FAVOURABLE SMALL BUSINESS TAXATION: TO WHAT EXTENT IS IT JUSTIFIED FROM A TAX POLICY PERSPECTIVE?

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ABSTRACT

Small businesses in many countries expect, and generally receive, special treatment, concessions or arrangements regarding taxation compared to medium and large business. Such policies are based primarily upon the role and importance of small business in economic growth, and especially job creation, and the high administrative and compliance costs of including a large number of small entities in the tax system. This article focuses on the latter aspect, using examples and data from various countries including the UK, USA, New Zealand and Australia. The arguments for special treatment seem compelling, although various difficulties, including legal form, are encountered in a complex policy environment. A rather neglected argument is that small businesses often engage in high levels of tax evasion, based on the so-called informal or cash economy, an opportunity generally denied to large business (at least domestically). It has further been argued that benefits arising from evasion roughly approximate to the higher compliance costs endured by small business, particularly for income taxation. This article discusses these and other perspectives and the extent that favourable taxation arrangements for small business are warranted. The conclusion sums up the experiences of the countries considered and the key tax policy implications, and recommends areas for further research.

I. INTRODUCTION

In various countries throughout the world, both developed and developing, small business has long enjoyed favourable tax policy treatment. Generally, the term ‘small business’ is used favourably by politicians, bureaucrats and others in the community. It is seen by many as synonymous with business enterprise, creativity and dynamism, healthy competitive markets and, most importantly, the creation of employment and generation of economic growth. In economic policy terms, favourable tax treatment of small business is justified in terms of market failure,[1] but difficulties are well noted.[2] Highly regressive tax compliance costs as well as high administrative costs are also used to justify special treatment. The former often give rise to calls for compensation for small business in addition to favourable tax policies. A recent example of this in Australia is from Brett Bondfield.[3] However, Bondfield notes that using compensation to reduce compliance costs would be marginal ‘in the absence of very significant whole of government efforts’.

From an international perspective, nearly all countries throughout the world, irrespective of their size and stage of economic development, are very concerned with problems in the taxation of small and medium enterprises (SMEs). The use of special regimes for SMEs, whilst varying internationally, is becoming increasingly popular, with

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1 Judith Freedman, ‘Small Business Taxation: Policy Issues and the UK’ in Neil Warren (ed), *Taxing Small Business: Developing Good Tax Policies* (2003) 13, 14.

2 See, eg, Judith Freedman, ‘Why Taxing the Micro-business Is Not Simple — A Cautionary Tale from the “Old World”’ (2006) 2(1) *Journal of the Australasian Tax Teachers Association* 58.

3 Brett Bondfield, ‘The Emperor’s New Clothes: The Review of Business Taxation, Small Business and Compliance Costs’ in Geoffrey Lehmann (ed), *Business Tax Reform: Meet the Critics* (2007) 311, 343-344.

greater resources to support such initiatives.[4] As well as the countries specifically discussed later in this paper, around 60 per cent of Asia-Pacific Economic Cooperation (APEC) economies adopt policies that intentionally target and discriminate in favour of SMEs, with the remainder adopting policies that support businesses irrespective of their size. Importantly, no two countries have the same overall package of policy measures.[5]

There is a reasonably large and growing literature specifically on, or including, small business taxation, especially focusing wholly or partly on Australia and New Zealand in the last few years.[6] Taxation and public policy issues towards small business in various countries are discussed by Francis Chittenden and Brian Sloan.[7] One of the most comprehensive and detailed analyses on small business taxation has recently been published in the UK by Claire Crawford and Judith Freedman.[8] In common with most other papers on this topic, this paper uses selected examples and data primarily from the USA, UK, New Zealand and Australia to support its arguments. Recent research suggests that this rather myopic Anglo-Saxon perspective may be misplaced, as illustrated by Swedish data cited later in the article.

The literature on the tax compliance costs of small business shows that one of the major findings of nearly all studies worldwide is their regressive nature. In other words, large business benefits from economies of scale of tax compliance and vice versa. There is often a 'fixed cost' nature of tax compliance that particularly disadvantages small business, who generally resent acting as an 'unpaid tax collector' for government. Such sentiments sometimes generate calls for compensation for tax collection by small business,[9] particularly regarding the value added tax (VAT) in Europe and the goods and services tax (GST) in Australia, New Zealand and Canada.[10]

Overall, there is a strong positive relationship between small business entrepreneurship and both the level of gross domestic product (GDP) per capita and GDP growth, certainly in developed countries where reliable data exists. For example, in Australia, small business accounts for around 30 per cent of GDP and has grown at an annual rate of 3.5 per cent per annum since 1983 compared with large business (those with more than 200 employees) growth of 2.5 per cent per annum over the same period.[11] Small business accounts for 97 per cent of all private sector businesses, employing around 3.6 million people and representing 49 per cent of all private sector employment.[12]

In the USA, small business accounts for 51 per cent of private GDP and generates 58 per cent of non-farm employment. Of the 22.4 million businesses in 2001, 99 per cent were

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4 International Tax Dialogue, *ITD Global Conference on Taxation of Small and Medium Enterprises* (2007) <http://www.itdweb.org/SMEconference/> at 22 January 2009 in Adrian Sawyer, 'SMEs in New Zealand: Is a New Era in the Tax Compliance Environment on the Horizon?' (Paper presented at the 8th International Tax Administration Conference, Sydney, 27-28 March 2008) 1, 2.

5 Mark Pizzacalla, 'Global SME Tax Policy Conundrum' (2008) 23 *Australian Tax Forum* 49, 54.

6 See, eg, Mark Pizzacalla, 'Australia's SME Tax Identity Crisis' (2007) 22 *Australian Tax Forum* 19; Bondfield, above n 3; Pizzacalla, above n 5; Paul McCullough, 'A Policy Perspective on Aspects of Tax Administration' (Paper presented at the 8th International Tax Administration Conference, Sydney, 27-28 March 2008); Sawyer above n 4; Binh Tran-Nam and Stewart Karlinsky, 'Small Business Tax Complexity in Australia' (Paper presented at the 8th International Tax Administration Conference, Sydney, 27-28 March 2008); Michael Dirkis, 'Tax Change or Tax Reform: Business Tax Reform Evaluated' in Geoffrey Lehmann, *Business Tax Reform: Meet the Critics* (2007) 17, 45-46.

