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Prafula Fernandez
and
Lynne Oats

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School of Business Law
Curtin Business School
Curtin University of Technology
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ABSTRACT

In not introducing GST, Australia seems to be saying as a mother once said, Everyone is marching out of step, except my son. Assuming Australia finally follows the example set by other countries in introducing GST, the special needs of the small business community should be factored into its design.

Lynne Oats, senior lecturer and Prafula Fernandez, lecturer with the School of Business Law have undertaken a study of the small business provisions in other countries, to be presented at the Tax Administration Conference, hosted by the University of New South Wales, in Sydney in April. The study, which looks at Singapore, Japan, Canada, U.K. and New Zealand, shows that small businesses facing high compliance costs can be assisted in a number of ways. Methods of assisting small business include less frequent filing of GST returns, simplified accounting methods to calculate GST, or granting a one off payment to offset the compliance costs. The most popular form of relief, however, adopted by all the countries examined, is an exemption from registration, if the business turnover is below a certain level.

Although an exemption from registration leads to a loss of revenue for the government, this can be largely offset by savings in administration costs. The right balance has to be achieved. It remains to be seen whether Australia will continue to march out of step in not granting an exemption from registration, even to the very small businesses, when GST is finally introduced in Australia.

GST AND THE SMALL BUSINESS¹

by

Prafula Fernandez and Lynne Oats²

1. INTRODUCTION

It is unlikely that the GST³ debate in Australia will go away. In not introducing GST, Australia seems to be saying, as a mother once said, "Everyone is marching out of step, except my son". David Vos, an indirect tax partner at Coopers and Lybrand pointed out that some 128 countries who have VAT could not be wrong. He further said,

"...if politicians are not prepared to call on the intestinal fortitude necessary to restructure Australia's tax base with some degree of commonsense then we risk being seen as "third world" ourselves."⁴

As the world becomes more integrated, Australia needs to think globally, and be able to compete globally. Australia needs to be able to sieve out the indirect taxes which are invisibly included in the goods and services it exports. A simple European style VAT, similar to New Zealand's GST could be the answer. However, Australia should learn from the problems of other countries and draft GST legislation accordingly.

The question is not if, but when GST will finally be introduced in Australia. The government should take heed of the business community, especially the small business community in drafting the GST legislation. The purpose of this paper is to examine the problems faced by small businesses and the different methods of providing assistance to small business in complying with the relevant legislation. .

¹ This paper has been prepared for presentation at the Tax Administration Conference to be held in Sydney 16-17 April 1998, hosted by ATAX, University of New South Wales.

² Lecturer and Senior Lecturer respectively, School of Business Law, Curtin University of Technology. The authors are grateful to Glen Barton, University of Western Australia for helpful comments.

³ The terms Good and Services Tax (GST) and Value Added Tax (VAT) are synonymous and are used interchangeably throughout this paper.

⁴ David Vos "A leader's job is to lead..." Taxation In Australia Vol. 30 No 11 June 1996, p581

This paper is in seven parts. Following this brief introduction, the second part provides a broad overview of how a VAT works. The third part considers the special needs of small business and the fourth examines the definitional problems associated with determining the scope of "small" for the purposes of providing a concession. The fifth part of this paper looks at measures which can be adopted to alleviate the special problems faced by small business, and the sixth section examines specific solutions adopted by a variety of jurisdictions. In the seventh and final part, some conclusions are drawn.

