

Reforming the Business Tax System: Does Size Matter? Fundamental Issues in Small Business Taxation

by

Judith Freedman¹

INTRODUCTION

Tax systems are generally not designed so much as developed over the years in an incremental way. The review of Australia's future tax system currently under discussion under the chairmanship of Dr Ken Henry (the Henry Review) offers an opportunity to look at the system holistically and to examine fundamentals.

Rather than designing a tax system that suits large business and then considering carve outs and concessions for small firms, such a review needs to think about small businesses as part of the initial design of the whole system. The "think small first principle" that requires policy-makers to take into account the needs of small businesses at an early stage of policy making is now widely accepted.² In the Mirrlees Review undertaken by the Institute for Fiscal Studies, small businesses were dealt with in a special study (of which the

1 KPMG Professor of Taxation Law, Oxford University Law Faculty and Director of Legal Research, Centre for Business Taxation, Oxford University. This paper draws heavily upon joint work undertaken for C Crawford and J Freedman, "Small Business Taxation", in J Mirrlees, S Adam, T Besley, R Blundell, S Bond, R Chote, M Gammie, P Johnson, G Myles and J Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review* (2009 forthcoming): Oxford University Press for Institute for Fiscal Studies <http://www.ifs.org.uk/mirrleesreview>. The author would like to thank C Crawford and the IFS for permitting her to use this work. The author would also like to thank C Evans, B Freudenberg, J Pope, her commentator, A Kokkinos, and others present at the Colloquium for providing valuable comments and information about the Australian tax system. This paper is, however, the sole responsibility of the author and should not be taken as expressing the views of any other person or organisation.

2 See for example the UK's Company Law Review leading to the *Companies Act 2006* (UK) and the European Union's proposed Small Business Act for Europe, available at http://ec.europa.eu/enterprise/entrepreneurship/think_small_first.htm

current author is a co-author),³ but, as is apparent from some of the key chapters on corporation tax and international issues, it was recognised by those working on corporation tax more generally that there is a need to deal with the structural issues of small business taxation as part of the fundamental design of the system and not simply as an add on or a carve out.⁴

How small businesses should be tackled within tax system design depends very much on the objectives of the design overall. Much of the discussion in the chapter written for the Mirrlees Review and in this paper arises from developments and pressures within Europe. It will be for Dr Henry, his team and those whom they consult to determine the extent to which these pressures and movements are relevant to Australia. Thus, this paper does not presume to make proposals for Australia but is offered as a contribution to the debate.

Small not medium sized

Very often the issue of small businesses is dealt with under the heading of small and medium sized enterprises (SMEs), but the issues arising around small businesses are usually different from those related to medium sized businesses. It is noted that the Henry Consultation paper⁵ refers to the treatment of *small business* and the Rudd Government announced in June 2008 that it was referring two methods of simplifying *small business* taxation to the Henry team.⁶ A joint proposal from the Institute of Chartered Accountants in Australia (ICAA) and Deloitte⁷ for an entity flow-through system suggests that its proposal should be confined to the “micro-SME”, being a firm with five or fewer members. This appears to be more simply described as “small”. In the same vein, this paper will focus expressly on the small business rather than SMEs. A small business is taken here to be an owner-managed business with fewer than 10 employees,⁸ whatever its legal form. This could be referred to as a micro-business. These micro-businesses lie at the interface between the personal and corporate tax systems and so give rise to the greatest structural problems.

3 C Crawford and J Freedman, “Small Business Taxation”, in J Mirrlees, S Adam, T Besley, R Blundell, S Bond, R Chote, M Gammie, P Johnson, G Myles and J Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review* (2009, forthcoming), available at <http://www.ifs.org.uk/mirrleesreview>.

4 See especially R Griffith, J Hines and P Sørensen, “International Capital Taxation”, in J Mirrlees *et al*, above, n 3.

5 Australian Treasury, *Australia's Future Tax System – Consultation Paper* (December 2008) (hereafter the Henry Consultation), para 6.6.

6 Australian Government, Ministers for Innovation, Industry, Science and Research, *Media Release* (11 June 2008).

7 ICAA and Deloitte, *Entity flow-through (EFT) submission* (April 2008).

8 The author is aware of the imprecision of this definition. It would not be workable for legal purposes and is deliberately qualitative and descriptive in order to serve the purposes of this paper. The 10 employee limit comes for the EU definition of micro-business.

The structural issue

A central issue investigated by this paper is the way in which the tax system should deal with the relationship between taxation of the business and that of the individual. This is not simply a question of integration of tax at the personal and entity level, but of the relative overall tax burden that should be borne by income from capital and income from labour. The formation of a corporation can be a method of converting labour income into income from capital, absent anti-avoidance provisions to prevent this. In a system which taxes those forms of income at different rates, this clearly presents opportunities for tax planning. Corporations can also be used to shelter income by virtue of retention. These possibilities raise both efficiency and equity issues. The Henry Consultation paper puts forward for discussion two possible schemes for dealing with this structural problem:⁹ first, an entity flow-through scheme¹⁰ or, alternatively, a system which attempts alignment of treatment such as a combination of a dual income tax system at the personal level and an allowance for corporate equity at the business level.¹¹ These are not true alternatives since the former could exist within the current Australian tax system while, as the Henry Consultation paper points out, the latter requires changes to the entire system.

How significant this issue is for the Australian system depends largely on the extent to which the corporation tax rate and the labour income rate diverge. International trends and economic thinking point in the direction of increasing divergence but Australia may resist the pressure to lower the company tax rate, in which case the structural issues will be less important in Australia than elsewhere.¹² There is, however, already sufficient divergence in Australia to give rise to distortions and tax planning incentives as described by Alexis Kokkinos in his commentary in this volume,¹³ as well as the need for anti-avoidance provisions such as personal services income measures, so that clearly Australia is not immune from these structural considerations. Indeed Vann has argued that Australia already has a system that closely approximates a dual income tax.¹⁴

Special measures for small businesses

Small businesses are often seen as having special tax needs. There are frequently demands made on their behalf by pressure groups and politicians for special concessions, incentives and reliefs. Small business representatives are vociferous and the cause is a popular one for politicians. The result is far from simplification. Often layer upon layer of regulation adds elections and

9 Henry Consultation, above, n 5, para 6.5.

10 ICAA and Deloitte, above, n 7.

11 R Griffith *et al*, above, n 4, and C Crawford and J Freedman, above, n 3.

12 See the discussion in the Henry Consultation, above, n 5, para 6.1.

13 A Kokkinos, *Commentary: Reforming the Business Tax System: Does Size Matter? Fundamental Issues in Small Business Taxation* (this volume).

14 R Vann, "Australia's policy on entity taxation" (2001) 4(3) *The Tax Specialist* 121.

decisions for the smallest businesses to cope with. There is also consequent frequent change, which is inevitably burdensome and costly. It does not follow from the small size of a business that the affairs of that firm or the law applying to it are, or can be, simple. Small business affairs interact with those of the family and other personal relationships and they offer a way of life as well as a financial venture. They are inherently complex. Even if complete simplicity is unattainable, however, general stability and good tax structures will benefit all businesses, including small businesses for whom learning about and understanding change is particularly burdensome. It may sometimes be the case that a reform that is argued to be needed for small businesses may be desirable for all. If that is the case then there are good grounds based on equity and allocation, as well as simplicity and definitional arguments, for not imposing restrictions by way of size. The arguments against this will often relate to costs in terms of reducing revenue raised rather than any objection by way of principle. If provisions are to be limited to small businesses only, the reason for this limitation needs to be made clear.

Policy objectives

Before a sensible strategy can be designed, a clear set of policy objectives is needed. This paper proceeds on the following assumptions about policy:

1. A small business taxation system should not distort commercial decisions about form of business organisation or enable those engaged in similar economic activities to be taxed differently unless this is intended for considered policy reasons: in other words it should aim at neutrality between different legal forms, including incorporated firms, unincorporated firms and employment, unless there are appropriate reasons for divergence.
2. The tax system should not discriminate against small businesses. This may occur due to their inherent disadvantages (such as the difficulties they experience in dealing with compliance costs due to problems of scale).
3. The tax system *might* usefully be used to counteract market failures in respect of small firms if there is a proven need and potential benefit to the economy, but only if this is a well targeted and efficient way of achieving this aim. Other methods of delivering this assistance may be preferable in some circumstances and should also be considered.
4. Where special concessions or provisions are designed to deal with objectives under 2 and 3 above, they should avoid creating new thresholds where possible. Entry requirements can themselves create distortions, barriers to growth and complexity. If a threshold must be imposed due to revenue costs, it needs to be considered whether this will distort economic decisions or competition between businesses.
5. Choice and change are costly for small businesses which may prefer a simple, broad-based tax to a higher rate with a series of concessions.

