

6: Small business

Overview

This chapter identifies characteristics of the tax system that impact on small businesses and their owners.

Key points

- Australian small businesses are numerous, diverse, and make an important contribution to the Australian economy. These businesses adopt different legal and management structures, and may be driven by different preferences and profit motives than larger businesses.
- Navigating a complex tax system can be disproportionately burdensome for small businesses, especially where certain features of the system encourage them to adopt particular legal structures that are costly to establish and maintain.
- Tax law provides a number of concessions intended to benefit small businesses, but these may add to the complexity and compliance burden.

6.1: Key features of Australian small businesses

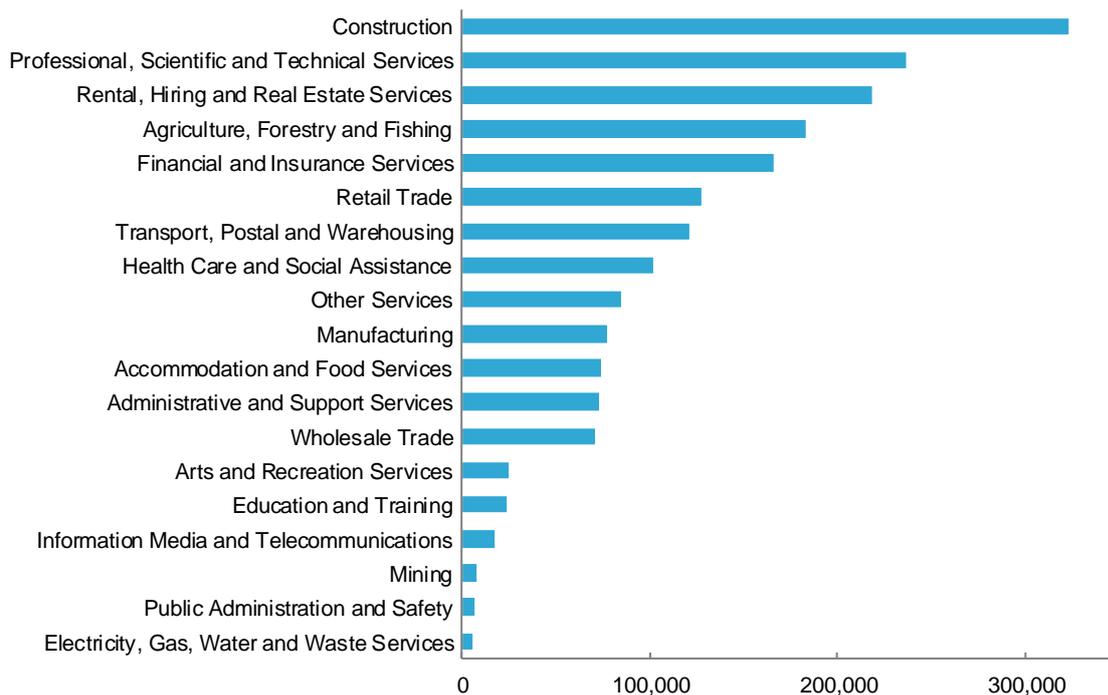
Australian small businesses¹²⁰ are numerous, diverse, and make an important contribution to the Australian economy. They account for about 43 per cent of private non-financial employment and 33 per cent of private non-financial sector production,¹²¹ spanning almost the entire range of business activities, particularly construction, professional services, and retail (Chart 6.1).

120 There is no single definition of 'small business', reflecting the diverse nature of small businesses and how they are currently regulated and taxed. For example, the Australian Bureau of Statistics defines a small business as employing fewer than 20 staff; much of the tax law defines a small business entity as a business with less than \$2 million of aggregated turnover; and Fair Work Australia defines a small business as one with fewer than 15 employees. This chapter does not adopt a strict definition of small business because the issues affecting small business often affect most businesses, although the proportionate effect is generally greater the smaller the business. Where external data is used, the paper adopts the definition used by the data source.

121 ABS 2014, *Australian Industry, 2012-13*, cat. no. 8155.0, ABS, Canberra. Data is not available to incorporate the financial and public sectors. As such, the contribution of small business to output and employment may be overstated.

Small businesses can differ significantly from large businesses. Larger businesses are more likely to be widely-held companies that seek to maximise profits for the benefit of owners (shareholders). As such, the owners of a large business are often different from the people involved in day-to-day management. In contrast, small businesses are often family businesses and a person can be simultaneously owner, manager, employer and employee. Further, generating profits is not the only motivating factor for some small business operators. This means that specialised tax treatments will only be effective to the extent that they align with the objectives of the small business owner. For example, tax incentives for growing businesses may not be relevant to small businesses that have no intention to grow.