7 Francis Chittenden and Brian Sloan, 'Taxation and Public Policy towards Small Firms: A Review' (2007) 22 *Australian Tax Forum* 31.

8 Claire Crawford and Judith Freedman, *Small Business Taxation: A Special Study of the Structural Issues Surrounding the Taxation of Business Profits of Owner Managed Firms* (2008) Institute for Fiscal Studies <http://www.ifs.org.uk/mirrleesreview/press_docs/small_businesses.pdf> at 22 January 2009. This chapter was prepared for *Reforming the Tax System for the 21st Century: The Mirrlees Review*, to be published in 2009.

9 Bondfield, above n 3.

10 See Jeff Pope, 'Estimating and Alleviating the Goods and Services Tax Compliance Cost Burden upon Small Business' (2001) 11 *Revenue Law Journal* 6, for a more detailed review of these issues. For discussion in a Malaysian, non-GST context, see Jeff Pope and Hijattulah Abdul-Jabbar, 'Small and Medium Enterprises and the Regulatory Burden in Malaysia: Alleviating the Compliance Costs of the Goods and Services Tax' (Paper presented at the 4th SMEs in a Global Economy Conference, Malaysia, 9-10 July 2007).

11 Commonwealth of Australia, *Annual Review of Small Business* (2002).

12 Australian Bureau of Statistics, *Small Business in Australia*, Catalogue No 1321 (2001) cited in Pizzacalla, 'Australia's SME Tax Identity Crisis', above n 6, 34.

classed as small business. Around 9 million were owned fully or partly by females, and a significant number by Native Americans, Asians, Hispanics and Afro-Americans.[13] Better economic opportunities for females and ethnic minorities need to be considered in any evaluation of small business taxation policies, factors often ignored by some tax analysts.

It is worth noting that the literature, government, business and various commentators refer to small business and SMEs, as well as using the term ‘microbusiness’ to refer to very small business. The term ‘self-employed’ also features prominently and usually they form an important part of the microbusiness sector. Terms and definitions vary from country to country, and even within the same country, and research and other reports may focus on any of these business sectors. Thus comparisons even within the same country, let alone internationally, are fraught with difficulty.[14] Within most countries there are not just several definitions but a plethora — for example, around 42 in the USA. The issue of definitions has been comprehensively discussed in an Australian context.[15] This article focuses on small business, although research from the larger SME sector is cited where necessary. Nearly all analysts of small business taxation discuss the problem of defining exactly what is meant by the term ‘small business’.

The types of special tax treatment for small business may be identified, focusing on major taxes prevalent in most developed countries rather than claiming to be comprehensive because of the complexities involved across different tax jurisdictions. Generally, these take the form of exemptions, thresholds, lower rates and special concessions for payment of taxes.

Having identified difficulties with the term ‘small business’, the key question of tax structure emerges in most countries. For example, a small business may operate as a sole trader, partnership or company, or possibly, in some countries, a more complicated structure such as a unit trust or discretionary trust. An important consideration often ignored concerns the ownership of small business in terms of income, assets and wealth. For example, a small business could be owned by a person with both low income and wealth, or alternatively be owned by a wealthy person while the small business itself may have low income. Ownership becomes an important issue in terms of equity, particularly where small business receives special and favourable tax treatment, a factor not considered further in this paper.

Importantly, this article discusses a factor nearly always ignored by politicians and commentators, and even by most academic researchers, namely significant tax evasion by small business, analysed by Joel Slemrod in the context of US income tax.[16] One of the reasons for this lack of attention is the high number of small business taxpayers that generate a relatively low amount of tax revenue, certainly in terms of the percentage of total tax revenue. Auditing and enforcement costs of the tax authorities are therefore high, and it is much more cost effective to focus on large business. There may also be political considerations to be taken into account, particularly in less well-off countries.

This article presents a succinct analysis of the main issues, as well as recognising the complexities of this topic. The structure of the article is as follows. Following this introduction, the difficulties of defining small business and the major taxes imposed are discussed in Part II. Part III discusses the types of special tax treatment received by small business. Part IV assesses the varying tax structures of small business and especially the relationship between taxation and the choice of legal form. Small business compliance costs are succinctly reviewed in Part V, followed by discussion of the significance of tax

13 Office of Advocacy, Small Business Administration, cited in Stewart Karlinsky, ‘How Does U.S. Income Tax Law Define a Small Business? Let Me Count the Ways’ in Neil Warren (ed), *Taxing Small Business: Developing Good Tax Policies* (2003) 45, 45.

14 Attempting to analyse data from different sources and make comparisons for policy purposes is usually a very difficult exercise.

15 Neil Warren, Garry Payne and Helen Hodgson, *Research and Recommendations on the Definition of Small Business* (2006).

16 Joel Slemrod, ‘Small Business and the Tax System’ in Henry J Aaron and Joel Slemrod (eds), *The Crisis in Tax Administration* (2004) 69.

evasion in the small business or SME sector in Part VI. The article concludes with some major observations.

II. DEFINING SMALL BUSINESS AND THE MAJOR TAXES IMPOSED

Stewart Karlinsky has identified 42 ways in which the US income tax system explicitly or implicitly defines small business, but focuses on nine major measures plus a 10th miscellaneous category.[17] These 10 measures (subject to certain exclusions, qualifications and technical details not discussed here) are:

1 Cost of assets placed in service during the year: eg, in 2004, if a business puts in service up to $400 000 in assets then it may deduct immediately up to $100 000.[18]
2 Gross receipts test: for many purposes, this is average gross receipts for three prior years of up to $5 million. Other tests include levels of an average up to $10 million, whilst others are $1 million (and up to 30 full-time employees) and $7.5 million.
3 Level of taxable income: eg, for corporate income below $100 000, then, next, $225 000 (with tax rates of 22.25 per cent and 39 per cent respectively in 2003).
4 Number of, or concentration of, shareholders, ie a simple corporate structure: eg, one class of stock, no more than 75 shareholders, no foreign investors.
5 Size of equity raised or total assets acquired: eg, losses converted from capital loss treatment to ordinary for the first $1 million of equity raised, capped at an annual $100 000 of loss ($50 000 for single taxpayers).
6 Phase of the business cycle: eg, amortise its start-up costs over five years rather than permanently capitalise the costs (applies also to large business but has greater benefit for small business).
7 Type of activity: eg, favours agriculture, home building, financial services and some specialised industries through particular rules.
8 Small Business Administration-defined investment companies: involves loan guarantee programs.
9 *De Minimis*: eg, foreign tax credit and social security contributions rule simplifications for small business.
10 Miscellaneous (‘pot pourri’): eg, timing of federal withholding and social security payments.