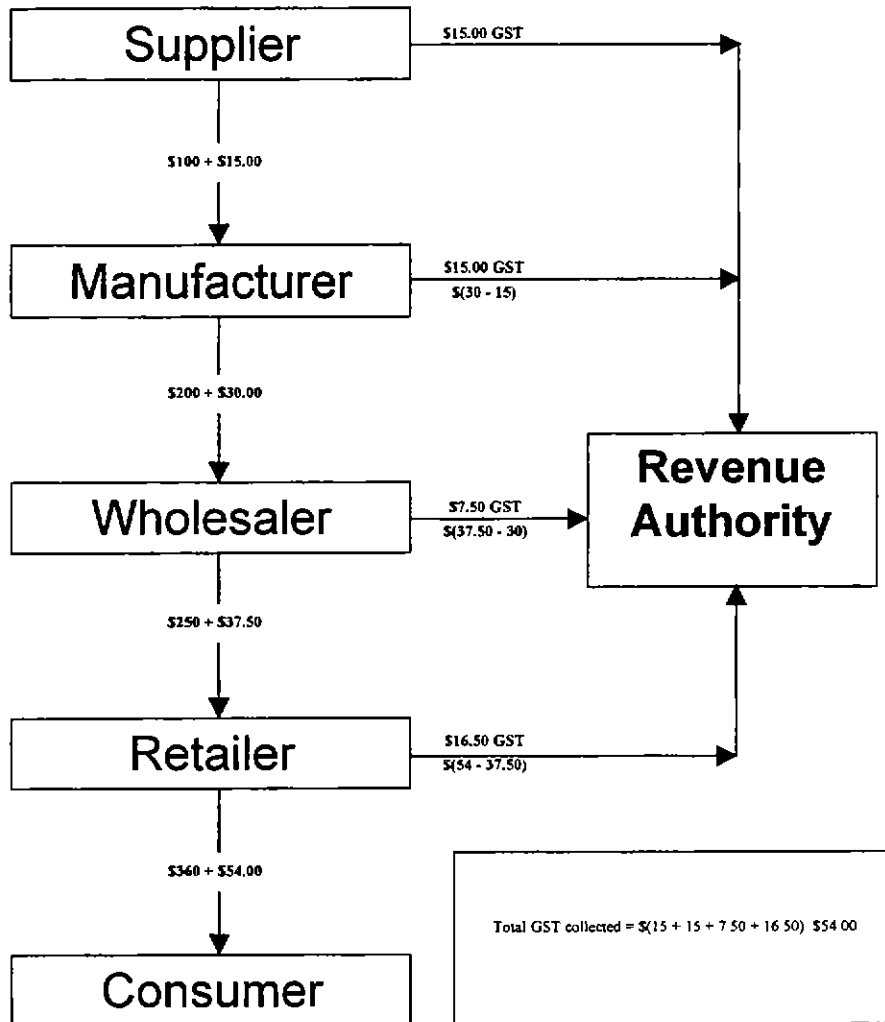
2. UNDERSTANDING VAT

Before examining the problems that small businesses face and how VAT legislation can cater for the needs of a small business, it is appropriate to analyse the basic workings of a European style VAT.

2.1 Calculating VAT

VAT is a tax on final consumer spending, collected in stages. Each person in the supply chain collects a sum of money from the next person down the line and deducts from it the tax paid to the previous person. The difference is the VAT liability. In other words, a payment is made to the revenue authority if the VAT on supplies exceeds VAT on inputs, and a refund of VAT is received if the VAT on the inputs exceed VAT on supplies. The process is illustrated in the following diagram, which assumes a 15% rate of tax and hypothetical profit margins:

Figure 1.



A European style VAT is usually an invoice or credit method. As Sandford notes⁵ the actual value added by each business is never calculated, rather the difference between the VAT on purchases and the VAT on sales is remitted to the revenue authority each accounting period. If in any period the purchases exceed sales, then a VAT refund will be due from the revenue authority.

⁵ C. Sandford Administrative and Compliance Costs of Taxation Fiscal Publications Bath 1989 p 111

It is not the product or service that is taxed, but the *supply* of product or service. For example a confectioner buys of ice cream, pays his supplier and recovers input tax, and stacks the ice cream in the freezer. If there is a power failure and the ice cream melts, there is no legal supply and therefore there can be no tax on the supply⁶. Similarly, loss or theft of goods will not bear VAT. VAT can therefore be categorised as a transaction tax. If the goods are supplied and the money is then stolen, the revenue authority will call for the tax, because there has been a supply.

2.2 Registration

Central to any VAT system is a registration process under which suppliers of goods and services must register as taxpayers. Often there is a threshold turnover level below which registration for VAT purposes is not required. If a person's annual turnover and quarterly turnover reaches a threshold, that person must register the business for VAT. Once registered for VAT, the person must keep appropriate accounting records to show input tax and output tax.

There are periods or parts of the year when VAT must be brought to account, usually quarterly periods. The usual procedure is that every tax invoice issued during the VAT period must be accounted for at the end of that period, and the output tax declared whether the trader has been paid or not. Similar principles generally apply to input tax.

The taxing point must be fixed in temporal terms, otherwise VAT will not be due at a particular time. The taxing point is often the date on which the goods are actually supplied or made available or when service is actually performed. The most common tax point is the date of invoice. Invoices usually have to be issued showing the date and the VAT.

2.3 Exemptions and Zero Rating

There are two methods by which supplies of goods and services can be effectively removed from the VAT system, they can be exempt or zero rated. When a person is exempt from VAT,

⁶ Lovell W. *Understanding VAT* Pitman Publishing London 1990.

he or she and cannot register, and therefore cannot recover input tax. Input tax is VAT paid not just on goods and services received, but also on overheads. Exempt supplies typically include items such as land, insurance, postal services, betting, gaming and lotteries, finance, education and health and welfare services.

A person who deals in zero rated supplies can register, and recover all the input tax, but cannot charge VAT on the goods and services sold or supplied. This is because the rate of VAT it can charge its customers is zero.

Imports of goods and services are generally assessed for VAT. Exports of services are often zero rated, i.e. where the beneficiary of the services is outside the country. VAT on the export of goods generally depends upon the types of exports and may be either exempt or zero rated.

3. WHY SMALL BUSINESSES SHOULD BE GIVEN SPECIAL TREATMENT

Research suggests that a large range of benefits to the economy stem from the operation of small firms.⁷ Some of these benefits are that small firms:

- add a large share to new employment;
- provide a seedbed for big businesses and new industries;
- add impetus to competition and efficiency;
- are a significant source of innovation; and
- contribute to economic flexibility and responsiveness.

