

The 2017 Small Business Tax Enterprise Plan

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Abstract

This paper examines the Commonwealth's 2017 Enterprise Tax Plan for small business. In doing the paper analyses these reforms having regard to the issue of defining a small business and by examining the various rationales that are commonly extended for such concessions. The government's rationale stated that increasing the small business threshold to \$10 million will allow an additional 90,000 to 100,000 businesses to access the benefits of the small business concessions, decreasing the compliance costs such as for record keeping and calculation requirements and would increase cash flow. The government also asserted that the reforms would enable greater reinvestment in small businesses and provide the opportunity for these businesses to increase employment and increase wages. The lower corporate tax rate and the expanded tax discount for unincorporated small businesses will provide increased cash flow to profitable small businesses. Notwithstanding the stated rationales for the small business tax concessions, they should be used sparingly if at all. Defining a small business is problematic. The new measures produce four definitions of a small business with turnover thresholds of \$2m, \$5m, \$10m or \$25 now applying. Tax concessions generally contribute to complexity, inefficiency, inequity and damage fiscal adequacy. This paper submits direct targeted government grants are a better alternative to support both small business and the wider economy.

Keywords: *small business, income tax, enterprise tax plan*

1. INTRODUCTION

Australia's small business tax concessions have grown in both availability and number and appear to be very political, as governments' seek electoral support from an estimated 2.7 million small businesses. However, the tax expenditures associated with these concessions are significant. Additionally, their complexity produces considerable uncertainty as to their practical operation and for many the concession benefits do not appear to outweigh the additional compliance costs. The various concessions favour particular types of businesses of a certain size and / or with certain structures over other taxpayers and this hinders economic growth, creates distortions and inequities. A number of government reviews however, The *Ralph Review* (1999) and The *Henry Review* (2009) have generally supported concessions for small business. Over time, and with each election cycle, the scope of these concessions have significantly broadened. During the 2016-17 the Liberal Coalition Government introduced its Enterprise Tax Plan (ETP) for small business. The paper first outlines the ETP and then analyses the reforms having regard to the issue of defining a small business and the examining the various rationales that were provided for these concessions. This paper is innovative since it highlights the regressive nature of the

small business tax concessions that helps comparatively few wealthier businesses. The paper is also innovative in suggesting a better way to help small business and the broader economy.

2. ENTERPRISE TAX PLAN

In 2016 the Commonwealth government announced its Enterprise Tax Plan (ETP) to greatly expand access to tax concessions and reduce income tax rates for small business. The ETP provided an immediate reduction in the corporate tax rate to 27.5 per cent for the 2016–17 tax year for small business entities (SBEs) and a progressive increase in the tax discount for unincorporated SBEs equivalent to the above reductions in the corporate tax rate. The ETP also broadened the definition of small business by increasing the aggregated turnover threshold from \$2 million to \$10 million. This allowed access to most of the pre-existing small business tax concessions as well as the ETP concessions. Additionally, from 2017–18, a new category of corporate entities, known as base rate entities (BRE), with higher aggregated turnover threshold are also eligible for a lower tax rate.

The Senate referred the Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016 to the Economics Legislation Committee for inquiry and reporting. The Liberal majority on the Committee found that the ETP is “a critical reform that will improve Australia's tax system for businesses and drive investment and growth in the economy”. The Labor minority sought against increasing the SBE threshold and to only reduce the company tax rate to 27.5% for businesses with a turnover of less than \$2 million; and only increase the unincorporated small business tax discount from 5% to 8% for SBEs. Noting:

the Grattan Institute made a submission and stated that the best analysis from the Commonwealth Treasury shows that the net benefits to Australians' incomes will be much smaller once profits flowing out of Australia are taken into account. In addition, a cut to the corporate tax rate places pressure to raise taxes in other areas and the benefits from additional investment may take time to emerge.

Notwithstanding these concerns, in 2017 the *Treasury Laws Amendment (Enterprise Tax Plan) Act 2017* increased the small business entity aggregated turnover threshold from \$2 million to \$10 million effective from the 2016-17 income year. The threshold for the small business tax offset though was only increased to \$5 million, and the \$2 million threshold was retained for the CGT small business concessions in Div 152. The explanatory memorandum's rationale provided:

Increasing the small business threshold to \$10 million will allow an additional 90,000 to 100,000 businesses to access the benefits of the small business concessions, decreasing the compliance costs (such as for record keeping and calculation requirements) and increasing cash flow.

