compliance costs of a business and that depreciation is only required under accounting standards where it is material.

The pooling approach is designed to strike an appropriate balance between taxpayer equity, simplicity and tax system integrity, while also reducing compliance costs and providing revenue safeguards.

Private use calculation

Where a tangible depreciable asset of a business has a component of private use, and fringe benefits tax (FBT) arrangements do not apply, some special rules will be necessary. Such a situation would be where FBT arrangements do not apply because the operator of an unincorporated business uses business assets for non-business purposes.

In the case of a motor vehicle so used, an unincorporated taxpayer will use a statutory formula covering both depreciation and running costs based on the approach adopted for FBT. This will effectively add back the amounts representing the value of the private use of the motor vehicle.

In the case of tangible depreciable assets other than motor vehicles, used in part for private purposes, the private use component of depreciation will be accounted for in a similar way to that proposed in the GST legislation. This will entail an estimate of the 'private purpose component of an asset' at the time of purchase and a corresponding adjustment to the value of the item prior to its inclusion in the pool. Where there is a subsequent modification to the private purpose component, the pool balance will need to be adjusted to reflect this modification. Any expenditure in connection with the private use of these assets will not be recognised in the calculation of taxable income.

Depreciation of non-pooled assets

Tangible depreciable assets with an effective life of more than 25 years will be treated in the manner proposed in the recommended general depreciable assets regime.

Primary producers

Where electing to enter the STS, a primary producer who currently enjoys concessional treatment in respect of a tangible depreciable asset may continue to utilise this concession, or alternatively place the item in the depreciation pool.

Transitional depreciation arrangements

To enable early compliance cost savings from the availability of the simplified depreciation arrangements to be realised, measures will be introduced to allow businesses to move all their existing tangible depreciating assets at their current written down value into the pool at the date of effect of this proposal. Where the total value of all these tangible depreciable assets is less than $1,000, they may be written off in the first year.

Where a business ceases to qualify due to an increase in turnover above $1 million or to its opting out of the STS, the pool will be frozen as a single item attracting a 30 per cent depreciation rate until it is written off. All assets acquired subsequent to the exit from the simplified cash system will be subject to the normal effective life provisions.

Recommendation

17.4 Simplified treatment for trading stock for small business

That as part of the simplified tax system, an eligible taxpayer electing to use that system adopt a simplified taxation treatment for trading stock under which:

(i) where the value of opening stock on hand is no greater than $5,000 — no amount need be included in taxable income where it can be reasonably expected that the value of closing stock on hand is also no greater than $5,000;

(ii) where the value of opening stock on hand is greater than $5,000 — changes in the value of the physical stock need not be accounted for where it can be reasonably expected that the difference between the value of the physical closing stock and the value of the physical opening stock is not more than $5,000; and

(iii) where the difference between the closing stock value and opening stock value in the base year (or substituted base year) exceeds $5,000 — the amount of the change be included in taxable income and a new base year opening stock value be established.

Accounting for trading stock

Under existing income tax law, an increase in the value of stock over a year is included in income. If the value of stock declines, the decrease is excluded from income. From a timing point of view, this system aligns with the recognition of sales and purchases. Generally speaking, an item of stock is considered on hand when the purchase expense is incurred and no longer on hand when the sales income is derived.

Under the cash accounting system, sales and purchases will only be recognised when money actually changes hands. Assuming a business employing a cash basis continues to buy and sell stock on credit, it would have:

- stock physically on hand for which a deduction for the purchase has not been allowed; and
- dispatched stock from which no sales income has yet been assessed.

Physical stock is trading stock over which the taxpayer has the power of disposal.

Where the simplified tax system is adopted, trading stock on hand will also be calculated on a cash basis. To calculate the cash value of stock, the value of the physical stock on hand will be:

- reduced by the value of stock held which has not yet been paid for; and
- increased by the cost of stock sold on credit where the payment has not as yet been received.

The Australian Taxation Office will develop a simple worksheet to assist with the calculation of the cash value of stock on hand.

Features of the proposal

As a means of simplifying the treatment of trading stock for small businesses that elect to use a cash basis, two measures are proposed:

- where the taxpayer can reasonably expect the opening physical stock on hand and the closing physical stock on hand, both have a value of less than

$5,000, the trading stock values are not taken into account for the purpose of calculating taxable income; that is, the trading stock value will be treated as if it had not changed; and

- where the value of opening physical stock on hand is greater than $5,000, the change in value of physical trading stock on hand at the close of a year will only be brought to account where it can reasonably be expected that the change in the value of the closing physical stock exceeds the value of the opening physical stock of a base year or a substituted base year by more than $5,000.

These measures will mean that over 75 per cent of small business taxpayers will not have to account for trading stock for the purposes of preparing their annual tax return. Only taxpayers who have fluctuations in physical trading stock of more than $5,000 will have to continue to undertake a stocktake each year.

Where the difference between opening and closing physical stock is more than $5,000, the difference will be included in taxable income and the opening value of the next year (then the 'substituted base year') will be reset at the new level. Thereafter, the same treatment of stock will continue to apply.