3.1 Importance of Small Business

Small businesses form a powerful sector of the Australian economy. According to one report, there are 900,000 small businesses in Australia.⁸ These small businesses account for 96% of all firms, half of the private sector employment and a third of all employees in Australia. In

⁷ As discussed in Bureau of Industry Economics Small Business Research Unit *Small Business Review* AGPS Canberra, 1992 p33

⁸ Peter Switzer "New Party voices GST wishlist for underdogs" *The Australian* 15 December 1997, p21.

February 1997 it was estimated that there were 846,000 employing small businesses in Australia, an increase of 6.5% over the previous two years⁹. Of these, home based businesses form a large part, estimates are that 493,400 small businesses operate from home, approximately 58% of employing small business. The Federal Government has estimated that small businesses generates some 57% of Australia's Gross Domestic Product.¹⁰ Therefore it is fair to say that small businesses should be a powerful lobby in Australia. The government may be able to sell GST to the electorate more easily if small businesses were given some form of preferential treatment.

From an administrative point of view, the small business sector results in high costs of collection for little return. Research done in the UK has shown that a million small businesses forming 76% of those registered for VAT pay only about 7% of the total VAT.¹¹ Thus the cost of administration can be drastically reduced without substantial loss of revenue by eliminating these small businesses from the VAT net. Research from the US into a proposed Business Transfer Tax (BTT) shows that if businesses with less than US\$ 50,000 were exempted, the number of returns to be filed would drop from 20 million to 5 million and the cost of administration would drop from US\$700 million to US\$200 million, with only a 2% drop in revenue collected.¹²

A New Zealand¹³ study noted that if administration costs are allowed for, there is a high probability that the combined administration and compliance costs of goods and services tax exceed the revenue obtained from small business.

In Mexico, almost 90% of the VAT revenue is collected from 10% of the registered traders. In Korea and Taiwan, small businesses represent 75% of registered traders and produce only 5% of the VAT revenue.¹⁴

⁹ ABS *Characteristics of Small Business* Cat 8127.0 February 1998.

¹⁰ "Small Businesses in Australia – Challenges, Problems and Opportunities: Recommendations and Main Conclusions" Standing Committee on Industry Science and Technology: AGPS January 1990 (The Beddall Committee.)

¹¹ Alan A Tait *VAT International Practice and Problems* (International Monetary Fund, Washington,DC.1988) p117.

¹² *ibid.*

¹³ Hasseldine *Compliance Costs of Business Tax in New Zealand in Taxation Compliance Costs Measurement and Policy* Sandford Ed 1995

¹⁴ *ibid.*

The Australian Taxation Office (ATO) has observed¹⁵ that the small business sector is “generally and substantially less compliant than salary and wage earners and larger business” and further that “ the diversity and variety of factors influencing compliance behavior of small business” makes the administrative task more difficult.

3.2 Problems faced by Small Business

Small businesses face special problems because of their size. They have more difficulty in dealing with complex government laws and regulations. Some of the problems faced by small businesses are as follows:

3.2.1 High Compliance Costs

Research shows that compliance costs¹⁶ for small businesses are high.¹⁷ Research done in the UK in 1989 showed that the compliance costs as a percentage of the turnover for small business¹⁸ was 1.94% as opposed to large business¹⁹ which was 0.004%. Thus compliance cost of a small business was 600 times more than the compliance cost of a large business.

The Plamondon study in Canada²⁰ showed that compliance costs as a percentage of either turnover or tax remitted decrease as the size of the business increases. For small businesses²¹ net compliance costs as a percentage of turnover were 0.33% compared with 0.04% for large business²². Net compliance costs as a percentage of remittances were 16.97% and 2.65% for small and large businesses respectively.

¹⁵ Mitchell Australian Tax Forum 1997 p 57

¹⁶ Sandford describes compliance costs as “costs incurred by taxpayers in meeting the requirements laid on them by the tax law and the revenue authorities. They are costs over and above the actual payment of tax...which would disappear if the tax was abolished”. Tax Compliance Costs Measurement and Policy, Fiscal Publications, Bath UK 1995, p1

¹⁷ William J Turnier “Small Businesses under a VAT” December 1994, VAT Monitor Volume 5 No.6 p333.

¹⁸ Being businesses with a turnover up to £10,000

¹⁹ With turnover of £10,000,000 or more

²⁰ This study was commissioned by the Canadian government to obtain a better understanding of the impact of goods and services tax on small business compliance costs. The report was released in December 1993.

²¹ With a turnover of less than C\$100,000

²² With a turnover of C\$1million or more

In Australia the Beddall Committee²³ noted that increases in taxation reporting and awareness costs had a disproportionate impact on smaller businesses because of:

- absence of economies of scale; and
- inability of many owner operated businesses to bring the cost of taxation compliance to account as a tax deduction against income.