For the UK, Crawford and Freedman recognise the government approach of defining small business in both qualitative and quantitative terms.[19] For example, the Bolton Report defined a small business in terms of its relatively small market share; managed by its owners in a personal way; independent, ie not part of a larger organisation.[20] Essentially, such businesses are owner-controlled although this term is currently little used and the all-encompassing term ‘small business’ widespread. Such factors also pose difficulties for legislators who far prefer quantitative measures, as Karlinsky demonstrates above.[21]

In the UK, quantitative definitions of small business for 2007-08 are based on:[22]

- annual profits (up to £300 000, with marginal relief between £300 000 and £1.5 million), five or fewer directors [for corporation tax];
- annual turnover for registration (£64 000 pa) and use of simplified systems (£1.35 million pa) [for VAT];
- any two of: annual turnover up to £5.6 million, a balance sheet total of up to £2.8 million, not more than 50 employees [for the small companies accounts regime];
- annual turnover less than £5.6 million [for audit exemption];

17 Karlinsky, above n 13, 48-59.
18 All monetary data in this paper is in US dollars unless otherwise indicated.
19 Claire Crawford and Judith Freedman, ‘Small Business Taxation’, Confidential Draft Report (2007).
20 John E Bolton, *Report of the Committee of Inquiry on Small Firms*, Cmnd 4811 (1971).
21 Karlinsky, above n 13.
22 Crawford and Freedman, above n 19, 41.

- 0-49 employees, used by the UK Small Business Service;
- 0-9 for a micro enterprise and 10-49 for a small enterprise, used by the Observatory of European SMEs.

Historically, there were essentially two definitions of Australian small business. A business employing less than 20 persons for non-manufacturing industries and those employing less than 100 in manufacturing is used as the definition by the Australian Bureau of Statistics (ABS).[23] The Australian Taxation Office (ATO) formerly defined a small business as one with an annual turnover of less than A$10 million or roughly around US$9 million or £4.4 million as at January 2008 (currency conversions not repeated hereafter). The ATO, however, moved away from the A$10 million turnover definition in 2003,[24] essentially related to the introduction of A New Tax System (ANTS) in 2000 and to facilitate small business access to various concessions. The ATO now classifies a microbusiness as one with annual turnover up to A$2 million, and small and medium enterprises (SMEs) are those with turnover of between A$2 million and A$100 million.[25]

The ATO had been using the following definition to operate the Simplified Tax System (STS) until 30 June 2007: the entity carries on a business; turnover is less than A$1 million; and the business and related entities have depreciating assets of less than A$3 million. The STS has recently been abolished and replaced by a broader small business entity framework.[26] As from 1 July 2007, an entity may automatically be eligible for small business entity concessions without having to lodge an election with the ATO, if they satisfy the following small business entity test: the entity carries on business and aggregate turnover is less than A$2 million.

An interesting policy perspective from the Australian Government Treasury on the above changes and what has been termed 'small business alignment' is provided by Paul McCullough.[27] He argues that, taken individually, each of five main eligibility tests for tax concessions[28] were 'clearly justified', yet the small business taxpayer was typically overwhelmed and not claiming their entitlements. The costs for small business, or their advisers, in identifying and complying with the concessions simply outweighed the benefits. Thus, in the 2006 Budget, Treasury advised that a single eligibility test, as noted above, would be clearly beneficial to small business. Moreover, the term 'wellbeing', within a wellbeing framework, is being increasingly used and emphasised in Treasury's advice to government on tax policy, particularly from an aggregate perspective. Such an approach is welcome as long as it leads to clear, positive tax policy outcomes.[29]

The major taxes imposed on small business in various countries may include: income or corporation tax; sales taxes, particularly VAT (Europe) or retail sales tax (USA); employment-related taxes, especially payroll tax, and social security and/or superannuation levies; capital gains tax; fringe benefits tax; property and assets-transfer taxes, eg, stamp duties; local taxes such as rates; and withholding taxes, such as pay-as-you-earn (PAYE), or pay-as-you-go (PAYG) in Australia.

23 Small Business Deregulation Task Force, *Time For Business* (1996) 13 (the 'Bell Report').

24 Cynthia Coleman and Chris Evans, 'Tax Compliance Issues for Small Business in Australia' in Neil Warren (ed), *Taxing Small Business: Developing Good Tax Policies* (2003) 147, 150.

25 Pizzacalla, 'Australia's SME Tax Identity Crisis', above n 6, 37: a detailed discussion can be found at 31-54.

26 Tax Laws Amendment (Small Business) Bill 2007 (Cth).

27 McCullough, above n 6.

28 These were for income tax, goods and services tax, capital gains tax, fringe benefits tax and pay-as-you-go.

29 Treasury emphasises an ongoing review of the tax system with a view to minimising complexity whilst ensuring the balance of risks is appropriate. The current government Henry Review, due to be completed late 2009, will be an 'acid test' of Australian government resolve on the issue of reducing systemic tax complexity. See *Australia's Future Tax System* <http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/home.htm> at 22 January 2009.

III. TYPES OF SPECIAL TAX TREATMENT

The special tax provisions for small business may be classified in a number of ways. One approach by Garry Payne is to classify into three main categories:[30]

- positive concessions: eg, lower tax rate; exemption; expense an item a larger firm must depreciate;
- negative (relieving) concessions, in the sense that it is relieved from requirements otherwise imposed on large business: eg, not having to nominate the extent to which a dividend is franked at the time it is paid;
- additional burdens: eg, loans to shareholders in private (often family) companies being deemed to be dividends unless they meet certain criteria, a harsher treatment than upon public companies (Australian examples used).

