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**SMALL BUSINESS TAXATION:
AN EVALUATION OF THE ROLE OF SPECIAL
TREATMENT POLICIES**

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Small Business Taxation: An Evaluation of the Role of Special Treatment Policies

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ABSTRACT

In many countries small businesses expect and generally receive special treatment, concessions or arrangements regarding taxation compared with 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 paper focuses on the latter aspect, using examples and data from various countries in the world, particularly the UK, USA, New Zealand and Australia. The arguments for special treatment seem compelling, particularly lower administrative and compliance costs, although difficulties usually arise at the margin or threshold where the special treatment ends. However, an often neglected argument is that small business often engage in high levels of tax evasion, based on the so-called 'cash economy', an opportunity generally denied to large business (at least domestically). It can be argued that benefits arising from evasion roughly approximate to the higher compliance costs endured by small business, particularly for income taxation. This paper evaluates this argument and the extent that special treatment taxation arrangements of small business are warranted. The conclusion sums up the experiences of the countries considered, the key policy implications, the limitations of the analysis, and indicates areas for further research.

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 and 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 a generator of economic growth. In economic policy terms, favourable tax treatment of small business is justified in terms of market failure (Freedman, 2003 p14), but difficulties are well noted (eg Freedman, 2006).

There is a reasonably large literature on small business taxation and this paper uses selected examples and data primarily from the USA, UK, New Zealand and Australia to support its arguments; a comprehensive coverage of international literature on this topic is not intended. Wider public policy issues are discussed by Chittenden and Sloan (2007).

Overall, there is a strong positive relationship between small business entrepreneurship and both the level of GDP per capita and GDP growth, certainly in developed countries where reliable data exists. For example, in Australia small business accounts for around 30% of economic activity and has grown at an annual rate of 3.5% per annum since 1983 compared with large business (those with more than 200 employees) growth of 2.5% per annum over the same period (Commonwealth of Australia, 2002). Small business accounts for around 30% of GDP and 49% of all private sector employment (Coleman and Evans, 2003, p147, citing Industry Tourism Resources and Australian Bureau of Statistics data for 2002 respectively). In the USA small business accounts for 51% of private GDP and generates 58% of non-farm employment. Of the 22.4 million businesses in 2001, 99% were classed as small business. Around 9 million were owned fully or partially by females, and a significant number by Native Americans, Asians, Hispanics and Afro-Americans (Karlinsky, 2003, p45, citing Office of Advocacy, Small Business Administration data). 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.

Nearly all analysts of small business taxation discuss the problem of defining exactly what is meant by the term small business. Even within any one country there are not just several definitions but a

plethora – for example, around 42 in the USA. Analysing data and making comparisons for policy purposes within any one country is difficult because of different definitions by different agencies. To attempt to do this between different countries is practically impossible without a great deal of tedious work and simplifying assumptions.

Having defined what is meant by the term small business, the question of tax structure emerges in most countries. For example, a small business may operate on the basis of 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 yet 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.

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.

There is a reasonably large literature on the tax compliance costs of small business, as one of the major findings of nearly all studies worldwide is the regressive nature of tax compliance costs. 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 often generate calls for compensation for tax collection by small business, particularly in Europe regarding the Value-Added Tax (VAT), also known as the Goods and Services Tax (GST) in Australia, New Zealand and Canada (Pope, 2001).

Importantly, this paper 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 Slemrod (2004) in the context of the US income tax. One of the reasons for this is the high number of taxpayers that generate a relatively low amount of tax revenue, certainly in percentage of total tax revenue terms. 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.

The paper presents a succinct analysis of the main issues, as well as recognising the complexities of this topic. The structure of the paper in terms of sections essentially follows the key points made in this introduction. The paper concludes with some major observations.

DEFINING SMALL BUSINESS AND MAJOR TAXES IMPOSED

Karlinsky (2003, pp48-59) 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 tenth miscellaneous category. These ten 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.
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% and 39% 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 amortize its start-up costs over five years rather than permanently capitalize 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 specialized 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 (2007) recognise the government approach of defining small business in both qualitative and quantitative terms. For example, the Bolton Report (1971) 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. 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.