A smaller level of compliance costs can lead to an expansion of the small business sector, and an increase in employment, since small businesses are generally labour intensive. On the other hand, an increase in compliance costs could lead to a decline in output and employment.²⁴

3.2.2 Record Keeping

A large number of small businesses are cash traders with no cash registers or less sophisticated cash registers and as a result may not be able to keep sufficient records to calculate the VAT liability. Examples of such traders are local delicatessens, fish & chip shops and owner operator tradesman. These types of businesses are renowned for not providing invoices to their customers.

Also, small traders, especially family businesses have a tendency to pay for their purchases and expenses out of the till. This could distort the VAT record of both sales and purchases.

3.2.3 Financial and Cash Flow Problem

The Beddall Committee concluded that the failure rate in small businesses is a matter of concern. The Committee was concerned about the finance problems experienced by small businesses and the lack of business training undertaken before people commenced small

²³ "Small Businesses in Australia – Challenges, Problems and Opportunities: Recommendations and Main Conclusions" Standing Committee on Industry Science and Technology: AGPS January 1990 (The Beddall Committee.)

²⁴ Peter Bardsley "Simplifying the Tax Law, Some Implications for Small Business" Australian Tax Forum, Volume 13, 1 1997, p94. Note that small business employed almost 2.7million people, comprising 49% of the total non-agricultural private sector workforce in 1995, according to the Australian Bureau of Statistics publication *Small Business in Australia 1995*, Cat. No. 1321.0.

businesses.²⁵ Small businesses tend to be particularly vulnerable during the establishment phase with regard to obtaining finance in the absence of a track record. In addition, attending to record keeping requirements may be particularly neglected in this phase due to conflicting priorities.

4. DEFINING SMALL BUSINESS

Before examining the possible solutions to the problems encountered by small businesses, it is imperative to identify what small business is, and the problems associated with this definition. If special treatment is given to a small business, the definition of a small business becomes important, as businesses then have a clear incentive to be included in that category.

There are a number of possible definitions of small business, for example the Australian Bureau of Statistics defines a small business in the non agricultural sector as one which employs less than 20 employees in the non manufacturing industries and less than 100 employees in the manufacturing industries. In the agricultural sector, it defines a small business as having an Estimated Value of Agricultural Operations of between \$20,000 and \$399,000.²⁶

The Beddall Committee defined small business as being independently owned and managed, closely controlled by the owner managers who control most, if not all of the operating capital and having the principal decision making functions resting with the owner managers.

In the UK, the Bolton Committee²⁷ defined a small business using nine different statistical definitions for various industry groups. The definitions ranged from less than 20 employees for manufacturing businesses to less than £50,000 turnover for retailing businesses.

However, a decision has to be first made whether it is the business that has to be small, or the person who conducts that business that has to be small. Having determined that, a decision

²⁵ "Small Businesses in Australia – Challenges, Problems and Opportunities: Recommendations and Main Conclusions" Standing Committee on Industry Science and Technology: AGPS January 1990 (The Beddall Committee.)p xix.

²⁶ "Summary of A Question of Balance – The Tax Treatment of Small Business" Senate Economics Reference Committee, June 1995, Canberra, p1.

must then be made as to what criteria to use to define "small" in the context of small business concessions.

4.1 Person or Business?

Although VAT is charged on the supply of goods and services, it is the "taxable person" who must register for VAT and who can be sued for non compliance. Thus the definition of a taxable person is important. The taxable person must be one who is carrying on a business, since a private sale by a private individual, either as a one off sale or as a hobby, should not have to account for VAT. There are a number of problems associated with the definition of a "taxable person".

If a person is liable for registration, then all his other businesses should be aggregated to determine whether that person has exceeded the registration threshold. There may be a tendency for such a person to place the legal ownership of those businesses with different persons to avoid registration. For example, the fish and chip shop that was run by father on Monday, mother on Tuesday, daughter on Wednesday, son on Thursday, a couple of them on Friday, a different pair on Saturday and everyone on Sunday. Other examples are a shoe shop, where each fitting stool was a separate business, or the hairdresser, where each chair was a separate business.²⁸

In one UK case²⁹ a husband and wife as partners carried on two separate businesses, one as estate agents and the other as land developers. The Commissioners held that the partners were entitled to only one registration. The Queens Bench on appeal confirmed the Commissioners decision that the registration is that of the person and not the businesses he or she carries on.³⁰

²⁷ Bolton J E (Chairman) *Report of the Committee of Inquiry on Small Firms* HMSO London 1971

²⁸ William Lovell *Understanding VAT*, Pitman Publishing (1990), p20.

²⁹ *C & E Commrs v Glassborow and Another* (1975) QB 465.

³⁰ *Tolleys VAT Cases* 1990, p374.

Whether it is the business or the person to be registered, the legislation for GST should have anti avoidance provisions in place, to sieve out taxpayers whose intent for separate registration is to avoid tax.

A partnership is generally not a legal entity. However, if partners were held liable for registration, this would be an administrative nightmare both from the point of view of the partners and from the point of view of the taxing authorities. A change in partnership would further complicate the calculation of the VAT liability. In civil law countries, partnerships can be legal entities and as such can be registered for VAT. The UK has accepted that a partnership can register for VAT. However, if the same partners carry on different businesses, they should then aggregate those businesses.³¹

A company is a legal person and should be separately registered for VAT . Thus, even if a company has two shareholders, being husband and wife, and the husband and wife also have a separate business, the company should be separately registered from the other business.