Chart 6.1 Number of small businesses by industry, 2013



Note: Small businesses are based on the ABS definition of less than 20 employees. There are approximately 83,000 small businesses which are classified as 'Unknown' by the Australian Bureau of Statistics (ABS). These businesses include unclassified or other industries that do not belong to the other classified industries. Source: ABS 2014, *Counts of Australian Businesses, including Entries and Exits*, June 2009 to June 2013, cat. no. 8165.0, ABS, Canberra.

Current policy context

Businesses operate in an often complex regulatory environment. Compliance costs associated with regulation are felt most by small businesses (see the compliance cost discussion at section 6.4). The Government is committed to reducing the regulatory burden facing all Australian businesses, including small businesses.¹²² Tax is just one element of the broader regulatory environment small businesses must navigate.

¹²² Chapter 10 provides further discussion on the Government's deregulation agenda, and the impact of complexity more generally.

Recognising the impact of the tax system on small businesses, on 28 March 2014, the Government announced that the Board of Taxation (the Board) would conduct a fast-track review to identify features in the tax system that are hindering or preventing small businesses from reaching their commercial goals. The Government asked the Board to identify short- and medium-term priorities for small business tax reform, with a particular focus on high-priority options for simplification and deregulation. The Government released the Board's report *Tax Impediments Facing Small Business* on 20 January 2015. In releasing the report, the Government noted that the ATO had already begun implementing most of the administrative recommendations identified in the report.

6.2: Legal structure of Australian small businesses

All Australian businesses should choose the structure that best suits their business objectives and needs. While large businesses tend to operate as companies, small businesses operate as a sole trader, partnership, trust, corporation or a combination of these. The choice between structures depends on a number of factors, including different tax treatment, nature of ownership (such as a family business), limited liability for companies, easier access to equity capital for companies and differences in compliance costs.

Trends in business structures

There are three key business structure trends in recent years: the increasing use of companies and trusts; the rise of superannuation funds; and the decreasing use of partnerships (Chart 6.2). The increased use of companies may reflect the legal protection provided by companies to owners, as well as the lower tax rate imposed on companies relative to personal income tax. The reduction in the number of partnerships may reflect the relative decline in the number of entities in the farm sector due to consolidation.¹²³

Using trusts as a business structure has grown strongly since the early 2000s. There are a range of different types of trusts, such as testamentary trusts, unit trusts and investment trusts. These trusts all serve different purposes and are used in different circumstances, depending on the objectives of those using the trust. In the small business context there has been an increase in the number of businesses utilising a discretionary trust as their preferred business structure.

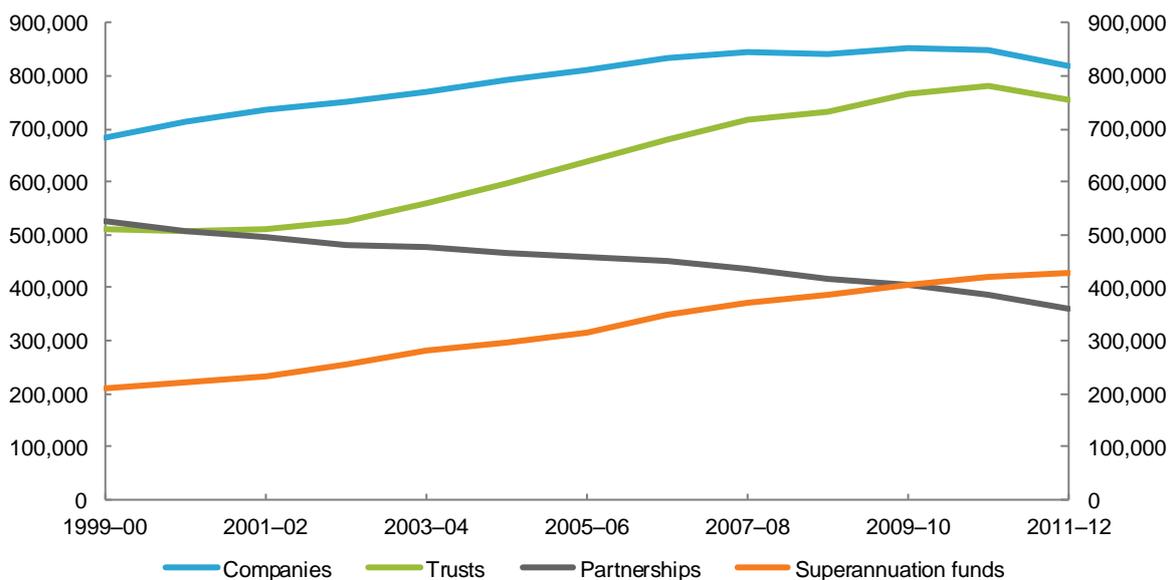
A discretionary trust can offer more legal protection to business owners than a partnership or sole trader. Further, a trust with a corporate trustee offers business owners similar legal protection to a company but offers tax advantages, such as greater flexibility in distributions and access to the 50 per cent capital gains tax concession when an asset appreciates and is