In the UK quantitative definitions of small business for 2007-08 (Crawford and Freedman, 2007, p41) are based on:

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

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 by the Australian Bureau of Statistics (Bell Report, 1996, p13). The Australian Taxation Office (ATO) formerly defined a small business as one with a turnover of less than A\$10 million annual turnover (roughly around US\$9 million or 4.4 million pounds at the time of writing; currency conversions not repeated hereafter). The ATO, however, has moved away from the \$10 million turnover definition since 2003 (Coleman and Evans, 2003, p150), 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 micro business as one with annual turnover up to \$2 million; small and medium enterprises (SMEs) are those with turnover of between \$2 million and \$100 million (in Australian dollars).

The ATO has been using the following definition to operate the Simplified Tax System (until 30 June 2007):

- The entity carries on a business;
- Turnover is less than \$1 million; and
- The business and related entities have depreciating assets of less than A\$3million

The Simplified Tax System has recently been abolished and replaced by a broader small business entity framework (Tax Laws Amendment (Small Business) Bill 2007). 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:

- Entity carries on business;
- Aggregate turnover is less than \$2million.

The major taxes imposed on small business in various countries may include: income or corporation tax; sales taxes, particularly Value-Added Tax 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.

THE VARYING TAX STRUCTURES OF SMALL BUSINESS

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 (Warnock, 2003, p61, based on Australian SMEs). 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 Warnock (2003, pp72-74) identifies 36 tax or tax-related criteria. 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 (year 2000 data from ABS 2001, p12 and 2000 p5 respectively).

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%, 15% and 23% 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 (Freedman, 2003, p20).

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 partially or fully self-employed individuals, and 13 million individual filers with supplemental income/business expenses (Slemrod, 2004, pp71-73).

TYPES OF SPECIAL TAX TREATMENT

The special tax provisions for small business may be classified in a number of ways. One approach by Payne (2003, p87) is to classify into three main categories:

- 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; exemption. These may be illustrated using a few specific examples mainly from the UK and Australia, where possible.

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 pounds in 2007-08, roughly double Australia's A\$75,000 (around 33,000 pounds), a figure only recently increased from \$50,000. However, many small businesses do register voluntarily for a variety of reasons. In Singapore its 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.

Tax Rates

For 2007-08 the UK's small company rate is 20% compared to that for large companies of 30% and the basic individual rate of tax of 22%. For 2009-10 the proposed rates are 22%, 28% and 20% respectively 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 pounds pa. In Australia a small business may gain a 50% discount on Capital Gains Tax (CGT) in addition to the discounts, if any, available to other taxpayers, where under certain conditions a 50% discount is available ie the small business would gain a discount of 75% rather than 50%.

In Australia, a 25% entrepreneurs' tax offset is available to small business entities if their turnover is less than A\$75,000. In addition, small businesses are eligible for a number of CGT tax concessions where certain conditions are satisfied:

- 15 year asset exemption;
- 50% active asset reduction;
- CGT retirement exemption;
- CGT roll-over relief

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\$8,000 (2003 figures).

Accounting rule-related

A small business accounts regime exists under the UK's Companies Act 1985. Australia has its Simplified Tax System (STS) that particularly benefits small business in the areas of cash accounting, depreciation and trading stock.

Exemption

An auditing exemption for small business with less than an annual turnover of 5.6 million pounds (since 2004) exists under the UK's Companies Act 1985. In Australia, under section 45A of the Australian Corporations and Securities Legislation 2001, a company is classified as small if it satisfies two of the following three criteria: consolidated gross revenue of up to A\$10million per financial year; consolidated gross assets of up to A\$5million at financial year end; up to 50 employees at financial year end. A small proprietary company is not required to prepare audited financial reports for its members, unless 5% of the members request it.