It is common to allow groups of companies to register for VAT, which means that the “group of companies” must be defined. In New Zealand, companies are in a group if there is two-thirds common ownership or control. Another decision to make is whether the group of companies are compulsorily required to register together, or have a choice of registering separately.

Considering the problems above, a good definition of a “taxable person” would be a person running a small business or small businesses, the aggregate of which fits into the definition of a “small business”. The “taxable person” should then include not only a natural person and a company, but also a partnership, if none of the partners have a business of their own.

4.2 Defining “Small” for VAT

The next problem is to define a “small business” for the purposes of a GST concession. The various choices available and the problems associated with this definition are as follows:

4.2.1 Turnover

The most common criterion for identifying a small business is turnover, or sales, or supply. This should be broadly defined to include all commercial transactions concerning goods and services. This definition would require an agreement as to the timing of when the supply or sales occurred, since GST is normally calculated for a return period. The different variations in the timing depending on the type of supply is illustrated in Table 1:

Table 1 Timing of supply

Type of Supply	Timing
Arms length sale	Earlier of invoice or date of payment
Hire arrangement	Earlier of date payment due or payment received
Hire Purchase agreement	Time when hire purchase agreement signed
Lay-by sales	When ownership passes, i.e. when full payment is made
Debit/Credit Notes	Earlier of date on which debit/credit note is issued or date of payment.
Coin operated machines	Date on which machine is emptied
Door to door sales	The date on which the cooling off period is over.
Contract with progress payments	Earlier of:
	1) date progress payment due;
	2) date progress payment is received;
	3) date invoice relating to progress payment is issued, or
	4) date of payment.
Insurance claim	Date of payment.

In order to prevent future litigation as to what is a supply and the timing of the supply, the definition in the GST legislation must be clear. This is particularly important when turnover is used as a periodical measure of "smallness" for concession purposes.

4.2.2 Number of People Employed

³¹ Alan A Tait *VAT International Practice and Problems* (International Monetary Fund, Washington,DC.1988) p367.

The number of people a business employs may appear to be the easiest way of defining a small business, but this raises other problems, for example, whether to include only full time employees or include part timers and casual employees. Moreover, if a business is on the borderline of the definition, it could be a disincentive to employ an extra person.

4.2.3 Capital employed or profit

A small business could be classified by looking at the amount of capital employed or profit made. The problem with this definition is that it relies on the accounting rules and this may create discrepancies. Moreover there is a problem in producing timely figures as there is usually at least a six months lag in preparing financial reports. Thus a business that may be small six months ago may have become large without knowing it.

Certain countries use more than one criterion to decide whether the business is considered small. For example, Columbia uses four criteria, being:

- must not be a juridical person
- net income must be below a specified amount
- gross assets at end of previous year must be below a specified amount, and
- must not operate more than 2 establishments.

Some countries use 2 criteria, for example, Indonesia which uses turnover and capital employed.

Argentina has one of the most complex set of criteria to establish whether the business is exempt. It uses a combination of net capital used in the business and the numbers employed to determine a "fiscal debit" and different industries are allowed different "fiscal debits" to decide on its size.³²

5. HOW THE VAT LEGISLATION CAN ADDRESS SMALL BUSINESS PROBLEMS

A number of options are available to mitigate the problems faced by small business in dealing with obligations under a VAT. Some of these are discussed under the following sub-headings.

5.1 Exemptions from Registration for VAT

Many countries exempt small businesses from registration. If a business is exempt, it does not have to charge VAT on its sales to its customers. However it cannot obtain a credit for the VAT it has paid on its purchases. The exempt business will have no obligation to file a VAT return or keep VAT records. Exemption may be voluntary or mandatory.

Although many jurisdictions exempt small businesses, none appear to zero rate them.³³ If small businesses were zero rated, the government would lose the VAT revenue without any savings on the administration costs. The small businesses would also face the compliance costs which accompany participation within the system.

In order for a small business to be granted exemption from registration, a small business must be defined. The problems of defining a small business as discussed should be carefully considered. Once a decision is made as to the criteria for defining a small business, be it sales, or numbers employed or capital employed or profit made, or a combination of these, the next problem is to set a ceiling amount for exemption. This political decision should weigh the lost revenue as a result of exemption against the savings in administration costs.

Another question to address is whether the exemption should be mandatory or elective. If exemption is elective, the objective of saving administration and compliance costs will not be fully achieved. On the other hand, if the exemption is mandatory, this may be too harsh on small businesses who would otherwise be entitled to significant refunds.

The decision for small business is one between avoiding the need to account for the tax to the revenue authorities and giving up the right to a deduction of tax on inputs. Messere³⁴ points out that this choice will vary depending upon the category of small business. For a business

³² Alan A Tait *VAT International Practice and Problems* (International Monetary Fund, Washington,DC.1988) p111.