123 Connolly, E, Norman, D, and West, T 2012, *Small Business: An Economic Overview*, Small Business Finance Roundtable, Sydney; and Bishop J, and Cassidy N 2012, 'Trends in National Saving and Investment', *Reserve Bank of Australia Bulletin March Quarter 2012*, Reserve Bank of Australia, Sydney.

then sold. A company must distribute dividends in proportion to the size of shareholdings,¹²⁴ whereas a trustee of a discretionary trust has complete discretion about the size of distributions to beneficiaries of a trust. This allows the tax position of beneficiaries to be taken into account in making distributions to beneficiaries of trusts. In addition, the growth in the number of companies and trusts may reflect the increasing sophistication of business structures, where individual businesses involve a number of companies and/or trusts. One example is where a trust will have a corporate beneficiary that acts as a ‘bucket company’. In this instance, income is either distributed and held, or made presently entitled. If income is made presently entitled, there must be a reciprocal Division 7A-compliant loan arrangement, which enables the trust to avoid distributions to individuals in high marginal tax brackets. The Board of Tax has reviewed the operation of the tax law as it relates to some business structures often involving trusts, in particular the extraction and retention of profits from private companies and provided advice to Government.¹²⁵

The different treatment of different legal entities, and the ability of a small business owner to navigate this complexity, can have a significant effect on a business’ tax liability, and can lead to different tax outcomes for economically similar activities.

Chart 6.2 Number of entities lodging tax returns



Source: Australian Taxation Office 2014, *Taxation Statistics 2011-12*, Australian Taxation Office, Canberra.

124 Within each class of share.

125 Board of Taxation 2012, *Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936 — Discussion Paper*, Board of Taxation, Canberra; and Board of Taxation 2014, *Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936 — Second Discussion Paper*, Board of Taxation, Canberra.

Tax implications of different legal structures

Each business structure is treated differently under the tax law, both in terms of the applicable tax rate and in terms of the concessions that apply. While the choice of business structure should be driven by the objectives of the business, it is likely that the tax treatment of different structures is now a key factor in choosing a business' legal structure.

For some small businesses, the cost of identifying the optimal structure (from a tax perspective) may be higher than the benefits they would obtain, particularly given that expert tax advisors are likely to be required to advise and assist with establishing complex structures. Even for those businesses, however, the complexity of the system can drive owners to seek advice, adding to costs. Further, the potential need for complex business structures can act as a disincentive for some small businesses to pursue growth activities.

As a business grows, it would be increasingly rational for it to adopt the legal structure that would minimise its tax liability. This may involve incorporating, or utilising a trust, but more likely it would involve a combination of structures. The primary objective of these structures is often to minimise tax liability by dispersing income to attract either the lowest marginal tax rate or the corporate tax rate.

The tax treatment of different structures means that economically similar activities can be taxed in different ways and at different rates depending on the legal structure employed by the business. From a first principles perspective, similar economic activities should be taxed similarly. Also, a perception arises that those with additional resources are able to 'play' the system, which challenges the perception of equity within the tax system.

Box 6.1: Flow-through tax treatment for 'S-Corporations' in the US

Given the evolution of complex structures, it has been suggested that a new, single structure which contains the benefits of these structures without the complexity may be useful in Australia. One option that has been proposed is the adoption of the 'S-Corporation' as it is applied in the US. An S-Corporation is a corporation which has elected to have a set of special tax rules applied to them (Subchapter S of Chapter 1 of the US Internal Revenue Code). S-Corporations can pass corporate income, losses, deductions and credit through to shareholders for federal tax purposes — the corporation itself is not taxed, as all taxation is done at the individual income level. Shareholders report the flow-through of income and losses on their personal tax returns and are assessed for tax purposes at their individual income tax rates.

S-Corporations offer the benefits of reduced establishment cost and complexity, limited liability (which follows from a corporate structure), and tax treatment similar to a partnership, including for losses. However, the tax treatment is not as favourable as a discretionary trust, as there is only limited ability to choose which taxpayer is liable for tax on the profits of an S-Corporation.

S-Corporation shareholders may claim deductions for losses incurred by the corporation but there are a number of overlapping limitations to the use of S-Corporation losses. Shareholders must satisfy a series of requirements, such as:

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- basis rules — which limit the use of losses to each shareholder's level of investment in the corporation and loans the shareholder has made to the business;¹²⁶
- at-risk limitation — which limits the use of losses to the amount the shareholder stands to lose from their investments or loans to the company;¹²⁷
- passive activity loss limitation — provides that shareholders who do not have a regular, continual and substantial engagement with the company may only deduct losses from the S-Corporation against income from other passive investments; and
- hobby-loss rules which quarantine deductions where a business is not carried on for profit.