SMALL BUSINESS COMPLIANCE COSTS

Based on international research, and widely supported by nearly all studies, recurrent tax compliance costs of VAT are very regressive (eg Pope, 2002 and 2005). This includes major studies in Australia (Pope, Fayle and Chen, 1993; Evans *et al*, 1997), Netherlands (Allers, 1994) and USA (Slemrod and Venkatesh, 2002). Tax start-up costs follow a similar pattern (Pope and Rametse, 2002). In developing countries, that generally have lower compliance costs, the regressive effect is less marked (Ariff *et al*, 1995; Ariff and Pope, 2002). 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% of turnover, compared with 0.005% for the largest businesses (with an annual turnover over NZ\$50 million) (Hasseldine, 1995, Table 6.6: 135), a factor of 540 times greater.

The regressivity of small business GST compliance costs has been clearly established by Cnossen (1994) in his comparative analysis in US\$ of data from three countries, the UK, Canada and New Zealand, as shown in Table 1.

Table 1

GST Compliance Costs of Small Businesses in the UK, New Zealand and Canada

Size of business	UK	New Zealand	Canada

Taxable turnover in US\$ thousands pa	86/87 % of turnover	90/91 % of turnover	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
500-1,000	0.34	0.28	0.09
1,000-10,000	0.07	0.04	0.06

Source: Cnossen (1994).

More recent European Commission (2005) research suggests that the VAT compliance costs for small and medium sized enterprises are now even higher at 2.6% of turnover, and considerably higher when compared to large companies at 0.02%.

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 (one of the most comprehensive comparative data sets in the world; the UK being another (Sandford, Godwin and Hardwick, 1989), 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% of overall compliance costs, GST 17%, and PAYE 17%, with Fringe Benefits Tax (FBT) negligible (derived from Sandford and Hasseldine, 1992, p108). 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 (Sandford and Hasseldine, 1992, p116).

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 (2004, especially pp72-90) has analysed the issue using Internal revenue Service (IRS) data in the context of the US income tax, and cites 'substantial evidence' of small business tax evasion. An important reason for this high level is the large number of taxpayers that generate a relatively low amount of tax revenue, certainly in percentage of total tax-take terms. 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. Bajada (2001, pp61-63) states that '...small firms appear to participate much more actively in the cash economy than large business', over all industry classifications, although less so than for wage and salary earners (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 Evans, Carlon and Massey (2005), 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 (Slemrod, 2004, p83). 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 (2004, pp84-85) cites IRS Tax Compliance Measurement Program (TCMP) data for 1987 that shows that compliance was around 99.5% for those with salaries and wages income, compared with less than 50% for small business income eg 42.1% for partnerships and S corporation income, and only 13.1% for informal suppliers, although the difference in later data is not as marked as this. Slemrod (2004, p88-90) also cites various evidence that non-compliance is regressive in the same way that compliance costs are. For example, the compliance rate for corporations with less than \$50,000 of assets was only 26.8%, rising thereafter until it reaches 77.0% for corporations with assets of between \$5 million and \$10 million (citing Morton, 1992). Overall, several but not all studies suggest that small business non-compliance may be as high as one-third to half of true income.

Using rough estimates based on particular assumptions necessitated by data limitations, Slemrod (2004, pp93-94) suggests that the average S corporation may be evading around \$39,000 pa in corporate taxes. This approximately equates with compliance costs of around \$35,000 pa for companies with assets in the \$5 million to \$10 million category (Slemrod and Venkatesh, 2002). Unfortunately there 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 Bickerdyke and Lattimore (1997, p71), 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.'

CONCLUDING COMMENTS

Based on a consensus of small business research in the USA, and confirmed by the experience of other countries such as the UK and Australia, the small business sector generally receives favourable tax treatment. In short, when the overall level of taxation increases the small business sector attracts more resources. Such policies are justified by governments in terms of economic growth, job creation, competition and, in more theoretical terms, because of market failure.

This paper 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. Rationalisation in this area is long over-due.

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' (reviewed in, for example, Pope, 2001; Pope, and Abdul Jabbar, 2007) 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 paper 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?

Finally, these concluding comments of course need to be qualified: far greater research is needed on all aspects discussed in this paper, particularly the scale of small business tax evasion in countries other than the USA, and the relationships between type of tax, tax evasion, compliance costs and size of small business. In short, this topic is a 'work-in-progress'. There are also interesting and challenging policy issues in terms of the effect of tax thresholds on small business economic behaviour, and ensuing competitive distortions, and that too is left for another day.

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