Whilst additional burdens may be imposed, overall the tax policy treatment of small business by governments throughout the world is extremely favourable.

Another approach is to classify special tax treatment into: registration threshold; tax rates; timing-related, eg, frequency of payment of tax; accounting rule-related, eg, cash accounting, depreciation, trading stock; and exemption. These may be illustrated using a few specific examples, mainly from the UK and Australia where possible.

A. Registration Threshold

This is an important concession, particularly in the UK and Australia, that minimises both administrative and compliance costs by keeping taxpayer numbers manageable. For the UK's VAT, the annual registration threshold is relatively high at £64 000 (turnover) in 2007-08[31], roughly double Australia's A$75 000[32] (around £33 000), a figure only recently increased from A$50 000. However, many small businesses do register voluntarily for a variety of reasons. In Singapore, GST registration is a very high S$1 million pa. The Australian State government payroll tax threshold is approximately A$1 million, but varies from State to State.

B. Tax Rates

For 2007-08, the UK's small company rate is 20 per cent compared to that for large companies of 30 per cent and the basic individual rate of tax of 22 per cent. For 2009-10, the proposed rates are 22 per cent, 28 per cent and 20 per cent respectively,[33] ie the basic rate will be lower than the small company rate. The small company rate is fully available where profits are less than £300 000 pa.[34] In Australia, a small business may gain a 50 per cent discount on capital gains tax (CGT) in addition to the discounts, if any, available to other taxpayers where, under certain conditions, a 50 per cent discount is available, ie the small business would gain a discount of 75 per cent rather than 50 per cent.[35]

In Australia, a 25 per cent entrepreneurs' tax offset is available to small business entities if their turnover is less than A$75 000.[36] In addition, small businesses are eligible for a number of CGT tax concessions where certain conditions are satisfied: 15-year asset exemption; 50 per cent active asset reduction; CGT retirement exemption; CGT rollover relief.

30 Garry Payne, 'Problems with Current Tax Concessions for Australian SMEs' in Neil Warren (ed), *Taxing Small Business: Developing Good Tax Policies* (2003) 83, 87.
31 Crawford and Freedman, above n 8, 57.
32 Australian Taxation Office, *Choosing a Business Structure* (2008) 10-13 <http://www.ato.gov.au/content/downloads/BUS25193n1908_06_08.pdf> at 22 January 2009.
33 Crawford and Freedman, above n 8, 58.
34 Ibid 56.
35 Bondfield, above n 3, 333-334.
36 Pizzacalla, above n 5, 63.

C. Timing-related

Annual GST returns may be made in Australia for small businesses with an annual turnover of under A$2 million (rather than quarterly or monthly for large business), and annual PAYG returns for those with a notional tax of under A$8000 (2003 figures).

D. Accounting Rule-related

A small business accounts regime exists under the *Companies Act 1985* (UK). Australian taxation benefits small business in the areas of cash accounting, depreciation and trading stock.

E. Exemption

An auditing exemption for small businesses with less than an annual turnover of £5.6 million (since 2004) exists under the *Companies Act 1985* (UK).[37] In Australia, under section 45A of the *Corporations Act 2001* (Cth), a company is classified as small if it satisfies two of the following criteria: consolidated gross revenue of up to A$25 million per financial year; consolidated gross assets of up to A$12.5 million at financial year end; and up to 50 employees at financial year end. A small proprietary company is not required to prepare audited financial reports for its members, unless five per cent of the members request it.

Estimates of the cost of small business tax concessions are difficult to obtain and little is quoted in the literature. One recent estimate for Australia is around A$1 billion for the 2006-07 year, comprising the entrepreneur tax offset at A$400 million, small business CGT concessions at A$414 million and the (then) STS regime at A$180 million[38].

IV. TAXATION AND THE CHOICE OF LEGAL FORM

The possible legal tax structures available to small business vary from country to country, but in many countries essentially provide three main options: sole trader; partnership; company; with a fourth, trust, available in some countries such as Australia. Of particular interest, in choosing a structure from a tax perspective, is that generally different structures are taxed differently; concessions apply differently to different structures; and anti-avoidance measures do not apply to all structures.[39] Non-tax factors, such as asset protection, employment regulations, succession, may also be important. In analysing factors to be considered when choosing the most appropriate tax structure for small business in Australia, Robert Warnock identifies 36 tax or tax-related criteria.[40] In Australia there are around 1.2 million actual small businesses, although the number of tax entities is much larger, at around 2.2 million, as some businesses have more than one entity, mainly for tax avoidance purposes.[41]

In the UK, the three main forms of tax structure for small business are sole trader, partnership and company. In 2001, these accounted for 62 per cent, 15 per cent and 23 per cent respectively of the 3.7 million small businesses in the UK. Since 2000, a fourth is also available known as limited liability partnership (LLP) — corporate in legal form but treated as a partnership for many tax (and tax data) purposes. This form was originally intended for professional partnerships but is attracting the interest of small business more generally.[42]

37 Crawford and Freedman, above n 8, 57.
38 Pizzacalla, above n 5, 65.
39 Robert Warnock, ‘Which Structures for an Australian SME?’ in Neil Warren (ed), *Taxing Small Business: Developing Good Tax Policies* (2003) 61. Based on Australian SMEs.
40 Ibid 72-74.
41 Year 2000 data from Australian Bureau of Statistics, *Australian Business Register — A Snapshot*, Occasional Paper, Catalogue No 1369.0 (2000) 5; Australian Bureau of Statistics, above n 12, 12.
42 Freedman, above n 1, 20.