This will enable greater reinvestment in small businesses and provide the opportunity for these businesses to increase employment and increase wages. It will also provide incentives for small businesses at or near the existing \$2 million turnover threshold to grow, as they would currently lose these concessions once they pass the threshold.

Taxpayers will need to be aware of and familiarize themselves with the new changes. This is expected to be relatively straight forward and potentially part of the routine update processes.

Additionally, the company tax rate was reduced from 28.5% to 27.5% for the 2016–17 income year for SBEs. The SBE small business definition remains at \$10 million from 2017–18 whilst the BRE threshold rises. From 2017–18, BREs are eligible for the lower tax rate, initially set at 27.5%. In 2017–18 the

threshold for BREs is \$25 million and in 2018–19 to \$50 million. The changes to the turnover threshold and tax rate reductions for base rate entities are set out in the following table:

Table 1: Enterprise Tax Plan Corporate Tax Rates and Thresholds

Year	Aggregated annual turnover threshold (\$m)	Base rate entities	Other corporate tax entities
2017–18	\$25m	27.5%	30.0%
2018–19	\$50m	27.5%	30.0%
2019–20 to 2023–24	\$50m	27.5%	30.0%
2024–25	\$50m	27.0%	30.0%
2025–26	\$50m	26.0%	30.0%
2026–27	\$50m	25.0%	30.0%

Under the changes the maximum franking credit that can be allocated to a frankable distribution paid by a corporate entity will be based on their corporate tax rate for that particular year, unless the entity's turnover for the prior year is equal or greater than the threshold for the current year (the corporate tax rate for imputation purposes). The Government has also introduced a second Bill that proposes to progressively extend the lower corporate tax rate to all corporate entities with a proposed 25% tax rate applying from 2026-27.

The unincorporated small business tax discount (the small business income tax offset) will be increased to 16% by the 2026-27 income year. For the 2016-17 to 2023-24 income years, the offset is 8 per cent of net small business income. For the 2024-25 income year, the offset is 10 per cent of net small business income. For the 2025-26 income year, the offset is 13 per cent of net small business income. The explanatory memorandum asserted:

Reducing the corporate tax rate does not provide a tax cut for those businesses that are not operated through a company. Approximately 70 per cent of small businesses are unincorporated. This means that 2.3 million businesses would not receive any benefit from a corporate tax cut.

The 2015-16 Budget introduced a 5 per cent unincorporated tax discount for small businesses to provide them with a tax cut at the same time as small business companies. This further increase in the unincorporated tax discount for small businesses is consistent with the original design parameters and mirrors the company tax cut for small business.

An expanded tax discount for unincorporated small businesses will provide increased cash flow to profitable unincorporated businesses. Unincorporated small business owners will have higher after-tax earnings which they will be free to reinvest in their businesses.

In assessing the ETP there are two key questions. What is a small business? Should small business receive tax concessions?

3. WHAT IS A SMALL BUSINESS?

Defining a small business is extremely challenging. Should a small business be defined qualitatively or quantitatively? For practical reasons qualitative definitions are inappropriate since objective and measurable criteria are needed in legislation. Using quantitative measures brings the problem of ascertaining the parameters, whether it be by sales, profit, assets and / or number of employees. Different parameters will produce different ranges of small businesses. There does not appear to be any clear way of working out when a business ceases to be small. The Australian experience illustrates the dilemma. As noted above, prior to the SBE framework the various small business tax concessions adopted different parameters and this created uncertainty and complexity. For example, the former Simplified Tax System STS originally required a \$1 million STS average turnover and \$3 million depreciating assets test, whilst other small business concessions provide separate tests. The SBE regime then harmonized the definition of small business for many of the tax concessions. The STS depreciating asset test was abolished and a \$2 million aggregate turnover replaced the \$1m turnover test. The ETP though results in four definitions. For SBEs the aggregate turnover was increased to \$10m from 2016-17. For larger small businesses, BREs, the aggregated turnover threshold for accessing tax concessions is \$25m in 2017-18 (increasing to \$50m by 2026-27). A \$5 m SBE aggregated turnover applies to access the SBTO, and a \$2 m SBE aggregated turnover applies to access the CGT concessions.