These objectives are derived from the literature as well as from experience of previous small business policies and will be further justified in the discussion that follows, although it is recognised that they may not be universally

agreed.¹⁵ These *desiderata* may be in conflict with each other at times and in that case simplicity and efficiency should be overriding considerations.

Outline of paper

The Henry Consultation paper poses the question:

*Q6.6 Should the tax system be structured to cater for the specific circumstances of small business, and if so, how?*¹⁶

This requires discussion of both structural issues and special measures. This paper will consider in the next section the structural issues to be dealt with in relation to small businesses involving legal form and methods of integration and alignment and in the subsequent section, “Special measures for small businesses”, the claims of small businesses to special tax incentives and to assistance through the tax system with inherent difficulties consequential on their size, such as the burden of compliance costs. The final section concludes.

STRUCTURAL ISSUES

Relative rates of tax

The structural issues facing tax system designers when considering small firms will depend to a considerable extent on their approach to broader questions and in particular to the relative tax rates to be applied to corporate and personal income, including labour income. The current trend towards a reduction of tax on capital income, especially in corporation tax rates, has been noted in submissions to the Henry Review. There are strong arguments in favour of such a trend based on competitiveness and on efficiency.¹⁷ On the other hand, some submissions to the Henry Review question these economic arguments or state that they must be balanced by equity issues which suggest that lower corporate tax rates could result in an increased burden of labour taxes falling on low to middle income earners.¹⁸ In addition the Henry Consultation reports that representatives of small and medium enterprises:

15 OECD, *Taxation and Small Businesses* (1994); OECD, *Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices* (1997); A Johansson, C Heady, J Arnold, B Brys and L Vartia, *Tax and Economic Growth*, OECD Economics Department Working Paper No 620 (2008); J Freedman, “Small Business Taxation: Policy Issues and the UK”, in N Warren (ed), *Taxing Small Business: Developing Good Tax Policies*, Australian Tax Research Foundation Conference Series No 23 (2003), p 13; and C Crawford and J Freedman, above, n 3.

16 Henry Consultation, above, n 5, p 7.

17 R Griffith, J Hines and P Sorensen, above, n 4.

18 Whether lower corporate tax rates and higher taxes on labour would actually increase the *overall* burden on labour once wage levels and other factors were taken into account is a contested issue. It is not the purpose of this paper to comment on this question. For further discussion see J Mirrlees *et al*, above, n 3.

generally view reducing the company tax as secondary to reducing personal tax rates. Such organisations prioritise aligning the top personal tax rate with the company tax rate.¹⁹

There is a clear tension between the pressure for alignment of tax rates and that to reduce corporation tax rates, since unless there is a major shift to tax collection via VAT/GST type taxes it will remain necessary to raise substantial revenue from personal taxes.

A reduction of rates on corporate income significantly below the highest marginal rate of personal income tax on labour income will distort the choice of business organisation for small firms and lead to costly use of the resources of small firms for tax planning purposes rather than productive activity. Incorporation reduces the overall tax payable on business profits if methods of extracting the profits are available to the owners that do not result in the higher progressive personal tax rates (and social security payments) on labour income being payable. Thus, switching salary of owners to dividends will produce a substantial tax saving, as will splitting ownership of shares in the corporation between family members so that nil or low rate allowances can be used before getting into higher rate bands. Profits may also be retained, subject to tax only at the corporate rate and then sheltered and switched into capital gains taxed at a lower rate than income. In Australia it seems that there is a further complexity in that discretionary trusts are sometimes used to facilitate income splitting to maximise the use of lower personal rate bands and corporate tax rate, while at the same time being able to flow through tax preferences to individuals.²⁰

In the UK there is a reduced rate of corporation tax for small companies (currently 21%)²¹ and dividends carry a tax credit which wipes out the basic rate of tax. Employment income, on the other hand, is taxed at rates up to 40% and in addition bears high rates of social security contributions. Self-employed earnings are also taxable under the higher progressive rate but bear a lower rate of social security payments than do salaries.²² The effect of this combination of rates is that there is a perceived lack of horizontal equity between different legal forms and especially between employees and those who incorporate but continue to provide very similar services to those

19 Henry Consultation, above, n 5, p 125.

20 B Freudenberg "Are transparent companies the way of the future for Australia?" (2006) 35 *Australian Tax Review* 200. The Australian trading trust has been described as a "commercial monstrosity": H Ford, "Trading Trusts and Creditors' Rights" (1981) 13 *Melbourne University Law Review* 1; nevertheless in 2002 the Board of Taxation rejected a call to tax discretionary trusts as companies (Board of Taxation, *Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer* (November 2002)). Substantial anti-avoidance legislation has, however, been introduced: ICAA and Deloitte, above, n 7. In the UK discretionary trusts do not offer equivalent advantages and they are not widely used for trading operations as in Australia.

21 The full rate of corporation tax is 28%, the basic rate of income tax for individuals is 20%.

22 Due to the social security payments in particular, this gap is greater than the 18.5% gap reported in Australia inclusive of Medicare levy in 2002: Board of Taxation, *Taxation of Discretionary Trusts*, above, n 20, para 42.

provided by employees. As a result there have been attempts at legislation to curtail the benefits of personal services companies, as there have been in Australia. In addition corporate income is often shared with family members who hold shares but do not actually provide much by way of labour to the company. Litigation has therefore been attempted to prevent this type of income splitting.²³ Neither the litigation nor, arguably, the legislation has been very successful. Adjustments to rates of corporation tax, in particular the small business rate, and social security payments²⁴ over recent years have gone some way to reduce the savings that can be made by incorporation by moves in the direction of alignment, but they have not been eliminated entirely.²⁵

Possible approaches to the structural problem

Entity flow-through approach

One proposal which has been put to the Henry Review for consideration is an optional entity flow-through arrangement (EFT) along the lines of the US sub-chapter S (S corporation) treatment, although with adaptations. This has been worked through in detail in a joint submission by the ICAA and Deloitte.²⁶ They claim the advantages of such a regime to be, first, reduced compliance costs as a result of fewer integrity measures being needed due to transparency; second, the ability to obtain limited liability coupled with flow-through taxation; and, third, the ability to consolidate the affairs of the owners of the business with those of the operating entity.

In the US, S corporation treatment can be chosen by companies with up to 100 shareholders. A series of fairly complex provisions must also be satisfied to be eligible for this treatment. The only shareholders permitted are individuals, estates and certain exempt organisations and trusts.²⁷ They then have the option to be taxed on a partnership or sole proprietorship basis or as corporations.²⁸ Losses also pass through in this way and can be set against other income but are limited to the amount representing the shareholder's

23 The personal service companies legislation, sometime known as the "IR35 legislation" is contained in the *Income Tax (Earnings and Pensions) Act 2003* (UK) Pt 2, Ch 8. It was supplemented by managed service company legislation in the *Finance Act 2007* (UK), which attempts to deal with some of the outstanding problems. Income splitting between spouses was attacked by the UK revenue authorities (HMRC) in the case of *Jones v Garnett (Arctic Systems)* [2007] UKHL 35 but the application of the settlements legislation for this purpose was held by the House of Lords to be unsuccessful in that case. Further legislation was promised but has not yet been enacted due to the difficulties encountered in drafting this. The author's understanding is that this issue is sometimes dealt with in Australia under general anti-avoidance rules: ATO Taxfacts, "General anti-avoidance rules and how they may apply to a personal services business", October 2008, <http://www.ato.gov.au/businesses/content.asp?doc=/content/37495.htm> (accessed 25 March 2009).