The USA also has a similar pattern to the UK and Australia. The main forms of tax structure in 2002 for small business are sole proprietorship, partnership and corporation (either an S corporation or ordinary small corporation). Small business data is complex, but essentially shows that there were around 6.2 million small partnerships and corporations, 19.3 million partly or fully self-employed individuals, and 13 million individual filers with supplemental income/business expenses.[43]

There is very strong evidence, especially from the UK, that the choice of legal form adopted by a small business is heavily influenced by the taxation arrangements for small business, and can change on a short-term basis in response to tax changes[44]. This is a peculiar characteristic of small business. Many taxpayers have no choice but to accept the withholding taxes, namely PAYE/PAYG, that are part and parcel of being an employee. Large businesses generally incorporate in order to raise capital more easily, and for other commercial reasons. Yet small owner-managed businesses have a choice of three legal forms: employment; self-employment; and incorporation.

Any favourable treatment of small business may lead to employees feeling unfairly disadvantaged, whilst constraints on small business in the form of anti-avoidance measures may lead to far higher compliance costs and untoward impacts on the overall corporate taxation system. Further complications arise because not only do tax rates per se have to be taken into account, but other taxes, for example, national insurance contributions[45] in the UK and payroll tax in Australia, may also have to be included in the overall effects.

A critical issue from an economic perspective is the distinction between income from labour and income from capital, with some commentators adding a third possibility, a return from risk-taking or entrepreneurship. These distinctions raise complex theoretical economic and practical estimation issues, as well as political questions, especially in terms of equity; these are not pursued further here. Research and policy needs to recognise and focus on the three boundaries, namely between employment and self-employment; between self-employment and incorporation; and employment and incorporation. Normally, the focus is on the first two rather than the latter. A holistic approach needs to be taken, as dealing with difficulties at one boundary may exacerbate the situation elsewhere.

It should be emphasised that the choice of legal form is not entirely a tax matter. Incorporation affords small business limited liability and other commercial advantages other than tax, and the various trade-offs in terms of legal form would be carefully evaluated by most, if not all, small business persons. Ironically, incorporation would see the business person as an employee, but with the ability to decide how much is received in the form of more highly taxed wages and how much in terms of dividends.

These days, incorporation may be insisted upon by the client (for whom services are provided) rather than emanating from the small business itself, in order for the client to achieve lower regulatory costs and other related advantages. This raises the issue of largely, if not entirely, personal services (labour) income being converted into capital income, with ensuing anti-avoidance provisions usually being introduced. In the UK, such provisions, especially the personal service company (PSC) legislation, encountered definitional difficulties and are seen as ‘contentious and complex and, until 2007 at least, not very effective’.[46]

Overall, the UK has tried a number of approaches to small business over the past decade or so, with little success and various unforeseen, negative consequences. Essentially, differences between tax and national insurance contributions for individuals as employees and small business create an incentive to be self-employed rather than an

43 Slemrod, above n 16, 71-73.

44 Crawford and Freedman, above n 8, 10-27. Much of the following discussion in this section is based upon the key points made by these UK authors, acknowledged with thanks.

45 There are different rates of these social security contributions for the employed and self-employed, with higher contributions for the former. They are not paid on corporate dividends or capital gains.

46 Crawford and Freedman, above n 8, 16.

employee, and incorporated rather than self-employed. Thus the UK experience has led Crawford and Freedman to conclude that 'the tax system should not seek to favour one legal form over the other.'[47] This is reflected in current UK policy to encourage 'all businesses to grow' without distortion by means of an annual investment allowance for the first £50 000 for expenditure on plant and machinery from 2008-09.[48]

The reasons why small business should not receive too many special tax concessions are complex and largely based on economic theory and rationale. Crawford and Freedman discuss these in some depth. Suffice it to say that arguments in favour of special treatment for small business largely rely upon market failure; inherent size disadvantages, particularly compliance costs, the trade-off between compliance and evasion, and asymmetry of profits and losses (especially the lag in obtaining relief for losses); keeping small business intact (especially inter-generational transfers); and political economy considerations (especially vociferous small business lobbying).[49]

Australian tax policy on small business can learn much from past and current UK policies and also current research. The UK has very strong small business lobby groups that are 'vociferous and forceful when it comes to tax policy' and 'create a sense of distrust in the tax system even if the number of people affected by a change is relatively small.'[50] It could be argued that the same sentiments apply to Australia.

Crawford and Freedman emphasise that any thorough assessment of small business tax policy needs to take into account the effects upon employment, self-employment and incorporation, and upon both personal and business taxation. They conclude strongly in favour of neutrality between legal forms. Exceptionally, small business may be provided with targeted tax incentives only where there is a clear case of market failure, as recognised above. On both equity and efficiency grounds, an overall tax system free from distortions is the best approach.[51] A very strong argument is that many small business owners may prefer a simpler system with lower levels of tax, yet this is difficult in our political system whereby 'politicians love to provide "incentives"!'.[52]

V. SMALL BUSINESS COMPLIANCE COSTS

Based on international research, and widely supported by nearly all studies, recurrent tax compliance costs are very regressive.[53] This includes major studies in Australia,[54] the Netherlands[55] and the USA.[56] Tax start-up costs follow a similar pattern.[57] In developing

47 Ibid 27.

48 HM Revenue & Customs, 'Building Britain's Long-term Future: Prosperity and Fairness for Families' (Press Release, 21 March 2007) in Crawford and Freedman, above n 8, 27.

49 See section titled 'Should Tax Systems Favour Small Businesses? A Note to the Chapter' in Crawford and Freedman, above n 8, 38-48: see especially 40-48. The authors cite Organisation for Economic Co-operation and Development (OECD), *Taxation and Small Businesses* (1994) which states, from a strict economic efficiency viewpoint, all special provisions for small business need to be justifiable in terms of market failure or malfunction, although income distribution objectives may be important and justify special treatment. Overall, the OECD recommends its preference for a neutral tax system (insofar as one exists) and using direct expenditures to pursue small business policy objectives, as they are better targeted than small business tax measures. A later report, OECD, *Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices* (1997) recognises the potential role of the tax system regarding limiting compliance cost disadvantages faced by small business, encouraging the creation of new small business and ensuring small business is kept intact in transfers from the founder to another person.