S-Corporations provide business owners with limited liability, without the tax treatment that would ordinarily apply to an entity that is legally separate from its owners (that is, separate taxation applicable to the profits of a company). In the US context, S-Corporations also provide for the avoidance of double taxation of corporate profits, as profits are only taxed once in the hands of the shareholders. This benefit is not as relevant in the Australian context, where dividend imputation eliminates the double taxation of corporate profits that occurs in a classical tax system (see discussion of imputation in Chapter 5).

Reporting, accounting and administrative requirements of S-Corporations can be burdensome and complex compared to those placed on other organisations. The most burdensome requirements involve providing shareholders with the necessary information regarding what has been passed through to them. Other requirements are related to an S-Corporation's corporate status, such as the need for separate accounts and scheduled director and shareholder meetings.

While, in isolation, an S-Corporation style entity may be an attractive option for some small businesses, introducing such an entity in Australia without otherwise reducing the complexity of the tax system may have mixed impacts on the overall compliance burden for small businesses. This is because businesses will need additional time and possibly professional advice to determine whether such an entity would be better overall than the existing suite of complex structures.

Discussion questions:

41. What effect is the tax system having on choice of business structure for small businesses?
42. What other options, such as a flow-through entity (like an S-Corporation), would decrease the overall complexity and costs for small business involved with choosing a business structure? How would such an entity provide a net benefit to small businesses?

126 The losses a shareholder can utilise are limited to the shareholder's basis, which equates to their cost basis plus their loan basis. Cost basis equals initial contribution for membership interest; additional capital contributions; and allocated income; less allocated deductions and actual distributions. Loan basis is the indebtedness of the S-corporation to the shareholder.

127 A shareholder's amount at risk equals the sum of the cash and the adjusted basis of non-cash property contributed to the business, as well as amounts borrowed for use in the S-corporation for which the shareholder is personally liable, or for which the shareholder has pledged property they own. A loss in excess of either basis or the amount at risk is non-deductible in the year it is incurred, but carries over into future years and may be utilised when basis is restored or the amount at risk is increased.

6.3: Personal-business tax interaction

As already stated, the Australian tax system applies different tax rates to different types of entities. In particular, income derived by individuals is taxed at progressive rates of up to 49 per cent, depending on the level of income. In contrast, companies currently pay a 30 per cent rate on all income. The imputation system seeks to provide an interface between the flat rate of company tax and the progressive individual tax system (see Chapter 5).

This interaction between personal and business tax systems influences the choices that small businesses make about business structures. If all company profits were immediately paid out as dividends, dividend imputation would ensure that corporate profits are ultimately taxed at the individual tax rates applicable to the owners of a company. The tax system would achieve neutrality across these business structures because business owners would pay the same tax on profits earned as a sole trader or partnership, or on dividends received from a company. The same would apply to passive investors using holding companies (see Chapter 5).

However, there is no legal obligation for companies to pay out profits as dividends to shareholders. If shareholders pay additional tax on dividends, as they would if they pay the highest marginal tax rate of 49 per cent, there is an incentive to avoid paying dividends to delay tax payments. For example, if a company makes a profit of \$100,000 and its sole shareholder has a marginal tax rate of 49 per cent, the shareholder will face an additional \$19,000 of tax when a dividend of \$70,000 (for example, \$100,000 profit minus \$30,000 corporate tax) is received. If \$70,000 is reinvested in the company and a dividend is paid 10 years later, the present value of \$19,000 of tax would be reduced to approximately \$13,700.¹²⁸

The incentive to retain profits in a company is further enhanced by the treatment of capital gains. Following from the earlier example, if, instead of paying a dividend of \$70,000, profits are retained and the company is sold for a capital gain that is \$70,000 higher than otherwise, an individual can halve the capital gain to pay tax of \$17,150 (\$35,000 x 49 per cent). Again, assuming this tax payment has been delayed by 10 years, its present value would be approximately \$12,400 instead of \$19,000 that would be payable on a dividend paid immediately. Furthermore, if the individual's marginal tax rate is 30 per cent in 10 years' time, the present value of tax payable would be further reduced to approximately \$7,600. Alternative structuring arrangements, such as using a superannuation fund, could achieve lower tax outcomes than in this worked example.

These incentives may provide a strong reason for privately-held companies to retain earnings as much as possible — for example, where the owner does not require the funds for their personal expenses. This can provide a cheap form of finance for future activities. Conversely, they generate the need for rules around private access to company funds and resources, such as those found in Division 7A of the tax law.