³³ See the meaning of zero rating on page 2

³⁴ Messere Tax Policy in OECD Countries IBFD Publications 1993 p 409

which supplies predominantly services such as a hairdresser, it may be better to forgo the deduction of input tax in order to keep prices down. Small businesses supplying registered traders, exporting or selling low or zero rated goods on the other hand may find it advantageous to remain within the system so as to recover the input tax.

If the exemption is elective, whether this election should be irreversible and the time period within which the election can be made should be taken into account. This is because when a business first starts operation, it may have more purchases and expenses than sales and as a result it would be in a position to obtain refunds of VAT from the revenue authority. Once the business picks up, its sales could exceed the purchases and expenses, and the business would end up making a payment to the revenue authority. If a small business is allowed to register and deregister when it likes, it could be advantaged at the expense of the revenue authority.

The advantages and disadvantages of an exemption system are essentially as follows:

5.1.2 Advantages

- Exemption would significantly reduce administrative and compliance costs;
- Since small taxpayers may not have the ability to keep sufficient records to calculate VAT, the revenue authority may need to operate complex schemes to calculate the VAT liability. The cost of operating such schemes may be more costly than a modest exemption.
- The cost of compliance for a small business is far in excess of their larger competitors. An exemption would help the small business to eradicate some of this disadvantage and allow more small businesses to thrive, thereby enhancing the economy.
- If the exemption is not granted, the revenue authority's resources are stretched as they have to be spread over a large number of taxpayers and as has been seen from overseas studies, most of the small businesses provide little revenue.

- In Australia it is proposed that introduction of a GST will allow for the abolition of State imposed pay-roll taxes. This will only be of benefit to larger business, however, since all states have a threshold which effectively exempts small business from pay-roll tax. This will exacerbate the competitive position of small business, which could have significant consequences. Exempting small business from GST could redress this imbalance.

5.1.3 Disadvantages

- Since small businesses form a significant part of the Australian economy, exempting them would be a loss of revenue for the government. Exemption leads to the erosion of the tax base.
- The survival of a small business could be endangered if it erroneously believes that it qualifies for exempt status.
- Exemption creates an advantage for small businesses and a loss of competitive neutrality between exempt and non-exempt businesses. Thus taxable businesses may resent the competitive advantage which exemption creates. Eland³⁵ notes that it can “cause serious distortions of competition around the margin of whatever threshold is set”.
- Since exempt businesses do not need an invoice to claim input credit, the vendors selling to exempt businesses may not issue such an invoice, thereby, creating a tendency for VAT avoidance by the vendors.
- Borderline businesses may be encouraged to under-report to take advantage of the exemption.
- If exemption is granted to a trader who sells goods that are not necessarily final sales, but instead are used as inputs in the further production of other goods and services, then the

³⁵ Eland “Tax Compliance Costs: The Problems and the Practice” in Tax Compliance Costs Measurement and Policy C. Sandford Ed Fiscal Publications (1995) p40

VAT borne on the exempt trader's inputs is built into his price and forms part of the cost of any other trader buying the goods for further production. This hidden tax creates a "cascading" effect, which is not good for the economy. The hidden tax also raises the cost of the Australian goods for export and makes our product uncompetitive against products from other countries whose indirect tax has been removed by exempting goods for exports.

- An exemption would need to be accompanied by a business anti splitting provision of some sort to prevent avoidance.
- Finally, whilst much is written about the onerous compliance burden on small business, there are in fact benefits of compliance which cannot be ignored. There is a clear cash flow benefit, determined by commercial conditions, where the VAT liability is based on the invoice date rather than the payment date.³⁶ In addition there is a managerial benefit to be gained by forcing small businesses to keep proper books of account.³⁷

5.2 Exemption from filing a VAT return

As an alternative to exemption from the VAT altogether, small business, appropriately defined, could be merely excused from filing a VAT return. Such a business would be registered for VAT, would charge VAT to its customers and give a VAT invoice to its customers for claiming input credit, but would not claim input credit itself and would not have to hand over the VAT collected from the sales to the revenue authority.

The main advantage of such an exemption is that it prevents the "cascading" effect since the exempt party's customers purchases would qualify for input credit, thereby providing a mechanism to remove the hidden tax from goods for export or other zero rated goods. However, such an exemption should be kept modest to prevent loss of revenue for the government and erosion of the tax base. Such an exemption also gives a competitive

³⁶ Sandford *Administrative and Compliance Costs of Taxation* 1989 p 117

³⁷ *ibid.*

advantage to a small business, especially if the small business passes on the net VAT collected from its customers back to the customers in the form of a price reduction.

5.3 Compensating Small Businesses

The Senate Economics Committee report stated that since large businesses benefit from the economies of scale and associated tax deductions to cope with compliance costs, the small businesses should be given some concessions.³⁸ One such concession could be for the government to compensate a small business for acting as a collection agent for the government in collecting VAT. This payment could be provided in the form of a reduction in VAT payment to be submitted to the revenue authority, the reduction being a small percentage of the VAT payment.