50 Crawford and Freedman, above n 8, 36.

51 Ibid.

52 Freedman, above n 1, 43.

53 For example Jeff Pope, 'Administrative and Compliance Costs of International Taxation' in Andrew Lymer and John Hasseldine (eds), *The International Taxation System* (2002); Jeff Pope, 'Tax Compliance Costs' in Margaret Lamb, Andrew Lymer, Judith Freedman and Simon James (eds), *Taxation: An Interdisciplinary Approach to Research* (2005) 203.

54 Jeff Pope, Richard Fayle and Dong Ling Chen, *The Compliance Costs of Employment Related Taxation in Australia* (1993); Chris Evans et al, *A Report Into the Taxpayer Costs of Compliance* (1997). Evans et al (at 81) found that, for all Commonwealth taxes in 1994-95, small business had taxpayer (net) compliance costs around 25 times higher than for medium business, whilst large business had negative compliance costs (mainly because of large cash flow benefits). Income tax clearly accounted for the highest amount of small business aggregate social (gross) compliance costs with 53 per cent of the total (at 82).

55 Maarten Allers, *Administrative and Compliance Costs of Taxation and Public Transfers in the Netherlands* (1994).

countries, which generally have lower compliance costs, the regressive effect is less marked.[58]

In New Zealand, for the year 1990-91, mean GST compliance costs for the smallest businesses (with a turnover less than NZ$30 000 pa) were 2.7 per cent of turnover, compared with 0.005 per cent for the largest businesses (with an annual turnover over NZ$50 million), a factor of 540 times greater.[59] The regressivity of small business VAT/GST compliance costs has been clearly established by Sijbren Cnossen in his comparative analysis in US dollars of data from three countries, the UK, Canada and New Zealand, as shown in Table 1.[60]

Table 1

VAT/GST COMPLIANCE COSTS OF SMALL BUSINESSES IN THE UK, NEW ZEALAND AND CANADA

Size of business Taxable turnover in US$ thousands pa	**UK** 86/87 % of turnover	**New Zealand** 90/91 % of turnover	**Canada** 92 % of turnover
Under 50	1.49	2.06	na
50-100	0.70	0.91	0.39
100-200	0.50	0.67	0.36
200-500	0.44	0.47	0.15
500-1000	0.34	0.28	0.09
1000-10 000	0.07	0.04	0.06

More recent European Commission research suggests that VAT compliance costs for SMEs are now even higher, at 2.6 per cent of turnover, and considerably higher when compared to large companies at 0.02 per cent.[61]

In terms of the relative impact of major taxes upon small business compliance costs, business income tax is generally the most important, followed by GST and PAYE and related taxes, based upon New Zealand data for 1989-90[62] (one of the most comprehensive comparative data sets in the world; the UK being another,[63] although both are dated). For small businesses with turnover of between NZ$100 000 and $NZ250 000 pa, business income tax accounted for around 66 per cent of overall compliance costs, GST 17 per cent,

56 Joel Slemrod and Varsha Venkatesh, *The Income Tax Compliance Cost of Large and Mid-Size Businesses*: *A Report to the IRS Large and Mid-Size Division* (2002).

57 Jeff Pope and Nthati Rametse, ‘Small Business Start-up Compliance Costs of the Goods and Services Tax: Estimates and Lessons from Tax Reform’ in Mike Walpole and Rodney Fisher (eds), *Fifth International Conference on Tax Administration: Current Issues and Future Developments* (2002) 182.

58 Mohamed Ariff, Alfred Loh and Ameen Ali Talib, ‘Compliance Costs of Corporate Income Taxation in Singapore, 1994’ (1995) 8 *Accounting Research Journal* 75; Mohamed Ariff and Jeff Pope, *Taxation & Compliance Costs in Asia Pacific Economies* (2002).

59 John Hasseldine, ‘Compliance Costs of Business Taxes in New Zealand’ in Cedric Sandford (ed), *Taxation Compliance Costs: Measurement and Policy* (1995) 126, 135: Table 6.6.

60 Sijbren Cnossen, ‘Administrative and Compliance Costs of the VAT: A Review of the Evidence’ (1994) 8 *Tax Notes International* 1649.

61 International Tax Dialogue, ‘The Value Added Tax: Experience and Issues’ (Background Paper for the International Tax Dialogue Conference on the VAT, Rome, 15-16 March 2005).

62 New Zealand is one of the leading countries in terms of estimating tax compliance costs, particularly for SMEs. As well as an annual survey by BusinessNZ in conjunction with KPMG, a major study by Colmar Brunton was undertaken in 2004: see Colmar Brunton, *Measuring the Tax Compliance Costs of Small and Medium-sized Business — A Benchmark Survey: Final Report* (2005). A BusinessNZ-KPMG survey in 2005 found that SME tax compliance costs were not decreasing to any discernable extent: see BusinessNZ-KPMG, *Summary Report of the Business NZ-KPMG Compliance Cost Survey* (2005). These and other reports are cited in Sawyer, above n 4, 10-14. Sawyer notes that the ‘relentless pace of legislative reform’ is ‘defeating much of the value of the reforms introduced’: at 15. A comparison of the 1989 study and later New Zealand studies, with differences especially in methodology and results presentation, is outside the scope of this paper.

63 Cedric Sandford, Michael Godwin and Peter Hardwick, *Administrative and Compliance Costs of Taxation* (1989).

and PAYE 17 per cent, with fringe benefits tax (FBT) negligible.[64] Of course, any particular business would have its own cost profile.

The effect of compliance costs upon employment by small business is an important factor. New Zealand research suggests that the cost of employing the first worker is around five times greater than employing additional workers.[65]

VI. TAX EVASION

A factor nearly always ignored by politicians and commentators, and even by most academic researchers, is the significant overall tax evasion by small business. Slemrod has analysed the issue using Internal Revenue Service (IRS) data in the context of US income tax, and cites 'substantial evidence' of small business tax evasion.[66] An important reason for this high level is the large number of taxpayers that generate a relatively low amount of tax revenue, certainly in terms of the percentage of total tax take. Auditing and enforcement costs of the tax authorities are therefore high, and it is much more cost effective to focus on large business.