24 Known in the UK as National Insurance Contributions.

25 The UK situation is described in more detail in C Crawford and J Freedman, above, n 3.

26 ICAA and Deloitte, above, n 7.

27 J McNulty, *Federal Income Taxation of S Corporations* (West Group Publishing, 1992).

28 Under the check-the box regulations: Treasury Decision 8697.

investment to prevent avoidance. One advantage of an S corporation for owners is that, despite the pass-through treatment, the majority of the profits escape various employment, social security and healthcare payments and taxes. Anti-avoidance provisions appear to be somewhat ineffective.²⁹ The US Treasury describes the S corporation form as “a multibillion dollar employment tax shelter for single owner businesses”.³⁰ The growth in popularity of S corporations described by Auerbach, Devereux and Simpson³¹ is likely to be at least partially explained by these tax advantages.

In the US, the Limited Liability Company (LLC) form also gives limited liability with an option for partnership tax treatment. These options give many US businesses a choice of tax treatment, but, as can be seen, they also increase the opportunities for tax planning. Special provisions are needed to deal with manipulation of losses. Difficulties also arise as to whether to treat the income as income from capital (distributions) or salary, where there are differences in treatment between the two, whether these arise from social security payments or tax rate differences. Whilst the detailed issues would be different in Australia, as Kokkinos points out,³² the points demonstrated here are that the creation of such options will create tax planning opportunities.

Policymakers need to consider whether it is desirable to create these opportunities for tax planning with the consequent need for complex anti-avoidance provisions. For small business owners the choice may be a costly distraction from more productive activity at the time of business start-up, although there may be tax savings to be made in this way. Limiting the choice to a one-off election, as suggested by Kokkinos, will reduce the use of the option for tax planning but make the initial choice even more demanding and distracting for the business owner.

It is reasonable to question what problem it is that is actually being addressed by the proposed flow-through solution for Australia. Pass-through treatment has been seen as attractive in the US largely because of the classical corporation tax system adopted there. In the UK, which has had an imputation system and now continues to give a measure of credit for tax paid at the corporate level, the need for pass-through treatment in terms of reducing double taxation on corporate dividends is not readily apparent and the same is true in Australia, given its imputation system. Kokkinos argues that, in

29 Nearly 80% of all S corporations were either owned, or majority owned, by a single shareholder. There was an estimated loss of \$5.7 billion employment taxes in 2000 as a result of the use of S Corporations: US Treasury, *Actions are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single Shareholder S Corporations*, Memorandum for Deputy Commissioner for Services and Enforcement, Reference No 2005-30-080 (2005); R Winchester, “Working for Free: It Ought to be Against the (Tax) Law” (2006) 76 *Mississippi Law Journal* 227, and R Keatinge, *Self-Employment Tax Issues in LLCs Taxed as Partnerships*, Suffolk University Law School Research Paper No 07-33 (2007).

30 US Treasury, above, n 29.

31 A Auerbach, M Devereux and H Simpson, “Taxing Corporate Income”, in J Mirrlees *et al*, above, n 3.

32 A Kokkinos, above, n 13.

Australia, for corporations with low profits, the corporation tax rate exceeds the tax rate the owners would pay if they were not incorporated. It is true that this is not the case in the UK because of the low small companies rate of corporation tax described above which, until now at least, has been set at a rate close to the basic rate of income tax.³³ Nevertheless, for companies falling within this category the problem can be solved in many cases by paying wages to the owner-managers, which will be deductible from the corporate profits and taxable in the hands of the owners at their own personal rate. They will then be put into the same position as far as tax rates are concerned as if they were running an unincorporated firm, which seems equitable.

In the UK some have argued for pass-through treatment on the basis that it would allow use of losses by individual owners and we could see these arguments increasing due to the current economic climate.³⁴ On the other hand, pass-through treatment combined with limited liability is already available in the UK by use of a Limited Partnership or a Limited Liability Partnership (LLP). Although some have argued that the LLP would be a valuable vehicle for small firms,³⁵ it has not proved particularly popular for this purpose as yet, no doubt because it currently offers few tax advantages for ordinary small businesses, so that this could change.³⁶ It is a relatively new vehicle and was not designed for the purposes of small firms, so that there are costs involved in its use.

It has been argued that a flow-through system would be beneficial in Australia because taxpayers would be able to obtain both limited liability and flow-through tax treatment without having to rely on the utilisation of trusts. In terms of tax rates, as explained above, it is not immediately obvious why flow-through would be desirable, given that Australia has an imputation system, and the Henry Consultation paper questions the rationale of this

33 There are plans to raise the small companies rate in part to reduce tax induced incorporations. The rate has been raised slightly but a further rise has been put on hold due to the recession. For a full explanation see C Crawford and J Freedman, above, n 3.

34 Although UK corporations have been given increased carry-back for accounting periods ending between 24 November 2008 and 23 November 2009-the increase is from the normal one year to three years: HMRC, *Extension of Loss Relief Rules Technical Note* (24 November 2008).

35 R Murphy, *Small Company Taxation in the UK: A review in the aftermath of the "Arctic Systems" ruling* (Tax Research UK, 2007).

36 The LLP was introduced in the UK in 2000. The total number of LLPs registered under the *Limited Liability Partnership Act 2000* (UK) in the year ending March 2008 was 32,066, with new registrations in 2007-08 being 6,570 compared with 372,000 new limited companies registered in that period. Many of those LLPs are professional firms. The total number of Limited Partnerships registered under the *Limited Partnerships Act 1907* at the same point was 15,589 with only 1,251 registrations in 2007-8. These vehicles have been utilised for tax planning purposes, but there is legislation severely limiting their use as tax shelters. Statistics taken from Department for Business Enterprise & Regulatory Reform, *Statistical Tables on Companies Registration Activities 2007-8*. For further discussion of the UK LLP, see J Freedman, "Limited Liability Partnerships in the United Kingdom: Do They Have a Role for Small Firms?," in J McCahery, T Raaijmakers and E Vermeulen (eds), *The Governance of Close Corporations and Partnerships: US and European Perspectives* (Oxford University Press, 2004), p 293.

proposal for this reason.³⁷ It seems that one advantage for taxpayers would be that trusts would not be needed to achieve income splitting (or what the ICAA and Deloitte submission calls “flexibility in distributions”). The use of discretionary trusts in the Australian system clearly adds to complexity but it is not self-evident that their use is for purposes which are desirable as a matter of policy in themselves. The use of trusts is clearly very complex, and anti-avoidance provisions are making it more so, but if the objective of the Australian government is one of neutrality of treatment of income from labour regardless of legal form they may not wish to encourage this use of trusts in any event.

In Australia, a flow-through system would also facilitate the passing through to the individual of losses and other preferences (again without having to resort to the use of trusts) and this seems to be a major reason for the proposals being put forward. Such a flow-through has policy and revenue implications and limitation rules are likely to be needed which would add to complexity rather than reducing it. The Australian government’s policy has been that flow-through taxation should only be available if there is liability exposure for members, which is why such treatment is not available to companies or even limited partnerships.³⁸ If that is a fundamental premise underlying tax policy then logically it would seem that it should be carried over to situations in which trusts or any other form of organisation are used. If, on the other hand, there are to be exceptions to this principle, they could probably be achieved, more simply, by permitting limited partnerships to have tax transparency as they do in the UK and other jurisdictions, rather than introducing an EFT regime.³⁹ Since an EFT regime aims at partnership taxation where the underlying form of business organisation is a company, complexities arise through the mismatch of legal rights and the applicable taxation.⁴⁰ This could add another layer of complexity to an already complex area. Certainly, however, if it was sought to achieve tax transparency, anti-avoidance provisions would be needed, as is admitted by those proposing the EFT regime.⁴¹

37 Henry Consultation, above, n 5, p 153.

38 B Freudenberg, above, n 20.

39 As proposed by M Stewart, “Towards Flow Through Taxation of Limited Partnerships: It’s Time to Repeal Division 5A” (2003) 32 *Australian Tax Review* 171 and B Freudenberg, above, n 20. Freudenberg explains that legislation was introduced in 1992 to impose corporation tax on limited partnerships, no doubt because transparent tax treatment was being used for tax planning (as has been the case in the UK, where the approach has been to introduce a raft of highly complex anti-avoidance provisions, though not to remove transparency).

40 See B Freudenberg, *Submission to the Henry Review* based on an unpublished dissertation *Tax Transparent Companies: Striving for Tax Neutrality?* Kindly supplied by the author.