The silence in the ETP reform process detailing how the new SBE / BRE parameters were designed illustrates the arbitrariness. Under these rules, larger businesses with low turnovers would qualify as SBE (such as start up listed companies). Setting parameters also poses the problem of manipulation as businesses restructure so as to access the small business concessions. This is evident with complex anti-avoidance measures in the former STS and in the current SBE and BRE regimes.

Overall, there is no consensus on what a small business is, nor is there any consensus about the appropriate parameters. A number of parameters appear to be needed in order to appropriately identify the smaller businesses (to prevent manipulation) but the more parameters the greater the complexity. Also, more turnover thresholds increase complexity as seen in the new: \$10 m SBE aggregated turnover, the \$5 m SBE aggregated turnover to access the SBTO; the \$2 m SBE aggregated turnover to access the CGT concessions and the \$25 m plus aggregated turnovers for the BRE regime. The various current thresholds are ad hoc.

4. SHOULD SMALL BUSINESS RECEIVE TAX CONCESSIONS?

As to the question whether small business should receive tax concessions, the ETP argued the reforms would help offset the regressivity of compliance costs and to aid simplicity. The ETP also asserted the changes were needed given the importance of small business to the economy and to encourage investment and productivity. Research in Australia and elsewhere has found that the costs for small business in complying with tax laws are regressive given their lack of resources and expertise (Evans 2003). On this basis, the ETP called for tax concessions to offset these costs. The explanatory memorandum's rationale in the *Treasury Laws Amendment (Enterprise Tax Plan) Act 2017* asserted

increasing the threshold would decrease the compliance costs such as for record keeping and calculation requirements.

Although, it is counter argued that small business have a higher non-compliance with tax laws than employees which reduces the regressive impact of compliance. Slemrod (2004) provides evidence that non-compliance is similarly regressive to small business as are compliance costs. The smaller the business, the less compliant. Pope (2008) also pointed to a number of studies from OECD countries that showed small businesses, especially micro businesses are responsible for a large proportion of tax evasion. There is also a trade-off between compliance costs and evasion. Tax concessions introduced to reduce compliance costs may increase opportunities for tax avoidance. For example, the numerous turnover thresholds in the STS, SBE and BRE regimes provide avoidance opportunities by artificial means.

Since many small businesses will comply with tax laws there still exists an argument for tax concessions and exclusions where these provide an overall benefit in simplifying tax laws such that tax revenue and efficiency increase, Gentry (2004). For example, there is an apparent role for exclusions (such as the \$75,000 GST registration turnover threshold) to minimize the compliance and administration costs by reducing the number of affected taxpayers, OECD (1997). However, a high threshold may create inequity between who have to register and those who do not. This is inefficient since competition is impacted as more efficient larger small firms are at a disadvantage.

Tax concessions introduced to reduce compliance costs may also inadvertently increase these costs since the concessions can increase complexity. For example, the complexity of the STS resulted in a low take up by small business given the concession targeted 95 per cent of businesses. Only 14 per cent of eligible small businesses joined by 2002 (*Tax Laws Amendment (Small Business) Act 2007* (Cth)). Under the STS, SBE and BRE regimes there are numerous turnover thresholds which all produce added complexity for small business. Under the ETP, the SBE turnover threshold would increase from \$2 million to \$10 million and for BRE a \$25 m turnover initially applies. This reform to broaden the taxpayer eligibility will increase compliance and administration costs associated with more businesses accessing the SBE and BRE regimes, and thus will all damage fiscal adequacy. The revenue costs are of reducing the corporate tax rate for SBEs and BREs are not insignificant, being estimated at \$400m in 2016-17; \$500 m in 2017-18, \$800 m in 2018-19 and \$950 m in 2019-20. This will also lead to inequity as larger and asset rich small businesses will gain the most from the SBE and BRE regimes' generous tax concessions. This reform also shows how the introduction of small business tax concessions has led to the greater use of tax concessions by as more small businesses become eligible. The ETP asserted the reforms would "simplify" the tax system. Rather, small business continually need to keep abreast of an extensive range of ever changing tax concessions and eligibility requirements such as the ETP in order to benefit. The complexity of the concessions means that small businesses rely extensively on professional help. For many the high costs of professional advice outweigh the benefits. If simplification was the aim, the ETP should have recommended the abolition of small business tax concessions.