¹²⁸ Assuming a 10-year government bond rate of 3.29 per cent and the taxpayer continuing to face a marginal tax rate of 49 per cent.

The interaction between individual and business tax is one area where the tax system implicitly encourages the adoption of complex structures and makes the total compliance costs experienced by Australian businesses unnecessarily high. Significantly different tax outcomes from adopting different structures provide incentives for businesses to engage in tax planning and, in some cases, structures are adopted that involve significant compliance costs (for example, trusts with associated corporate beneficiaries).

Further issues arise in the context of trusts, where the default treatment is that tax is imposed on beneficiaries rather than in the trust. These issues are compounded by longstanding problems with the legal framework for the taxation of trusts, highlighted in recent court decisions (such as *Commissioner of Taxation v Bamford* (2010) 240 CLR 481). For instance, one problem is that income received by trusts may not retain its character for tax purposes when passed on to beneficiaries. Another is the mismatch between the amounts on which a beneficiary is taxed and the amounts that they are entitled to under trust law. Following the decision in *Bamford*, a discussion paper was released canvassing wider changes to address these systemic problems. However, while changes have been made to address some specific issues, wider reform has not occurred and the underlying problems remain.

Discussion questions:

43. Is the interaction of the personal and business tax systems a problem? What can be done to manage the personal-business tax interactions?

6.4: Tax compliance costs for small businesses

Compliance with tax laws is the most significant compliance cost faced by small businesses, accounting for between one-half and two-thirds of the total compliance burden on small business.¹²⁹ The ATO estimates that compliance costs associated with the tax system (for all taxpayers, including individuals) are likely to be in the order of \$40 billion per year.¹³⁰ Further, recent research has estimated that in aggregate, tax compliance costs for the small and medium enterprise (SME) sector are in the order of \$18 billion, which is approximately 1.2 per cent of GDP, or 14 per cent of tax revenue.¹³¹ Tax compliance costs are higher per dollar of turnover for smaller businesses than they are for larger business (see Table 6.1). These compliance costs can act as a disincentive to establishing a small business, and can impact the ability of a small business to grow.

129 Hasseldine J, Evans C, Hansford A, Lignier P, Smulders S and Vaillancourt F 2012, *A comparative analysis of tax compliance costs and the role of special concessions and regimes for small business in Australia, Canada, South Africa and the United Kingdom*, National Tax Association Conference, Providence.

130 ATO analysis of commissioned Newspoll survey data relating to the 2011-12 tax year, to be presented at a forthcoming conference in 2015.

131 UNSW and Chartered Accountants of Australia and New Zealand 2014, *Tax Complexity Research Project*, Sydney.

Table 6.1 Tax compliance costs (including state and territory taxes)¹³²

Business turnover	Annual cost	Cost per \$1000 turnover
<\$75,000	\$3,400	\$90
\$75,000 — \$2 million	\$12,000	\$12
\$2 million — \$50 million	\$55,000	\$2

While compliance costs are significant, some (but not all) of the costs are costs that would be incurred by a small business for operational reasons (such as to record sales and expenses). Many of the costs of complying with tax laws are either fixed, or do not vary in proportion to the size of the business. Small business owners can therefore choose either to spend limited resources seeking expert tax advice, or completing compliance activities themselves, instead of engaging in activities to support their business.

Discussion questions:

44. What are the most significant drivers of tax law compliance activities and costs for small business?

6.5: Small business tax concessions

Successive governments have recognised that small businesses make an important contribution to the Australian economy and provide opportunities for continued employment growth. Multiple policy rationales are often used to support proposals for differential tax treatment of small businesses, including:

- to address compliance costs falling disproportionately on small business;
- to correct a bias towards risk aversion — this can occur because:
 - individual small business owners may be risk averse because they have a limited ability to recover from a failure and a limited ability to diversify; and
 - there is asymmetry in the tax system whereby gains are taxed and losses are ignored or claimable only against future profits which may penalise risk-taking and exacerbate risk aversion;
- to improve equity as earnings from capital are treated more generously than labour income, while small business income is typically a mixture of return on capital and labour;

¹³² UNSW and Chartered Accountants of Australia and New Zealand 2014, *Tax Complexity Research Project*, Sydney.

- having adequate access to capital and resources on hand is essential for small businesses to thrive and thereby retain and create more jobs;¹³³
- to correct disadvantages of being small that do not stem from the tax system; and
- to support job creation.

While all of these rationales are used at different times, some concessions may overlay additional complexity and drive behaviour in ways that cancel out or exceed any benefits.