41 ICAA and Deloitte, above, n 7. In the UK anti-avoidance provisions in respect of LLPs’ losses have been introduced in the original implementing legislation and again in 2004, 2005 and 2007. This may be one reason why the number of registrations is low. In the US there are also loss limitation rules: see M Stewart, *Towards Flow Through Taxation of Limited Partnerships: It’s Time to Repeal Division 5A*, above, n 39.

A further advantage of the flow-through system is said to be that the fringe benefits tax would not be applicable, because of course wages would not be paid to the owners. Presumably then other provisions would need to be applied to prevent the deduction of expenses for personal benefits from profits, or there would be a loss of revenue and a reduction of horizontal equity here also.

The proposal for the EFT made by the ICAA and Deloitte, is designed to apply only to private firms with five or fewer members and there would only be one chance to elect into the system, at the time a firm came into existence. This would reduce manipulation and cost to the revenue and maintain the integrity of the system. It seems likely, however, that any such limitations would soon come under pressure since it is a very frequent phenomenon of small business policy-making that schemes designed for very small firms are hijacked by larger ones. The rule that the scheme could only apply if there were five or fewer members would be subject to manipulation through the use of trusts and other devices in order to obtain the benefits. If there were real benefits to the EFT regime, the threshold of five members could become a barrier to growth at a critical time in the firm's development as it would have to move away from the regime at exactly the time at which outside shareholders were sought.

Measuring the EFT regime against the benefits claimed for it, it is not clear that it would reduce compliance costs since integrity measures would be needed which would re-introduce complexities. It could conceivably achieve limited liability and a measure of flow-through without the need to resort to trusts but, if this was the policy objective desired by the government, it could have been achieved by taxing limited partnerships in a transparent way. The fact that in 1992 it was decided to tax limited partnerships as companies suggests that this was not an acceptable policy objective, at least not without severe limitations which then introduce complexity. The EFT would align the tax treatment of some corporate owners with some owners of unincorporated firms, but it would exacerbate differences at the border between those entitled to EFT and those not so entitled. It would not prevent the use of corporations to income split and would in fact assist in this method of converting labour income into income from capital, so that in a system which sought to tax dividends and labour income at different rates, this problem would not be solved by the EFT regime.

Aligning tax rates: More or less radical approaches

Aligning rates of tax

The author has argued for alignment of rates of corporation tax and personal tax in order to remove distortions and lack of horizontal equity between employees, the self-employed and owners of small incorporated firms.⁴² This becomes difficult if it is desired to reduce the rate of corporation

42 C Crawford and J Freedman, above, n 3. In the UK context, various methods of alignment, for bringing rates closer together, are proposed as one approach in this chapter.

tax but retain a progressive rate of tax on labour income. There is a strong international trend in this direction backed by efficiency arguments in its favour.⁴³ The reasons for reducing taxes on income from corporate securities are mainly pragmatic: the high and growing international mobility of portfolio capital, combined with the practical difficulties of enforcing taxes on foreign source capital income and the administrative and political difficulties of taxing some types of income from capital, such as imputed returns to owner-occupied housing, so that keeping a low rate of tax on income from capital generally minimises distortions. There are also theoretical justifications for a lower rate of tax on the return to capital; for example, if tax is levied on the whole nominal return to capital, including the inflation premium, the effective rate of tax is in fact higher than it seems, due to the lack of inflation adjustment. In relation to tax on corporations, there are also the effects on investment of a corporate tax as discussed below. Whilst the first of these reasons is of little direct relevance to most owner-managed domestic businesses of the kind discussed in this paper, if the arguments in favour of maintaining a tax differential are accepted for general reasons, then the problem of distortion in the case of small businesses will remain.

In the Nordic countries this problem of dual rates of tax has been tackled head on. The Nordic system of dual income tax levies a tax on income from capital at a low flat rate equal to the corporate tax rate (giving full credit for corporation tax) with a second progressive tax rate on labour income. Small business taxation was seen as the “Achilles heel” of this scheme when it was proposed and it was considered vital to tackle this problem.⁴⁴ In this way, this new business tax design for large business necessitated the development of a new approach for small business. Not all the Nordic countries have adopted exactly the same schemes and there are still adaptations of the schemes under way. It has also to be remembered that these are countries with very high progressive rates of income tax on labour income. It is not suggested that any of these schemes could be readily transplanted into Australia and all the regimes discussed here in this context would require root and branch reform. The schemes are, however, worthy of study, if only to highlight issues which may arise if other changes to the Australian system occur.

Thus, the proposal referred to in the Henry Consultation paper for a combination of an Allowance for Corporate Equity (ACE) at corporate level together with a dual income tax at the personal level⁴⁵ must be understood in the context of radical proposals for the tax system as a whole and not just small businesses. A variant of this proposal is discussed in the study by Crawford and Freedman⁴⁶ with a greater focus on the detail for small

43 A Johansson, C Heady, J Arnold, B Brys and L Vartia, above, n 15; R Griffith, J Hines and P Sørensen, above, n 4.

44 P Sørensen, “Neutral Taxation of Shareholder Income” (2005) 12 *International Tax and Public Finance* 777.

45 R Griffith, J Hines and P Sørensen, above, n 4.

46 C Crawford and J Freedman, above, n 3.

businesses. It is an alternative to the less radical approach also discussed there to gradually align tax rates through a combination of rate setting and credits, being an adaptation of the current UK system.

A shareholder income tax with a rate of return allowance?

Norway (as mentioned above) has a dual income tax system (in which the corporation tax rate is equal to the capital income tax rate, which, in turn, is equal to the lowest labour income tax rate). There is also a higher (progressive) labour tax rate. To combat the incentive this produces to convert labour income into capital income, Norway adopted a residents' shareholder income tax with a rate of return allowance (RRA) in 2006. This enables it to align the effective tax rate on part of the income of a corporation with that of labour income, whilst leaving normal returns to physical capital taxed at a lower rate, whether or not they are distributed. This meets concerns that the taxation of the whole of the distributed profits of a company as if they were labour income does not recognise the investment of shareholders, and also permits a lower effective tax rate on the normal return to capital than on labour income, which may be attractive for non-small business reasons.

Crawford and Freedman consider a system modelled on the Norwegian system and also a variation which would combine it with an Allowance for Corporate Equity at the shareholder level.⁴⁷ The aim would be to align rates of tax on all income other than the normal rate of return on capital, which would be exempt. This would require an expenditure tax at the personal level since all returns on savings would need to be tax exempt for this to be neutral. This system recognises only two classes of income - income from capital and labour income. It does not, therefore, grant any tax reduction to those who are arguably risk-taking more than an employee, but who are still earning their profits through their own skills and labour. It proceeds on the basis that generally such risk-taking should be rewarded through the market rather than the tax system. Tax incentives should be provided only in so far as they satisfy the criteria set out in "Special measures for small businesses", below.

The proposed RRA would exempt all shareholder income (including both dividends and realised capital gains, which are treated identically) below an imputed normal rate of return on the share basis (the RRA) at the personal level, as this income has already been subject to corporation tax (at a rate corresponding to the capital income tax rate) and should therefore not be taxed further.⁴⁸ The share basis in any given year would be defined as the sum of the original share cost plus all unutilised RRAs from previous years: this is equivalent to carrying forward retained profits (postponed capital gains tax

47 C Crawford and J Freedman, above, n 3.

48 If losses are fully deductible (which is necessary to ensure the neutrality of the shareholder income tax with respect to investment and financing decisions), then there is no need to include a risk premium in the RRA. For a more detailed discussion of the implementation issues surrounding the shareholder income tax, see P Sørensen, "The Nordic dual income tax: principles, practices and relevance for Canada" (2007) 55 *Canadian Tax Journal* 557.

liabilities) with a normal return, to ensure that only capital gains in excess of the normal return are subject to taxation at the higher labour income rate.

Above the RRA, income should be taxed at the capital income tax rate – which, in combination with the corporation tax rate (which has already been paid on this income), corresponds to the top marginal rate of taxation on labour income. This should be equivalent to the tax treatment of unincorporated businesses – for which an imputed return to business assets is taxed at the capital income tax rate, with the remainder taxed at the labour income tax rate – because the corporate and capital income tax rates are the same under the dual income tax system. It might be that such an approach should be optional for unincorporated firms, however, as it requires detailed book-keeping; those who do not wish to maintain such detailed records could simply opt to have the whole of their income taxed as labour income.