Alternatively there could be some waiver of the tax payable. This is used in a number of OECD countries³⁹ and can either waive tax based on net tax payable or on turnover.⁴⁰

5.4 Cash Flow Management

An alternative form of compensation could be a less frequent remittance system for a small business. Alternatively, a system similar to the Pay-as-you-go ("PAYG") system recommended by the Senate Economics Reference Committee⁴¹ be instituted for small businesses registered for VAT. Evidence to the Committee in that inquiry has indicated that the impact of timing of tax payments upon the cash flow of small businesses can significantly affect both the initial and ongoing viability of many small businesses.⁴²

There are 2 schools of thought within small businesses:

1. those who want regular, predictable timing for payment; or

³⁸ "Summary of A Question of Balance – The Tax Treatment of Small Business" Senate Economics Reference Committee, June 1995, Canberra, p3.

³⁹ For example Austria, Finland, France, Germany, Luxembourg and the Netherlands

⁴⁰ Messere p 409

⁴¹ Ibid., p92.

⁴² Ibid., p91

2. those who prefer to pay when they have the capacity, in tune with their actual cash flow.

Therefore, under the PAYG arrangement, the small business should be allowed the flexibility of choosing a pattern for making the VAT payment, which could be monthly, quarterly, bi-annually or annually. This choice of the pattern would be tailored to suit the income stream, with the flexibility of switching from one pattern to another.

As previously noted, a small business is most vulnerable during the establishment phase with regard to finance. Small businesses in their first year of trading could be given special treatment, for example, an election to defer the lodgement of the VAT return for 12 months, with the payment estimated and spread over the 12 months. This would give them a greater cash flow benefit from delays in remitting GST to the government. Table 2 illustrates that based on interest rate of 10%, the less frequent the payment of the GST to the government, the greater the cash flow benefit, as a percentage of the GST revenue.

Table 2: Cash Flow Benefits

<u>Frequency of Payment</u>	<u>Cash Flow Benefit as a % of the GST Revenue</u>
Monthly	0.42
2 Monthly	0.83
Quarterly	1.25
6 Monthly	2.5
Yearly	5.0

Thus allowing a small firm to pay GST to the government every 6 months rather than every 2 months provides the small business with a cash flow benefit of $(2.5 - 0.83) = 1.67\%$.⁴³

5.5 Record Keeping and lodgment of VAT returns

Many small businesses fail to meet their tax commitment, or incorrectly calculate their tax liability due to lack of record keeping skills. In order to overcome this, the revenue authority could provide training packages in record keeping skills for small businesses.

However the taxing authorities have to be careful in giving excessive free information. Under one study,⁴⁴ 140 respondents were given a copy of an Australian Taxation Office publication, “*A Guide to Keeping Your Business Records*”. Respondents were told that they will be contacted in 2-3 weeks to seek their opinion about the usefulness of the publication, but 81.4% had not read the publication when subsequently contacted. This indicates that unless the small business taxpayers are convinced of their shortfall of knowledge and of their need to be re-educated, they may not improve their knowledge by using the free resources.

Significant reduction in the burden of taxation reporting requirements may be achieved by reducing the frequency of transmission of information to the revenue authority and by having a flexible medium through which to transfer the information.

The revenue authority could install a toll free telephone hotline specially for small business VAT inquiry. The revenue authority could also outpost its advisers in small business advisory organisations to train staff and provide advice to small businesses.

5.6 Keep the VAT legislation simple

If the VAT legislation is complex, small businesses will spend an enormous amount of their time understanding their obligations, or pay an accountant, which means additional cost to the business. A simple GST would lead to a reduction in compliance costs and that reduction will have a beneficial effect on the small business sector. Higher profitability would be expected to lead to an increase in output and employment by that sector.

A simple GST would also reduce the cost of assessment and audit for the taxing authorities. Auditing a taxpayer is expensive and disruptive and both the government and the taxpayer would benefit from fewer audits arising from a simple GST. If the GST is complex, evidence suggests that small businesses tend to over comply in order to avoid the cost of tax audits. The uncertainty created by complex legislation has a regressive effect on tax incidence, i.e. small

⁴³ John Freebairn; Porter Michael “A Goods and Services Tax For Australia” (1990) 7 Australian Tax Forum, p 144.

⁴⁴ Margaret McKercher “ Summary of Understanding Small Business Taxpayers: Their sources of information and level of knowledge of Taxation” Australian Tax Forum, Volume 12(1) 1995, p42.

firms would end up paying more tax. Thus the effect of a simple GST is that small firms will not pay excessive tax, leading to an expansion of the small business sector.

The trend created by the Tax Law Improvement Project should be continued when the VAT legislation is drafted.

6. A COMPARATIVE STUDY – HOW OTHER COUNTRIES TREAT SMALL BUSINESSES

6.1 Singapore

Under the Singapore GST which was introduced in 1993, there are three concessions for small business.