The tax system contains a number of provisions which are either unique to small business, or are more commonly accessed by small business. The most significant include:

- measures to reduce the regulatory burden, such as:
 - businesses with turnover of less than \$75,000 can generally choose not to register for GST;¹³⁴
 - businesses with turnover of less than \$20 million can report and pay GST quarterly instead of monthly;
 - businesses with turnover of less than \$2 million can account on a cash basis;
 - simplified trading stock rules do not require a stocktake in certain circumstances;
 - simplified depreciation rules allow businesses with turnover of less than \$2 million to pool most depreciating assets and write them off at a 30 per cent depreciation rate (15 per cent in first year) irrespective of their expected life; and
 - availability of the Superannuation Clearing House;¹³⁵
- capital gains tax concessions (see below); and
- industry specific concessions, such as primary producer concessions including farm management deposits, and income tax averaging.

These types of provisions are intended to provide a benefit to small businesses in their engagement with the tax system. However, the introduction of concessions can lead to additional compliance burdens as businesses must learn about the concessions and, potentially, adjust their affairs to qualify. In addition, rules that determine eligibility for the concessions, such as hard cut-offs or connected entity tests, can be complex for small businesses to navigate. Tax concessions with hard cut-offs can also discourage growth, as passing a cut-off can remove entitlement to a concession.

Concessions which are intended to provide a benefit to small business may also introduce other difficulties, such as to cash flow. Concessions such as those to reduce the regularity of GST payments and pay as you go withholding instalments to once per year, are intended to reduce the amount of paperwork that a small business must comply with and improve small

133 Department of Industry, Innovation, Science, Research and Tertiary Education 2012, *Australian Small Business: Key Statistics and Analysis*, Australian Government, Canberra, p. 42; and Dilger R J 2013, *Small Business: Access to Capital and Job Creation*, United States Congressional Research Service, Washington.

134 While businesses can choose not to register for GST, many do in response to pressure from their customers.

135 Currently, small business employers with fewer than 20 employees can register to use the ATO's free online Small Business Superannuation Clearing House to pay their superannuation contributions in one transaction to a single location. The contributions are then distributed by the clearing house to employees' relevant superannuation funds on the employer's behalf.

business cash flow in the short term. However, they may cause difficulties where a business owner does not anticipate the size of the payment and does not have the cash flow to pay when it eventually falls due. This could be alleviated by small businesses making more regular payments, improved technology development, and other strategies to improve tax liability and payment predictability.

The introduction of concessions (as with all different specialised tax treatments) can introduce new elements of complexity as the boundaries between different taxes are shifted. This expanding complexity further creates incentives for more sophisticated taxpayers to organise their affairs to benefit from interactions within the tax system, and small businesses can have limited capacity to comply with complex laws.

In addition to the creation of new concessions, regular changes to the tax law require small businesses to continuously monitor the tax law and adapt to any changes. This adds to the compliance costs for all businesses. However, this has a disproportionate impact on small businesses as they often do not have the expertise or funds to use advisors, such as tax experts, to maintain up-to-date knowledge of tax law.

Capital gains tax concessions

The most significant, quantifiable tax concessions for small businesses are the capital gains tax (CGT) concessions. The CGT concessions are primarily intended to provide small business owners with access to funds for their retirement. There are four CGT concessions:

- the 15 year exemption — capital gains tax is not payable on the sale of business assets if they are owned for more than 15 years and the owner is over 55 and retiring or permanently incapacitated;
- the small business retirement exemption — capital gains tax is not payable if the owner is under 55 years old and amounts are paid into a superannuation fund or retirement savings account (subject to \$500,000 lifetime limit);
- the 50 per cent active asset reduction — sale of assets attracts a 50 per cent capital gains tax discount; and
- the small business roll-over — capital gains tax is deferred if the funds are used to replace small business assets or make a capital improvement to an existing asset.

A business can generally qualify for the concessions if they have less than \$2 million turnover or have net CGT assets of \$6 million or less. The turnover or the value of the assets of connected entities also counts towards these tests.

Capital gains tax concessions can add to the complexity of the system and the compliance burden for a small business. The concessions can also dampen the incentive for businesses to grow because larger businesses are not able to access them.

The value of these concessions to certain businesses is estimated at approximately \$1.4 billion (in 2013-14). This benefit is made up of up of \$390 million for the small business retirement exemption, \$160 million for the 15 year exemption, \$220 million for small business

roll-over relief for replacement small business entity active assets and \$600 million for the 50 per cent active asset reduction.¹³⁶

There may be scope to simplify and streamline the small business capital gains tax concessions while ensuring that they satisfy the stated objectives.

Specific small business tax treatments

Some tax concessions are available only for businesses in a certain industry, or are most commonly accessed by small businesses. Industry-specific concessions are intended to either support activity in a particular industry sector, or recognise an objective to provide differential treatment for that sector.