The ETP argued that small business is important to the economy and the concessions would increase investment and employment. In developed countries, there is a strong positive correlation between small business entrepreneurship and GDP growth as well as the level of gross domestic product (GDP) per capital, Pope (2008). In Australia the small business sectors provides about 30 per cent of GDP and from 1983 it has increased at an annual rate of 3.5 per cent per annum, Pope (2001). Whilst large business (with more than 200 employees) has only increased at 2.5 per cent per annum since 1983. In 2011 small business employed 47 per cent of all private sector employment, ABS (2012). An OECD report found that the contribution of small business to innovation is increasing as a result of new technologies which make it easier for small businesses to overcome barriers to entry and access larger

markets, OECD (2010). In Australia, small businesses account for around one third of research and development of spending in high-tech industries, Connolly et al (2012).

However, other data and studies suggest small business importance is overstated. In 2016 businesses that employ fewer than 20 people accounted for a lower 45% of private sector employment. Bigger businesses, having more than 200 staff have contributed more than three quarters of new jobs since 2009 Creighton (2017). Research has criticized studies purporting to show the importance of small businesses for job creation, De Ruyg (2005). In the United Kingdom research has also found that only a minority of small firms generate jobs, Bannock (2005). This leads to the impossible problem of targeting tax concessions (if justified at all) to such firms. Australia's former STS, the SBE regime and BRE small business tax concessions, for example apply to all small businesses. Under these concessions small businesses which do not intend to grow will benefit. Many small businesses do not wish to grow, with owners preferring a manageable scale and lifestyle, Small business roundtable (2012). Also, hobby and life-style businesses will also access these tax concessions (if not subject to the non-commercial loss rules). As noted above, the concessions may result in the restructuring or manipulation of businesses to create a small business in order to qualify for the tax advantages, leading to tax avoidance. Tax concessions targeted at size are blunt instruments, they do not focus on jobs growth. Other parameters such as innovation appear more appropriate. Identifying such firms can be problematical, which firms should be targeted for success or failure? Holtz-Eakin (2000). In 2009-10, only 42 per cent of small businesses were involved in innovative activity, versus 62 per cent of larger businesses, ABS (2012). Even if these firms could be identified, tax concessions are not focused on innovation unlike a direct subsidy. If the targeting is not effective then resources will be misallocated and reduce productivity Henry Report (2009). The US success with its Small Business Innovation Research program (of \$2 billion grants per annum over 26 years) shows though that innovative small business can be targeted and that such grants have a significant impact on catalyzing a broader economic transformation in innovation Keller and Block (2012).

5. CONCLUSION

First, having regard to the matter of defining a small business, the politically driven ETP reforms (like the *Ralph Review (1999)* and *Henry Review (2009)*) provided little analysis for introducing the four new ad hoc SBE / BRE thresholds for defining a small business. The Commonwealth government appears not to have learned anything from the Banks Taskforce () and the need to align and rationalize the definition of a small business. Whilst defining a small business is problematical for tax concessions, there may be a role for uniform definitions of 'micro', 'small', 'medium' and 'large businesses'. This would help the examination of the impact of the small business sector of taxation and promote more informed policy making. Secondly, the ETP concessions are significant: increasing the turnover thresholds, lowering corporate tax rates and increasing the SBTO. Having regard to the stated rationales for the concessions, the available evidence suggests that as a general principle, concessions should be employed in a very limited way. The concessions creates sets of winners and losers and impose significant compliance and administration costs as evident from the experiences in the former STS and SBE regimes. They impose a not insignificant cost to tax revenue collections and are inequitable and inefficient. Direct government grants are a better way of assisting small business as evident in the long standing success of the US Small Business Innovation Research program. The ETP neglected to answer this central question, as to whether small business tax concessions are justified, having regard to the available research. This highlights the highly political nature of the reforms.

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