Data on small business tax evasion from the USA is supported by that from Australia. Christopher Bajada states that 'small firms appear to participate much more actively in the cash economy than large business',[67] over all industry classifications, although less so than for wage and salary earners. Moreover, this analysis is based on ATO data over the period 1982 to 1999, ie before Australia's GST was introduced. The relationship between record-keeping practices and tax compliance costs is explored for Australia by Chris Evans, Shirley Carlon and Darren Massey,[68] who rather surprisingly found no obvious correlation between poor records and adverse compliance outcomes.

Nearly all theoretical and empirical literature on tax evasion focuses on the individual rather than business.[69] However, in the case of small business, the two are very closely connected as many small business owners do not have a diversified wealth portfolio.

Slemrod cites IRS Tax Compliance Measurement Program (TCMP) data for 1987 which shows that compliance was around 99.5 per cent for those with salaries and wages income, compared with less than 50 per cent for small business income: eg, 42.1 per cent for partnerships and S corporation income, and only 13.1 per cent for informal suppliers, although the difference in later data is not as marked as this.[70] Slemrod also cites various evidence that non-compliance is regressive in the same way that compliance costs are.[71] For example, the compliance rate for corporations with less than $50 000 of assets was only 26.8 per cent, rising thereafter until it reached 77 per cent for corporations with assets of between $5 million and $10 million.[72] Overall, several but not all studies suggest that US small business non-compliance may be as high as one-third to half of true income.[73]

Using rough estimates based on particular assumptions necessitated by data limitations, Slemrod suggests that the average S corporation may be evading around $39 000 pa in corporate taxes.[74] This approximately equates with compliance costs of around $35 000 pa for companies with assets in the $5 million to $10 million category.[75] Unfortunately, there

64 Derived from Cedric Sandford and John Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (1992) 108. This is similar to Australian data in Evans et al, above n 54 (allowing for the fact that Australia did not have a GST at the time of the study).
65 Ibid 116.
66 Slemrod, above n 16, 72-90.
67 Christopher Bajada, *The Cash Economy and Tax Reform* (2001) 61-63.
68 Chris Evans, Shirley Carlon, and Darren Massey, 'Record Keeping Practices and Tax Compliance of SMEs' (2005) 3 *eJournal of Tax Research* 288.
69 Slemrod, above n 16, 83.
70 Ibid 84-5.
71 Ibid 88-90.
72 Carolyn C Morton, 'Trends in the Compliance of Small Corporations' (1992) December *Internal Revenue Service Research Bulletin*, cited in Slemrod, above n 16, 88-90.
73 Slemrod, above n 16, 90.
74 Ibid 93-4.
75 Slemrod and Venkatesh, above n 56.

are no reliable US estimates for smaller companies. Support for this viewpoint, albeit from an overall regulatory perspective rather than a specific tax one, has been made earlier by Ian Bickerdyke and Ralph Lattimore,[76] who, citing US studies, state that '[t]he net effect of lack of actual compliance by small business is to reduce their potential competitive disadvantage arising from scale economies.'

Evidence from other countries on this issue is very limited and patchy, although the following is indicative. Friedrich Schneider, a leading authority, has estimated the size of the shadow economy[77] at 17 per cent of GDP in Organisation for Economic Co-operation and Development (OECD) countries. Estimates of 13.8 per cent for Australia, 12.3 per cent for Great Britain, 12.4 per cent for New Zealand and 8.6 per cent for the US for 2002-03 are given. All four countries have increased the size of their informal economies since 1989-90.[78] Another estimate for Australia is 14.1 per cent in 2000-01, but with minimal growth since 1989-90 (from 13.8 per cent).[79] Unfortunately, there is no breakdown into sectors in both studies.

In Australia there is currently no official estimate of the size of the informal economy, although academic studies estimate it to be between 3.5 per cent and 13.4 per cent of GDP[80]. A government task force argues that the latter figure is 'highly improbable' given the small business sector's contribution to GDP.[81] The ABS strongly argues that modelling techniques which place the informal economy as high as 14 per cent are not plausible. The ABS, taking full account of the role of small business as well as individuals 'moonlighting' in undeclared national income figures, estimated the Australian informal economy at between 1.3 per cent and 4.8 per cent of GDP in 2000-01.[82]

Recently, Michael D'Ascenzo, the Australian Commissioner of Taxation, in his speech on small business and the cash economy, emphasised the issue with (anonymous) individual examples of taxpayers who had been caught evading their tax obligations.[83] Unfortunately, and rather disappointingly, he did not provide any aggregate data on small business tax evasion. Interestingly, data from Sweden published in 2008 shows that microbusiness accounted for 39 per cent of the estimated tax gap by taxpayer segment in the year 2000, with small/medium businesses accounting for a further 20 per cent.[84]

In the UK it has been estimated that, for corporation and income tax only, the shadow economy in 2003-04 accounted for around £2.5 billion, compared with small companies at £1.5 billion and the self-employed at £3.6 billion, the highest category.[85] Further detailed estimates of general noncompliance by SMEs as a customer group found that self-employed/partnerships comprised 51 per cent noncompliers (worth £3.8 billion), with small/medium companies at 30 per cent (£2.4 billion), small/medium employers at 40 per cent (£0.6 billion) and construction industry schemes at 17 per cent (£0.2 billion).[86] For corporation tax, SMEs under-reporting was estimated at around 12.5 per cent in the 2000-

76 Ian Bickerdyke and Ralph Lattimore, *Reducing the Regulatory Burden: Does Firm Size Matter?* (Staff Research Paper, Industry Commission, 1997) 71.

77 This is basically defined as income from legal activities that is not declared to the authorities. Friedrich Schneider, 'Shadow Economies Around the World: What Do We Really Know?' (2005) 21 *European Journal of Political Economy* 598, excludes illegal activities such as burglary, drug-dealing, etc. The terms cash, underground or black economy may also be found in the literature. 'Moonlighting', or working for cash without declaring it to the authorities, is also a common term.

78 Ibid 598, 611. For Australia, the increase was 37 per cent over 13 years (it was 10.1 per cent of GDP in 1989-90).

79 Christopher Bajada and Friedrich Schneider, 'The Shadow Economies of the Asia-Pacific' (2005) 10 *Pacific Economic Review*, 379, 397.