Capital income (including both dividend income and realised capital gains) above the RRA could be taxed according to the same progressive tax schedule as that used for labour income. This could be achieved for the dividend income of domestic taxpayers, for example, either with a credit for corporation tax already paid and a correspondingly higher tax rate applied to grossed up dividends (as under the current system), or without a credit (and a correspondingly lower rate of tax applied to cash dividends). The administrative workings of this would depend on the relative tax rates, but clearly as much as possible would need to be done through withholding.

This system would apply to all shareholders, thus circumventing the need to define “active” shareholders or owner-managed companies or some other category of businesses to which special tax treatment would apply. It would not eliminate the ability of incorporated owner-managers to “split” their income with family and friends in order to minimise their tax burden, although the fact that they would be paying the labour income tax rate on all income might reduce the advantages.

A potential problem is that only returns to physical assets are taxed at the capital income tax rate. It could be argued, contrary to the view expressed above, that “self-generated goodwill”⁴⁹ should be taxed at a lower rate than labour income. This could be achieved, for example, via a cap on the amount of income subject to taxation at the labour income tax rate (with any income beyond this cap taxed at a lower rate, that is, the tax rate on capital income only).⁵⁰ Alternatively, these types of input could be valued and treated in the same way as tangible capital investments. On the other hand, there is also an argument that the rewards for “effort” in whatever form (be they bonuses

49 Such as the name of the business, customer lists, etc. This is only a problem with self-created intangibles, since the value of acquired intangible assets is included in the basis value (acquisition price) of the shares and hence in the basis for calculating the RRA.

50 In Norway, there was previously a system for taking into account self-generated goodwill; however, it was quickly abandoned, after it was found that almost 80% of “active” shareholders were reporting *negative* labour income for tax purposes: P Sørensen, *Neutral Taxation of Shareholder Income*, above, n 44.

awarded by employers, the above-normal returns made from an individual's investment portfolio, or the higher profits made by self-employed persons or persons providing their services through companies) should be taxed equally (and, possibly, at a different rate to the normal return on investment in physical capital). As a matter of general principle, however, returns to forms of input other than capital should be considered to be rewarded by the market and should not be given any special treatment by the tax system. If, however, a government wishes to recognise such input by favourable treatment for pragmatic or policy reasons then this could be done, though not without complexity and opportunities for manipulation, as seen in other jurisdictions.

Another issue is that the RRA could result in a distortion in favour of holding non-business assets (over business assets) unless above-normal returns to non-business assets are taxed at the labour income tax rate as well. Clearly these are proposals which can only be considered in the context of the tax system as a whole - they are not intended for piecemeal reform.

In most current tax systems the normal return to capital is taxed, with consequent implications for the level of investment.⁵¹ Companies' choice of financing methods may also be distorted, as a result of the differential treatment of debt and equity for tax purposes: while interest payments on loans (made to the company) are not subject to corporation tax, dividends (the return to equity) are.⁵² This has led many commentators to argue for a removal of these distortions.⁵³

Whilst the introduction of a shareholder income tax would exempt the normal return to capital invested in the corporate sector from taxation at the personal level, it would do nothing to eliminate the distortions outlined above.

For this reason it might be considered desirable to combine the RRA with an ACE. Under an ACE system, companies would be given an allowance – reflecting the opportunity cost of equity finance – to be deducted from taxable profits (in the same way that interest payments currently are). This allowance would be calculated by multiplying cumulative past injections of new equity and past retentions of profits by some appropriate interest rate,⁵⁴ representing the return that could have been obtained had these funds been invested elsewhere.⁵⁵ There would need to be an equivalent for unincorporated businesses.

A combination of an ACE with an RRA-based shareholder income tax along these lines would eliminate the distortions to choice of legal form. It

51 To give the same post-tax return, the gross return required for an investment to be worth undertaking is higher than if there were no tax, making some investments that would have been profitable without the imposition of the tax not worth undertaking thereafter.

52 This is further complicated by the availability of hybrid financial instruments, blurring the distinction between debt and equity (for tax purposes).

53 A Auerbach, M Devereux and H Simpson, above, n 31; R Griffith, J Hines and P Sørensen, above, n 4.

54 For example, this might be the risk-free interest rate on government bonds.

55 For more details see Institute for Fiscal Studies Capital Taxes Group, *Setting Savings Free: Proposals for the Taxation of Savings and Profits* (1994).

would also remove the incentive to choose debt-financing over equity-financing. Further, the normal return to capital would be exempt from taxation at both the business and the personal levels, thus reducing distortions to investment choices. Since many very small businesses have no equity finance at all this would effectively mean that they were taxed on all the profits of the business in the same way as if they were receiving income from an unincorporated business, which would be taxed at the same progressive rates as employment income.

SPECIAL MEASURES FOR SMALL BUSINESSES

Politicians, business representatives and practitioners often argue for special measures for small business on the basis of their contribution to the economy. The political power of the small business lobby can translate into special preferences for small firms and their owners which are ultimately unhelpful to all, including small businesses, because of the complexity and distortions they produce.⁵⁶

There are various problems with this. First, these groups are not always clear what they mean by “small” or “small and medium”. Even if it makes sense to target new firms or growth or entrepreneurship in some circumstances, targeting *size per se* is likely to lack rationale and therefore effectiveness. Second, it is easy to slip from thinking about entrepreneurship or growth to suggesting proposals about reliefs or incentives for *all* small businesses. This is a process that can create distortion in the tax system without necessarily being of clear economic benefit. Johansson *et al*⁵⁷ produce evidence to suggest that favourable tax treatment of investment in small firms may be ineffective in raising overall investment. In the current economic climate there will be even more pressure than usual to assist small firms through the tax system and there may be some justification for this where their size means that credit is harder to obtain and they have fewer other profits against which to set losses, but since all businesses are suffering there will be a need to consider very carefully the allocation of resources to such assistance.

Proponents of tax measures favourable to small businesses, or to some small businesses, put forward several possible rationales for their view. Broadly, these include i) the need to counteract market failures; ii) the desirability of countering inherent disadvantages of being small such as the regressivity of compliance costs⁵⁸ and the asymmetry of taxable profits and losses; iii) the need to ensure that small businesses can survive family and other events which might threaten to break them up. Overriding all these is the argument that

56 This has been demonstrated in an Australian context by M Burton, “The Australian Small Business Tax Concessions – Public Choice, Public Interest or Public Folly?” (2006) 21 *Australian Tax Forum* 71.

57 A Johansson, C Heady, J Arnold, B Brys and L Vartia, above, n 15.

58 Regressivity of compliance costs is well established in the literature. The term here is used in the same sense as in Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation* (Meade Report) (1978), Appendix 22.1.

small businesses are important to the economy in creating wealth, stimulating competition and creating jobs, and that this in itself justifies tax favourable provisions.

There are two distinct issues here. First, are claims for the importance of the small business sector justified? The second, and more important, question is: even if the importance of the small business sector is accepted, as it must be (to some extent), does it necessarily follow that it requires financial support, or that the tax system is an appropriate way to provide any such support as is appropriate? In particular, is it possible to target tax reliefs so as to support the possible rationales set out above?

Claims for significance of the small business sector

The small business sector undoubtedly creates jobs, generates wealth and contributes to innovation. Small firms provide work for their owners, at least, and contribute to local economies. They carry out functions that it would not be economic for large firms to carry out and some of them have “spillover” (external) effects which help to develop markets.⁵⁹ These attributes of small firms need to be recognised but not overstated. There is much debate over the extent to which small business creates valuable jobs.⁶⁰ It is also the case that some small businesses are poor employers and may be inefficient,⁶¹ although workers may also find compensating factors in a small business environment.⁶² Small firms have many functions in society and the job creation debate may to some extent miss the point,⁶³ but, to the extent that job creation by small firms is used to justify tax preferences, it is worthwhile pointing out that the issue is not beyond doubt. The small firm sector is heterogeneous and not susceptible to generalisations. There is a serious issue of targeting.