Where the value of closing physical stock is less than the value of opening physical stock, the difference can be excluded from the taxable income to compensate for the decline in the value of stock. In such circumstances the reduced stock value will be the reset level from which future changes in the value of stock will be measured and the substituted base year will be the corresponding year.

Streamlining capital gains provisions for small business

Recommendation

17.5 Capital gains tax — small business

Rationalising goodwill exemption and small business concessions

(a) That the existing 50 per cent Capital Gains Tax (CGT) goodwill exemption for small business be replaced with a small business assets exemption of 50 per cent of all capital gains arising on the disposal of active assets subject to capital gains treatment.

Eligibility criteria for replacement exemption

(b) That the provisions in the law used to determine eligibility for the CGT small business rollover and retirement exemptions be applied to determine eligibility for the small business assets exemption.

Additional concessions

(c) That for taxpayers who operate small businesses through partnerships or as sole traders, the 50 per cent exemption in paragraph (a) apply to the component of the capital gain remaining after the reduction in the gain from either the proposed 50 per cent exclusion or the frozen indexation amount — see Recommendation 18.2.

Recommendation 17.6 Flexible access to CGT relief

That the small business rollover and the retirement exemption continue to be available, as appropriate, in relation to gains remaining after application of the new small business assets exemption.

Existing provisions

Several concessions are available under the CGT provisions to assist small business *(A Platform for Consultation,* page 300).

- Taxpayers operating a small business with net assets of $5 million or less are eligible for CGT rollover relief where they dispose of some or all of their business and reinvest the proceeds. The proceeds, however, cannot be rolled over into the acquisition of goodwill.
- An exemption also applies on a capital gain arising from the disposal of an active asset of the business where the proceeds are used for retirement.
- Where the net assets of a business are $2.2 million or less, taxpayers are eligible for a 50 per cent exemption on capital gains arising from the disposal of business goodwill.

Need for reform

Rationalising the provisions

The CGT rollover relief, retirement exemption and goodwill exemption provisions have the same underlying objective — that is, to provide small business people with access to funds for retirement or expansion. As noted in *A Platform for Consultation* (page 300) these small business provisions are complicated and there is scope to merge and simplify them to allow them to operate more efficiently.

Compliance and simplification benefits will result from having the CGT small business assets exemption utilise the same eligibility rules as the CGT small business rollover provision. Submissions and participants in the focus group supported the need for rationalisation of the provisions.

Submissions to the Review also raised matters on some of the underlying policy design issues and on the practical operation of the CGT rollover and retirement provisions. These matters have arisen from the actual application of the measures since their introduction on 1 July 1997. The Review believes that it is appropriate for the rewritten legislation to clarify such issues.

Interaction with the capital gains exclusion

The recommended rationalisation of the small business provisions will allow taxpayers operating small businesses through partnerships or as sole traders to benefit from both the 50 per cent capital gains exclusion (or frozen indexation), as well as the 50 per cent small business capital gains assets exclusion. This category of small business will, therefore, benefit from a 50 per cent exclusion of eligible capital gains (or alternatively at the taxpayer's option the benefit of accumulated indexation to the end of the September quarter 1999) and a subsequent 50 per cent exemption of capital gains arising on the disposal of active assets. See Recommendations 4.10 and 8.11(c) for information on assets eligible for capital gains treatment.

In effect, this will provide taxpayers operating small businesses through partnerships or as sole traders with a minimum 75 per cent exemption of capital gains arising on the disposal of active assets. The residual 25 per cent of capital gain would be subject to tax at that time if it were not either rolled over or exempted under the small business rollover or exemption provisions.

In a situation where the frozen indexation is of greater benefit than a 50 per cent reduction in the capital gain, the small business taxpayer would be likely to choose indexation and the residual capital gain would be less than 25 per cent of the original capital gain.

Small businesses operating through companies or trusts will normally have access to frozen indexation and not the capital gains exclusion (Recommendation 18.2). However, small businesses operated through trusts will have access to either the capital gains exclusion or frozen indexation for any capital gains made on assets acquired by the trust before the date of announcement. This provision is designed to meet a commitment in *A New Tax System* to exempt the future gains on pre-CGT assets, realised indexation component of gains on post-CGT assets, and (on an ongoing and not just transitional basis) exempt CGT goodwill gains for small business.

Recommendations 12.6(b) and 18.2 provide general details of this transitional arrangement.

For administrative and practical reasons, eligible small business taxpayers would access the general capital gains exclusion (or frozen indexation) first and then access the small business provisions. It is also logical that access should first be to the general capital gains provision and then to the specific (small business) provisions.

Providing more choice

Under the existing CGT law there is a restriction that, for any one disposal, a small business cannot benefit from more than one of:

- the goodwill exemption (now recommended to be subsumed within the small business assets exemption); or
- the small business rollover; or
- the retirement exemption.

Submissions and public comment pointed to how the complexity of these CGT concessions create unnecessary compliance costs for small businesses in working out which concession they should claim.

Providing proprietors in small business with greater choice in how to use realised capital gains will increase incentives for investment in the sector and provide greater flexibility in how small business taxpayers can manage their affairs.