80 Australian Tax Office, Cash Economy Task Force, *Improving Tax Compliance in the Cash Economy* (1997), 7.

81 Australian Tax Office, Cash Economy Task Force, *The Cash Economy under the New Tax System* (2003) 3.

82 Australian Bureau of Statistics, *Australian Economic Indicators*, Catalogue No 1350.0 (2003).

83 Michael D'Ascenzo, 'The Rogue Cog in the Wheel — The Cash Economy' (Speech delivered at the Council of Small Business of Australia, Sydney, 11 June 2008).

84 Swedish Tax Agency, *Tax Gap Map for Sweden: How Was It Created and How Can It Be Used? Report 2008: 1B* (2008) cited in OECD, Centre for Tax Policy and Administration, *Monitoring Taxpayers' Compliance: A Practical Guide Based on Revenue Body Experience — Final Report* (2008) 69.

85 Her Majesty's Revenue & Customs (HMRC), 'Estimation of Tax Gap for Direct Taxes' (2005) 4-5 <http://www.hmrc.gov.uk/research/direct-tax-gaps.pdf> at 22 January 2009. The tax gap is usually defined as the difference between theoretical tax revenue and the total tax bill.

86 Ibid 11.

02 period.[87] A recent innovative UK study[88] investigated national small business opinion of the cash economy and estimated that 8 per cent of small business activity is conducted on a cash basis, with 14 per cent of small business being negatively affected by the informal economy. The most affected sectors were land transport, construction, motor vehicle trade and hotels and restaurants, and fledgling enterprises and businesses generally.

To sum up this section, there is reasonable evidence from several OECD countries that small business, especially microbusiness, accounts for a significant percentage of tax evasion. Interestingly, the Australian authorities appear to 'play down' this magnitude in comparison with the USA, UK and Sweden. Thus the role of small business in Australian tax evasion appears not to be investigated to the same degree as in some other countries, based on the evidence presented here.

VII. CONCLUDING COMMENTS

Based on the experience of countries such as the USA, UK, Australia and New Zealand, and international reports, the small business sector invariably receives favourable tax treatment. Such policies are justified by governments in terms of economic growth, job creation, competition and, in more theoretical terms, because of market failure. However, the policy difficulties in offering small business favourable tax treatment have been recognised in New Zealand by Adrian Sawyer. He states that 'most of the proposals individually are modest … what would be interesting to measure is how these collectively may reduce compliance costs (and tax revenues)'.[89] The key issue, however, is that, collectively, favourable treatment measures become complex and costly to understand and adopt by small business.[90]

This article shows that defining small business is a major difficulty, with a wide range of definitions used in legislation and by various government bodies. Moreover, special tax treatment for small business generally relies on a complex raft of measures and qualifying rules, no doubt reflecting political lobbying, 'flavours' or whims of the time, and ensuing government reviews.[91] Rationalisation in this area is long overdue.

Small business compliance costs are clearly regressive and, based on New Zealand's experience, arise particularly from business income taxation. It is for this type of tax, in the USA, that research suggests that there is significant tax evasion by small business, a factor that seems to be usually disregarded by government and politicians. It is possible that the higher compliance costs cited in the literature may be roughly offset by tax authorities tolerating a far higher level of evasion than that for personal income taxpayers and/or large business, depending on the country. In other words, calls for compensation for small business for acting as an 'unpaid tax collector', particularly with regard to VAT in countries where that tax exists, ie an effective reduction in overall tax paid, need to be treated particularly cautiously by government.

It must be emphasised that the data presented in this article are averages for particular small business categories. Many law-abiding, ethical small business taxpayers would incur high compliance costs, as indicated by the international research evidence, and still pay their legitimate share of taxation. The critical questions are what percentage, and how does this compare to personal income taxpayers and larger businesses? This issue has been recognised in New Zealand where it is argued 'proposals [to help SMEs] should be

87 OECD, above n 84, 53.

88 Colin Williams, 'Small Business and the Informal Economy: Evidence from the UK' (2007) 13 *International Journal of Entrepreneurial Behaviour and Research*, 349. As usual, the research excluded illegal activities and unpaid work.

89 Sawyer, above n 4, 22.

90 A point supported in Australia by McCullough, above n 6, 25-5, who stated that 'the costs for businesses … outweighed the benefits'.

91 The latest example of this in Australia is a Commonwealth Government review that proposed a turnover threshold which defines 'smaller' business as under A$50 million in the context of a proposed refundable tax credit of 50 per cent for research and development expenditure: Cutler & Company Pty Ltd, *Venturous Australia: Building Strength in Innovation*, Report on The Review of the National Innovation System (2008) Recommendation 8.3, 107 <http://www.innovation.gov.au/innovationreview/Pages/home.aspx> at 22 January 2009.

considered and developed with reference to the majority of businesses who strive to comply with the law, and not those who will seek to abuse it.'[92]

Overall, this paper concurs with recent and authoritative UK research by Crawford and Freedman, and earlier OECD reports, which argue essentially that, except where market failure occurs, small business should not receive special tax concessions. The reasoning is based on economic theory and rationale, essentially arguing for as neutral a tax system as possible in order to avoid undue tax complexity and economic distortions to businesses and the economy generally. Rather, it is far preferable for tax policy to focus on minimising tax compliance costs and lowering tax rates for all businesses. The arguments by Slemrod, using USA compliance costs and tax evasion data, albeit dated, as well as more recent data on small business tax evasion from some other countries, strongly support this view. Arguably, researchers and government in Australia, as well as some other countries including New Zealand, need to take a much more critical approach to small business tax policies than hitherto.

Finally, these concluding comments of course need to be qualified: far greater research is needed on all aspects discussed in this article, particularly the role of labour (generally more highly taxed) and capital (generally more lowly taxed) in small business activities, the scale and nature of small business tax evasion, and the relationships between type of tax, tax evasion, compliance costs, size of small business and legal form.

92 KPMG, *Reducing Tax Compliance Costs for Small and Medium-sized Enterprises* (2007) 3 <http://www.kpmg.co.nz/download/103435/113517/TXM2007_12_2.pdf> at 22 January 2009, cited in Sawyer, above n 4, 24.