A particular example of this is in agriculture. Small businesses make a significant contribution in the agriculture sector, making up 82 per cent of output and 83 per cent of employment.¹³⁷ While many sectors have some concessions available, the network of concessions available to primary producers is illustrative of some of the broader range of concessions also available in other sectors.

Primary producer concessions

Primary producers are able to access a number of special concessions to compensate for the impact of natural events that are difficult to predict such as drought, fire, flood or disease that contribute to the volatility of income received by primary producers. These concessions can be broadly grouped into the following categories: special deductions; treatment of abnormal receipts;¹³⁸ income averaging; and farm management deposits. Special deductions can be claimed for capital expenditure that relates to telephone lines, horticultural plants and grapevines, water facilities, land care operations and timber depletion. Primary producers can elect to apply abnormal receipt rules to profits relating to double wool clips, insurance recoveries for livestock and timber and the forced disposal or death of livestock. In addition, primary producers who are also small business taxpayers may also be entitled to small business tax concessions. Extensive primary producer concessions may, in some circumstances, operate to prevent or discourage rational exit from the industry.

Income tax averaging

Incomes of primary producers and specific professionals may fluctuate from year to year, for reasons such as adverse weather conditions or demand. The income averaging rules ensure that taxpayers with fluctuating incomes pay no more tax over a number of years than is paid by taxpayers with comparable but steady incomes.

136 Australian Government 2015, *Tax Expenditure Statement 2014*, Australian Government, Canberra.

137 ABS 2014, *Australian Industry 2012-13*, cat. no. 8155.0, ABS, Canberra. This calculation uses the ABS definition of small business — 19 employees or less.

138 Abnormal receipts is an accounting term applied to income earned outside of its normal earnings period. Double wool clips, where a second shearing of sheep in the year, brought forward by a natural disaster is one example of abnormal receipts.

Primary producers as individuals, partners or beneficiaries of trusts are eligible to smooth their income tax liability by averaging their primary production income over a period of at least two years. Primary producers may receive tax offsets if their average income is less than their basic taxable income.¹³⁹ Conversely, a primary producer may be required to pay extra income tax if their average income is higher than their basic taxable income. The averaging adjustment can include up to \$5,000 in non-primary production income. A 'shading out' system applies to non-primary production income between \$5,000 and \$10,000, meaning as non-primary production income increases up to \$10,000 only a proportion of this income can be included in income averaging. Any non-primary production income above \$10,000 is excluded from income averaging.

Basic taxable income follows the calculation of assessable income but excludes certain death benefits received by dependents and non-dependents and also any net capital gain. It also excludes above average special professional income included in the income year. Income averaging is optional. However, if the individual chooses not to do so, the decision once made cannot be reversed.

Farm management deposits

Farm Management Deposits (FMDs) are a risk management tool to help primary producers deal with unpredictable income, which can be due to challenging production circumstances or market variability. FMDs are designed to help primary producers become more self-reliant and better manage income fluctuations associated with price variability and seasonal variations. The scheme provides a tax incentive to save money to draw upon in times of hardship. It is available to individuals, a partner in a partnership and the beneficiaries of trusts.

The scheme allows primary producers whose off-farm income is less than \$100,000 to claim a tax deduction for any FMDs that they have made that income year. The total value of deposits is capped at \$400,000. When an FMD is withdrawn, the amount of the deduction is included in the assessable income of the income year in which it is withdrawn. The advantage of this system is that it allows primary producers to smooth their income against the natural fluctuations of business in primary production. Primary producers are able to pay a lower average tax rate over an extended period, as they can pay tax on income earned in a good year in later years, when their marginal rate is lower. There was around \$3.6 billion held in FMDs in June 2014.¹⁴⁰

'Non-commercial' losses

The 'non-commercial' loss rules prevent individuals from claiming losses from business activities that are more in the nature of hobbies or lifestyle choices against their other income (for example their salary) in the year it is incurred.

139 Basic taxable income is an accounting term applied to taxable income less: certain superannuation benefits; net capital gains; amounts above average special professional income; and deductions excluded under the non-commercial loss provisions.

140 Department of Agriculture 2014, *Farm Management Deposit Statistics*, Department of Agriculture, Canberra, viewed 5 December 2014: www.agriculture.gov.au/agriculture-food/drought/assistance/fmd/statistics.

The rules prevent losses from business activities (as opposed to passive activities like negatively geared residential property or shares) being offset against other income until one of four objective tests is passed. These four tests are based on the income, profits and assets of the business activity and determine whether an activity may be treated as commercial in nature for the tax laws. However, if an individual's adjusted taxable income is \$250,000 or more then the objective tests are not available and the loss cannot be offset against other income. Instead it can only be carried forward to offset future income from that business. The Commissioner of Taxation can exercise an extremely limited discretion only if a taxpayer does not pass one of the tests (including the \$250,000 test) and in limited circumstances such as drought, flood or bushfire or where there is a lead time before the activity becomes profitable.