In any event, even if the sector is very important as a whole, the conventional wisdom that small business is the engine of the economy and the fountainhead of job creation is not, in itself, a justification for tax preferences targeted at size as opposed to other attributes.⁶⁴ For example, it has been argued that new firms may increase overall productivity in the industry because

59 G Bannock, *The Economics and Management of Small Business: An International Perspective* (2005).

60 See B Harrison, *Lean & Mean* (1997); D Storey, *Understanding the Small Business Sector* (1994); S Davis, J Haltiwanger and S Schuh, “Small Business and Job Creation: Dissecting the Myth and Reassessing the Facts” (1996) 8 *Small Business Economics* 297; V de Ruyg, “Are Small Businesses the Engine of Growth?”, American Enterprise Institute Working Paper No 123 (2005), and D Storey, “A Symposium on Harrison’s “Lean & Mean”: A Job Generation Perspective” (1995) 7 *Small Business Economics* 337.

61 J Curran, J Kitching, B Abbott and V Mills, *Employment and Employment Relations in the Small Service Sector Enterprise – A Report* (Kingston University, London, 1993); D Storey, *Understanding the Small Business Sector*, above, n 60, and B Harrison, above, n 60.

62 J Curran, J Kitching, B Abbott and V Mills, above, n 61.

63 G Bannock, above, n 59.

64 D Holtz-Eakin, “Public Policy Toward Entrepreneurship” (2000) 15 *Small Business Economics* 283; J Slemrod, “Small Business and the Tax System”, in H Aaron and J Slemrod (eds), *The Crisis in Tax Administration* (2004), p 69; and V de Ruyg, above, n 60.

they are potential market entrants⁶⁵ but whilst this might be an argument for encouraging *new* entrants, or at least not setting up barriers to them, it is not necessarily an argument for providing relief to *small* firms *per se* as opposed to a group of firms with some other characteristic, such as innovation. For the sake of efficiency, some small firms need to fail. As Holtz-Eakin has pointed out, it is hard to know whether levels of business failure are the “right” levels, and even harder to determine which firms to target for success or failure.⁶⁶

Justifications for tax preferences for small firms

The OECD⁶⁷ has commented that, from a strict economic efficiency viewpoint, all special provisions for small businesses need to be justifiable in terms of market failure or malfunction. It recognises that there may be objectives beyond pure economic efficiency, such as income distribution, which might justify special tax and other provisions for small firms. Even where there does appear to be a rationale for assisting small firms or some class of them, however, there are many problems with ensuring that the objectives of the relief are satisfied through business tax reliefs and incentives based on size of firm, or through structural reliefs related to legal form, rather than by more direct subsidies and other regulatory policies. The OECD recommends that countries must first decide what problems are faced by small businesses and then, if they consider the problems are sufficient to warrant government action, they should consider the relative merits of preserving a neutral tax system (in so far as one exists) and using direct expenditures to pursue small business policy objectives, since non-tax measures will often be better targeted than tax measures. In a later report,⁶⁸ the OECD concludes that the tax system has a potential role in limiting the cost disadvantages faced by small businesses in complying with tax legislation, encouraging the creation of *new* small businesses and ensuring the continuation of small businesses when control passes from the founder of the firm to another person. Beyond that, the OECD concludes that since there is no such thing as a specific tax imposed on small businesses *per se*, as opposed to taxes on wider target groups, it is not necessarily helpful to attempt to provide special relief for small firms through the tax system.

Balanced against the possible role for small business reliefs, the following potential difficulties must be considered. In addition to the problem of targeting, referred to above, the provision of tax reliefs and exemptions for small businesses may be inefficient. They may distort the choice of business organisation, commercial decisions about forms of expenditure, timing and

65 P Aghion, R Blundell, R Griffith, P Howitt and S Pratl, “Entry and Productivity Growth: Evidence from Microlevel Panel Data” (2004) 2 *Journal of the European Economic Association* 265, and R Disney, J Haskel and Y Heden, “Restructuring and Productivity Growth in UK Manufacturing” (2003) 113 *The Economic Journal* 666.

66 D Holtz-Eakin, above, n 64.

67 OECD, *Taxation and Small Businesses*, above, n 15.

68 OECD, *Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices*, above, n 15.

method of change and transfer into other hands. In addition, they may result in economic inefficiency if they interfere with the market and result in the allocation of resources to small, less efficient, firms rather than to larger, more efficient, ones. Reliefs might even result in barriers to growth at the margins if restricted to businesses below certain thresholds. Small business reliefs often create complexity in the system, especially when coupled with anti-avoidance provisions. For this reason a simple and neutral system of business taxation might be preferred, even by small businesses, to a more complex system that seeks to favour some small firms.⁶⁹

The possible rationales for small business tax reliefs and concessions are now examined in more depth.

Market failures

There may be market failures that affect some small firms, such as asymmetric information (for example, on markets or products) monopoly power of large firms making entry into the market difficult, or difficulties for small firms in raising finance. These may be used as a justification for general tax reliefs or for specific schemes to promote investment in small firms. These schemes, it is argued, will assist not only the firms themselves but the market more generally with spillover effects from the innovative activity of the smaller firms.⁷⁰

Apparent market inefficiencies may, however, actually be examples of the market getting it right. If small businesses lack finance in some circumstances this might be because they do not have a good product or idea. Similarly, if the market rewards are not sufficiently high to compensate for undertaking risky activities, they may not be worth undertaking.⁷¹ Attempting to fine tune firm financing through the tax system could have unintended consequences. Thus, the OECD argues that tax measures are most likely to improve on the free market outcome in situations where the nature of the market failure is clear, but, of course, judging whether there is a market failure is the central difficulty that has to be addressed. It might be thought that the market is at least as likely to make sound judgments about the likelihood of the success of small business as are politicians. In addition, there needs to be evidence that the failure is significant, and a tax measure must be available that tackles the source of the inefficiency, has a significant effect on the behaviour in question and does not produce major distortions elsewhere. This will be quite a rare combination of circumstances.

Although capital market failures are often cited as a problem for small firms, it seems that in the UK there is no evidence of any general failure in the case of small businesses (although of course there are now general credit

69 J Freedman, "Why taxing the micro-business is not simple – a cautionary tale from the "Old World"" (2006) 2 *Journal of the Australasian Tax Teachers Association* 58.

70 R Gordon, "Can High Personal Tax Rates Encourage Entrepreneurial Activity?" (1998) 45 *IMF Staff Papers* 49; P Aghion, R Blundell, R Griffith, P Howitt and S Pratl, above, n 65, and R Disney, J Haskel and Y Heden, above, n 65.

71 S Adam, J Brown and C Heady, "Taxation in the UK", in J Mirrlees *et al*, above, n 3.

problems throughout the economy). The principal finance gap is for new and start-up businesses rather than small businesses.⁷² As a result of these findings, there has been an attempt to target tax assistance in raising external finance to those firms which do experience a problem, through the Enterprise Investment Scheme, Venture Capital Trusts and the Corporate Venturing Scheme. These seek to meet the perceived “equity gap” for unquoted trading companies, although there has been discussion about how well targeted they are, and the jury is still out on their effectiveness.⁷³ Non-tax-based assistance is given through the Small Firms Loan Guarantee,⁷⁴ which has been remodelled following the Graham review to focus on firms within their first five years of business rather than small firms generally. This is consistent with the position taken here that the focus should not be on size but on other characteristics.⁷⁵

One area often cited as being in need of intervention through tax incentives is investment in R&D. In the UK, the R&D credit was initially introduced for SMEs in the *Finance Act 2000* (UK) but was soon extended to all companies in the *Finance Act 2002* (UK), although the relief is still more generous for SMEs.⁷⁶ The availability of a cash credit to SMEs and not to large companies may be justified on the basis that smaller companies have fewer possibilities for balancing costs against profits from other activities, but the larger amount of relief available to small companies is less easy to explain in the absence of evidence of greater credit constraints or spillover benefits in these cases. The evidence as to whether the UK R&D tax credits address the real limitations on innovation seems to be equivocal.⁷⁷ Internationally, Johansson *et al*⁷⁸ find that the effect of these tax incentives is relatively modest and greater for structurally more R&D intensive industries. The extension of the relief to large companies is an example of the provision of reliefs for small companies fuelling demands by larger businesses. It is often the case that reliefs introduced for small companies result in pressure for extension to larger

72 T Graham, *Graham Review of the Small Firms Loan Guarantee: Recommendations* (HMSO, 2004).

73 N Boyns, M Cox, R Spires and A Hughes, *Research into the Enterprise Investment Scheme and Venture Capital Trusts* (Public and Corporate Economic Consultants, Cambridge, 2003), and M Cowling, P Bates, N Jagger and G Murray, *Study of the impact of the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) on company performance*, HMRC Research Report 44 (2008).

74 Now bolstered by the Enterprise Finance Guarantee Scheme to help meet the new financial circumstances: <http://www.berr.gov.uk/whatwedo/enterprise/enterprisesmes/info-business-owners/access-to-finance/sflg/page37607.html> (accessed 25 March 2009).

75 For a similar point from a US perspective see V de Rugy, above, n 60.

76 This measure does not extend to unincorporated SMEs, presumably for administrative and accounting reasons, since there is no principled justification for this.

77 L Abramovsky, R Griffith and R Harrison, *Background Facts and Comments on “Supporting Innovation: Enhancing the R&D Tax Credit”*, IFS Briefing Note No 68 (2006), and PWC, *Enterprise in the UK: Impact of the UK Tax Regime for Private Companies* (2006).

78 A Johansson, C Heady, J Arnold, B Brys and L Vartia, above, n 15.

companies (what Alt *et al*⁷⁹ call “policy creep”). Such pressure is not surprising if there is no very clear rationale for limiting the relief according to size. Furthermore, the fact that the relief is more generous to SMEs may mean that just as a business expands and needs most help its credit reduces.⁸⁰ An example of this in an Australian context might be found with the Wine Equalisation Tax: anecdotal evidence suggests that some wineries might decide not to expand to a level where they would exceed the beneficial cash accounting rule or the producer rebate.⁸¹ This also illustrates one way in which small business tax reliefs might create barriers rather than removing them.

If reliefs exist for all businesses, then the additional help required by smaller firms may lie in the need for assistance in accessing the schemes.⁸² This relates directly to the size of the firm because smaller firms are less likely to have staff with specialist expertise and time to understand and prepare claims subject to complex requirements. Indeed, concern about take-up by SMEs of the R&D credit led to the announcement in 2006 of additional assistance for small businesses to make claims.⁸³ This is closer to a compliance cost rationale, discussed below.

Inherent size disadvantages

A strong rationale for providing tax reliefs to small firms is that they are important in countering the inherent disadvantages of being small. The primary case is in relation to the regressivity of compliance costs.

Compliance cost work in various countries has established that the costs of complying with tax and other regulatory burdens fall disproportionately on small businesses which have fewer staff and less expertise and time to devote to understanding and applying such regulation, the necessary information gathering being a fixed cost.⁸⁴ Economies of scale and methods of organisation utilised by larger firms are not available to smaller firms. This is

79 J Alt, I Preston and L Sibieta, “The Political Economy of Tax Policy”, in J Mirrlees *et al* (eds) *Dimensions of Tax Design: The Mirrlees Review*, above, n 3.

80 J Alt, I Preston and L Sibieta, above, n 79.

81 *A New Tax System (Wine Equalisation Tax) Act 1999*: on the details of this see P Kenny, *Shiraz, Sauvignon and Champagne: The Old and New Wine Nations and Indirect Tax* (2009) (unpublished working paper, kindly provided by the author).

82 M Derregia and F Chittenden, *The role of tax incentives in capital investment and research and development expenditure decisions by small and medium enterprises* (Institute of Chartered Accountants in England and Wales, London, 2006).

83 HMRC, Research and Development Press Release (10 November 2006): <http://www.gnn.gov.uk/environment/fullDetail.asp?ReleaseID=241316&NewsAreaID=2&NavigatedFromDepartment=False> (accessed 25 March 2009).

84 Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation* (Meade Report), above, n 58; C Sandford, M Godwin and P Hardwick, *Administrative and Compliance Costs of Taxation* (Fiscal Publications, Bath, 1990); F Chittenden, S Kauser and P Poutziouris, “The Impact of Tax Regulation on Small Firms in the UK, USA, EU and Australia and New Zealand” (2003) 21 *International Small Business Journal* 85; C Evans, “Studying the Studies: An overview of recent research into taxation operating costs” (2003) 1 *Journal of Tax Research* 64, and KPMG, *Administrative Burdens: HMRC Measurement Project*, KPMG Publication No 300-808 (2006).

widely accepted as being a problem that may legitimately be addressed by reliefs and exemptions, and by removing certain reporting and disclosure requirements from small firms.⁸⁵

Slemrod argues that greater non-compliance on average by small businesses than by employees may offset their regressive compliance cost burden.⁸⁶ Such evidence as exists in the UK points to sole traders and partnerships being the groups with the highest levels of non-compliance (as compared with employees and also with directors of companies).⁸⁷ There are clearly greater opportunities for non-compliance by the self-employed than there are for employees and others with income from which tax is deducted at source. This might mean that some parts of the small business sector are paying a lower overall rate of tax than other taxpayers as a result of non-compliance. This does not mean that policy-makers should not seek to give relief from compliance costs where it is possible to do so without creating further problems, because there is unlikely to be a correlation between the tax savings of those prepared to reduce their taxes through non-compliance and those who suffer most through the regressivity of compliance costs.⁸⁸ Overall there should be a benefit to society through increased efficiency and greater revenue collection if compliance is encouraged by making it less costly. If this simplification also makes enforcement easier and so reduces opportunities for non-compliance, or encourages voluntary compliance, this will be an added bonus.

Complex deregulation

Attempts to reduce compliance costs may also inadvertently increase them because the reliefs themselves introduce complexities.⁸⁹ The proliferation of thresholds below which special treatment is available can be confusing and some reliefs can require a considerable amount of advice and calculation before it can be decided whether they are advantageous.

In the UK, these problems can be illustrated by some of the VAT simplification schemes which currently have a low rate of take-up and different thresholds.⁹⁰ A National Audit Office report remarks that the

85 OECD, *Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices*, above, n 15.

86 J Slemrod, above, n 64.

87 See National Audit Office, *Tackling Fraud against the Inland Revenue*, HC 429 (2003), Table 7. Although the text to this table refers to non-compliance, the figures on which it is based are the percentage of cases generating additional tax yield upon a random enquiry. There was generally little evidence of negligence or fraud, so that these cases may have been the result of accidental understatement of profits as opposed to deliberate non-compliance. See also HMRC, *Developing Methodologies for Measuring Direct Tax Losses* (2007). <http://www.hmrc.gov.uk/pbr2007/mdtl-direct.pdf> (accessed 25 March 2009). The different levels of compliance amongst different groups are largely the result of different opportunities for non-compliance amongst these groups.

88 W Gentry, *Comment on Small Business and the Tax System*, in H Aaron and J Slemrod (eds), above, n 64.

89 J Freedman, *Why taxing the micro-business is not simple – a cautionary tale from the “Old World”*, above, n 69.

90 These schemes are described at <http://www.hmrc.gov.uk/vat/vat-account-choose.htm> (accessed on 25 March 2009).

Institute of Chartered Accountants in England and Wales considers that the simplification schemes should not be used as a substitute for simplifying the whole tax system.⁹¹ In similar vein the Chartered Institute of Taxation has commented that some of its members consider that:

Stability is more important than more simplification schemes and simplification of the system is more beneficial than more schemes to counteract the complexity.⁹²

These schemes are targeted at real needs and so are better than some, but they are examples of complex deregulation,⁹³ with a variety of thresholds, some of which are not easily ascertainable in advance for firms, and with detailed anti-avoidance provisions. Businesses may need professional advice before they can be sure that they should use the schemes and, as the reliefs apply only to VAT and not to income or corporation tax, they do not reduce the need for record keeping more generally. Indeed, on one view, reduction of record keeping requirements may not actually assist the small firms because the tax requirement bolsters a commercial need, for example, to keep proper accounts. Some, such as Truman,⁹⁴ have argued for a move to cash accounting for income tax for the very smallest firms to reduce complexity, but small business owners might not find this helpful ultimately, because properly drawn accounts have an important management function.⁹⁵ Moreover, the end result could be a good deal of anti-avoidance regulation which might make for more complexity rather than less in the long run.

91 National Audit Office, *Helping Newly Registered Businesses Meet Their Tax Obligations*, HC 98 (2006).

92 See Chartered Institute of Taxation and the Association of Taxation Technicians, *Working Towards a New Relationship: Priorities for Reducing the Administrative Burdens of the Tax System on Small Businesses* (2005), p 10. However, there were clearly different views on the Committee since they also state the alternative view that the VAT cash accounting scheme could be extended to direct taxation to make it more popular.