The tax system should not operate in a way that discourages economic activity, however, it should not support or subsidise unproductive businesses or the private activities of taxpayers. The way tax losses are treated by a tax system is relevant to this outcome. Box 6.2 below compares the tax treatment of non-commercial losses to the tax treatment of company losses and of losses from non-business activities.

Box 6.2: Tax treatment of losses

Scenario 1 — Non-commercial losses

John's salary is \$300,000. John also owns and operates an established vineyard which has been profitable in previous years. The vineyard makes a loss of \$20,000.

The non-commercial loss rules prevent John from offsetting the loss against his salary, as his income (excluding the vineyard's loss) is greater than \$250,000. John could ask the Commissioner to exercise his discretion to offset the loss, however, the Commissioner can only exercise this in limited circumstances. If the Commissioner does not exercise his discretion, the quarantined or deferred loss can still be offset against any future profit of the vineyard.

Alternatively, in future years, if the vineyard business passes one of the four objective tests and John's income (excluding the vineyard's loss) falls below \$250,000, the quarantined or deferred loss can be offset against his salary.

Scenario 2 — Company losses

Sarah's salary is \$300,000. Sarah is also the sole shareholder of a company that operates an established vineyard which has been profitable in previous years. The vineyard makes a loss of \$20,000.

As the loss is incurred by the company and a company is a separate legal entity, Sarah cannot offset the loss against her salary. The loss can only ever be offset against other income of the company. If the company has no income to offset this year, the loss is carried forward and can be offset against its future income subject to the loss integrity rules. That is, the loss is quarantined in the company.

The non-commercial loss rules do not apply as the rules only apply to losses incurred by individuals, not by companies.

Company losses are considered in more detail in Chapter 5.

Box 6.2 con't

Scenario 3 — Passive investment losses

Matthew's salary is \$300,000. Matthew also has a loan for his portfolio of shares which are not from a share trading business.

His interest repayments on the loan exceed the income earned from this portfolio and he makes a loss of \$20,000.

Matthew can offset this loss against his salary. The non-commercial loss rules do not apply as the rules only apply to losses from business activities.

Non-business losses are considered in more detail in Chapter 4.

Alternatives to multiple, specific concessions

Instead of multiple concessions across the tax system, an alternative option that could be considered is to apply a lower or zero tax rate for small businesses. A lower rate that replaced multiple specific concessions could encourage small businesses to spend their resources expanding their business, rather than managing their tax affairs.

There are examples where other countries have used reduced tax rates as part of their small business tax policies, such as Canada, China, Belgium, Japan, South Korea, the US, the UK and Singapore, where tax rates on small business can be as low as zero.

In the Australian context, it may be possible to introduce a lower or zero tax rate on small companies to compensate for higher compliance costs and the removal of specific, small business concessions. Reduced tax rates on small corporations may also provide an easy source of finance to businesses by allowing them to retain more of their earnings and expand business activity.

The UK experimented with a low corporate tax rate for small companies. The aim of this lower rate was to encourage start-up businesses and investment. The UK established a special low corporate tax rate for small companies during financial years 2000 to 2005. It provided a low corporate tax starting rate to companies with profits not exceeding £10,000, and a progressively reduced benefit to companies with profits between £10,000 and £50,000. For financial years 2000 and 2001 the corporate tax starting rate was 10 per cent. From 2002 to 2005 it was reduced to zero.

This tax concession was a compelling reason for many existing UK small businesses to incorporate. While a large number of companies accessed the concessions, UK policymakers found that in the specific circumstances where it was introduced in the UK, it did not drive significant growth in small businesses or the economy. Instead, it introduced disincentives for companies below the threshold to grow and the disadvantages faced by small companies were not offset. The UK small companies starting rate 'experiment' ended in 2006. The Mirrlees Review (2011) concluded that this policy was ineffective and costly.

Another option is to allow an immediate refund for tax losses. Many start-up small businesses make taxable losses in their first years of operation. Refunding these losses would provide a cash-flow benefit to the business to help it grow and reduce the tax system's bias against risk aversion.

Discussion questions:

45. How effective is the current range of tax concessions (such as CGT and industry specific concessions) at supporting small business engagement with the tax system? To what extent do the benefits they provide outweigh the compliance, complexity and revenue costs they introduce?
46. What other mechanisms (such as a single lower tax rate, improved technology deployment or other non-tax mechanisms) could assist small businesses to engage with the tax system while decreasing compliance and complexity costs?