93 A concept explained further in J Freedman, above, n 15; see also S Dean, "Attractive Complexity: Tax Deregulation, the Check-the-Box Election and the Future of Tax Simplification" (2005) 34 *Hofstra Law Review* 405.

94 M Truman, *What's in a name?* (2006), <http://www.taxation.co.uk/taxation/articles/2006/11/23/4540/whats-name> (accessed 25 March 2009).

95 The UK government issued a consultation paper in November 2008 which includes discussion of such a move to a cash flow basis or, as an alternative, a move to harmonise the accounting and tax accounts of small corporations. The latter proposal risks creating a divide between incorporated and unincorporated firms. The proposals for a cash flow basis are lacking in detail but are more than purely administrative and amount to a change of the tax base, with full deduction of capital expenditure on plant and machinery and no deductibility of interest. As such they go far further than the proposals of Truman and others. It is not clear why such a radical change of the tax base is being considered under the heading of tax simplification and only for small companies. For more details, see HM Treasury and HM Revenue & Customs, *Simplification Review: corporation tax: calculations and returns for smaller companies – a discussion document* (November 2008), available at: http://www.hm-treasury.gov.uk/d/pbr08_simplificationreview_267.pdf (accessed 25th March 2009). Published responses by consultees such as the Chartered Institute of Taxation and the Institute of Chartered Accountants suggest that these ideas have not met with any enthusiasm.

One example of small business reforms which seem to have fallen into the complex deregulation trap is the Australian so-called Simplified Tax System (STS), which was actually rather complex, but the descriptions of its failings suggest that it fell into definitional and other traps which can result from the introduction of multiple concessions for small firms which then have to be limited by thresholds to control revenue cost. This resulted in the need to make changes in the *Tax Laws Amendment (Small Business) Act 2007* introducing the Small Business Framework.⁹⁶ It is not the purpose of this paper to discuss the details of the Australian tax reforms as such, on which others have more expertise than the author, but there seem to be lessons to be drawn from this experience.

Asymmetry of profits and losses

It is arguable that losses bear more heavily on small businesses than on others. Tax is paid immediately on taxable profits, but relief for tax losses may have to wait until the business generates sufficient taxable profits to absorb past accumulated losses. This is less of a problem for mature firms, which are likely to be generating profits from existing business and so can claim immediate relief for any loss on the new investment against other profits. This option is not open to new firms without existing taxable profits, so that there is discrimination against investment spending by new firms, or by small firms during a high-growth phase in which investment spending is high relative to current profits. As discussed above in relation to the EFT proposal, this is a question of policy. There may be stronger arguments in favour of permitting new corporations some level of pass-through treatment for tax purposes so that the owners can set their business losses against other sources of income than those which are simply small. In the case of high-risk investments, the fact that loss relief is of more use to firms where there are other investments against which to set the relief is likely to favour investment by mature firms as compared with start-up firms.⁹⁷

Keeping the small business intact

Another potential rationale that is in fact frequently adopted by governments is that used to justify special assistance to small businesses in relation to transfers, particularly from one generation of a family to another. It is argued that retirement or death might lead to the break-up of a business and therefore closure with consequent loss of employment and wealth generation.⁹⁸ On this view, not only should there be relief available on the death of a business owner but the owner should be encouraged to part with the business whilst alive in order to keep it intact and secure a sensible succession. The European

96 Criticisms of the STS can be found in the Report of the Banks Review (G Banks (Chair), *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (Canberra, 2006)) and also in Board of Taxation, *Scoping Study of Small Business Tax Compliance Costs* (December 2007), which also discusses the changes introduced.

97 IFS Green Budget (2000), Ch 8.

98 European Commission, Commission Recommendation of 7th December 1994 on the transfer of small and medium sized enterprises, (94/1069/EC).

Commission⁹⁹ takes it as given that there are advantages to intergenerational succession but provides no evidence.¹⁰⁰ In the UK context this is argued to support reliefs from inheritance tax. It might also be used to support capital gains tax concessions.

The UK has a number of tax reliefs aimed at easing the sale or transfer of businesses. In addition there is a general capital gains tax uplift on death for all property and this is accompanied by business property relief on certain business assets and 100% exemption from inheritance tax.¹⁰¹ During the lifetime of the business owner capital gains tax may (from 6 April 2008) be removed or reduced by entrepreneurship relief, which reduces the rate of capital gains tax on some sales of businesses or sales of business assets following the cessation of a business.

The basis for these reliefs on transfer is not clear. First, as Boadway, Chamberlain and Emmerson¹⁰² point out, the effects of the reliefs can be arbitrary, with 100% relief available for those who meet the inheritance tax provisions, for example, and none at all for those who do not. Second, the nature of the conditions means that the reliefs are utilised for tax planning purposes and the primary aim of holding the relevant asset may not always be a purely business objective. Third, the relief is available even if the business is not being maintained as a going concern by the person or persons inheriting it, so that it does not meet the test of being well targeted if the objective is to encourage continuity. It would be possible to provide relief as a deferral only whilst the business continues if the aim is to prevent break-up,¹⁰³ though it is not at all clear that this would be desirable since sometimes the continuity of the business in the most commercially efficient way will be best achieved by a sale to an outsider. Transfer of a business to the second generation is not necessarily better than the purchase of a business by a third party.¹⁰⁴ In light of the mixed evidence in this area, the best approach would seem to be not to give a tax preference to the passing on of businesses on death as opposed to lifetime sales, in order to allow the commercial considerations to govern.

99 European Commission, above, n 98.

100 P Bjuggren and L Sund, "A Transaction Cost Rationale for Transition of the Firm within the Family" (2002) 19 *Small Business Economics* 123.

101 For the details of this relief, see <http://www.hmrc.gov.uk/manuals/ihtmanual/IHTM25022.htm>; see also R Boadway, E Chamberlain and C Emmerson, "Taxation of Wealth and Wealth Transfers", in J Mirrlees *et al*, above, n 3, for a discussion of this issue. They put the cost of business property relief alone at £350m per annum.

102 R Boadway, E Chamberlain and C Emmerson, above, n 101.

103 R Boadway, E Chamberlain and C Emmerson (above, n 101) point out that this could distort decisions and create compliance costs. It might, however, prevent people from buying and holding business assets purely as a tax planning device.

104 W Handler, "Succession in Family Business: A Review of the Research" (1994) 7 *Family Business Review* 133; N Bloom and J Van Reenen, *Measuring and explaining management practices across firms and countries* (2006) <http://eprints.lse.ac.uk/733> (accessed 25 March 2009).

CONCLUSION

It has been argued here that small business tax design should be seen as part of the design of the tax system as a whole and not as a series of exceptions or carve outs.

In discussing choice of business organisation, the Henry Consultation refers to two possible reforms: the EFT and the ACE plus dual income tax. These are two very different types of proposal. The arguments in favour of an EFT regime have been discussed here. It is contended that it is not clear that the objective of simplification would be achieved by virtue of such a regime. Some of the aims of an EFT regime are achieved in Australia by the imputation system and other objectives, such as the ability to flow through losses and preferences, could be made available within the existing regime, if the revenue authorities wished to do this. Evidence suggests, however, that the Australian authorities would wish to restrict such flow-through to prevent tax avoidance.

As to the ACE, the RRA and the dual income tax, these are appropriate for consideration for small businesses only if radical reform of the system as a whole is being contemplated. In a system in which corporation tax rates are substantially lower than the top rate of tax on labour income, structural problems for small business taxation and the Nordic dual income tax systems, particularly the Norwegian system, have attempted to address these problems. If Australia does consider moving towards a dual income tax system then it will need to consider a mechanism to remove incentives to characterise labour income as income on capital.

Many of the distortions (though not all) present in tax systems as they relate to small businesses are the result of tax preferences. It is important, therefore, to consider the justification for such preferences. It is argued here that there are some, but only limited, circumstances in which small businesses and their owners should be advantaged through the tax system. Preferences should only be introduced if it is clear that they are targeted and cannot be delivered more efficiently in some other way. It is generally only assistance with compliance costs that is clearly justified on a size basis as opposed to some other test. The small business lobby groups have considerable influence but they should be required to justify their requests in order to avoid inequities, wasteful reliefs that do not achieve their objectives and complexities introduced to prevent abuse. Ultimately a simpler system might be of more benefit to small firms than a host of special measures.