6.1.1 Exemption from Registration

In Singapore it is optional for a small business to register for GST. A small business in Singapore for GST purposes is:

- one whose taxable supplies at the end of any quarter plus three immediately preceding quarters do not exceed S\$1million; and
- if it can be shown that the taxable supplies for the next 12 months are not going to exceed S\$1 million.⁴⁵

Therefore, borderline businesses with taxable supplies below the S\$1 million have to monitor their taxable supplies, both actual and potential regularly to ensure timely registration when its taxable supplies exceed or are expected to exceed the S\$ 1 million.

In Singapore, a business can be broken up into divisions and each division separately registered as a sub unit, if it is approved by the revenue authority. However anti avoidance provisions are in place to allow the revenue authority to amalgamate the value of supplies of separate entities to determine whether the taxable supplies exceeded the S\$1 million limit for

⁴⁵ CCH *Singapore Master Tax Guide* 1996, p923.

registration. Thus the anti-avoidance legislation prevents businesses from splitting into separate entities to avoid registering for GST.

6.1.2 Cash Accounting

Small businesses in Singapore whose taxable supplies are of a low unit value and are mainly made in cash can take advantage of the cash accounting scheme if they operate a cash accounting system. Under the cash accounting system, the GST is accounted to the revenue authority on the day on which the payment is made or received, or the date of the cheque.⁴⁶ However, this scheme is not restricted to just small businesses.

The cash accounting scheme is also available for the benefit of small businesses who are voluntarily registered and who have a good track record in carrying out the duties as a taxable person.⁴⁷

6.1.3 Accounting Cycles

All businesses, particularly small ones can benefit from the choice of accounting cycles available to fit the businesses financial year end. The choice of the cycles is as follows:

1. Quarter ending April, July, October and January.
2. Quarter ending May, August, November and February.
3. June, September, December and March.

Exporters who are likely to be in a refund position can request for a monthly accounting cycle.⁴⁸ This would help the exporters' cash flow and presumably enhance Singaporean exports.

⁴⁶ Ibid., p948

⁴⁷ Lai Seng Kwoon *Your GST Guide for Business* (SNP Publishers, 1994), p65.

⁴⁸ Ibid., p3.

6.2 Japan⁴⁹

The consumption tax in Japan is a hidden tax since there is no requirement for it to be shown on the invoice. Japan does not have an invoice method to calculate the consumption tax liability. Rather it has a hybrid books of account method, whereby the gross taxable sales and the taxable purchases are calculated using the taxpayers existing books of account. Thus the consumption tax that the taxpayer has to account for to the revenue authorities is not based on actual amount of consumption tax charged and collected, but on the sales and purchases shown on the books of account. This can be done since Japan only has one rate of consumption tax.

Under the Japanese system there are two forms of relief for small business.

6.2.1 Exempt Status

In Japan, there is no requirement to register for consumption tax. If a business has annual taxable sales in excess of ¥30 million, that business will have to send a consumption tax return to the taxing authorities. Businesses with less than ¥30 million turnover qualify for exempt status. However, since exempt businesses cannot claim input credits, they can apply for voluntary taxable status. If such a status is granted, it continues for a minimum of 2 years. In 1989, when the consumption tax was introduced in Japan, it was estimated that 70% of all businesses would qualify for exempt status. Thus businesses who are exempt can charge the tax and pocket the money, since they are not required to lodge a return.

If the previous years turnover was below ¥30 million, but the current year's turnover exceeds ¥30 million, the business may not have charged consumption tax to its clients, and yet find that it has to account for the uncollected GST. To overcome this problem, a marginal relief has been created for these firms with sales between ¥30 million and ¥50 million. The marginal relief is obtained by multiplying the normal tax liability by the fraction : $\frac{\text{¥50 million} - \text{Taxable Sales}}{\text{¥20 million}}$

¥20 million

⁴⁹ Vicki L. Beyer;Koji Ishimura “ The Progress of the Japanese National Consumption Tax” Revenue Law Journal 3 (1&2) February 1993, p115-124

Apparently the phasing out of the relief results in almost no under-reporting of turnover to retain exempt status.⁵⁰

6.2.2 Book-Keeping

Small businesses who have problems keeping proper books of account can employ the "Optional Summary Method" of tax calculation. This method is available for taxpayers with annual taxable sales of ¥500 million or less. Approximately 95% of all firms in Japan qualify to use this method. Once this method is adopted, it must be applied for a minimum of 2 years. Under this method, taxpayers can deem that the following percentages of their sales were their purchases:

<u>Taxpayer</u>	<u>Deemed Purchases as % of Sales</u>
Wholesalers	90%
Retailers	80%
Specified Core Industries	70%
Others	60%

6.3 Canada

Introduction of GST in Canada in 1991 was apparently opposed by small businesses who already experienced difficulty in complying with Provincial Retail Sales Tax. The situation in Canada is therefore complicated by the dual system.⁵¹

6.3.1 Exemption from Registration

When the taxable revenue is below the C\$30,000 threshold, a person is known as a "small supplier" and registration for GST is optional. Generally the C\$30,000 threshold is determined by reference to the total annual sales from taxable and zero rated supplies made by a person and associate of that person in the last four quarters.

⁵⁰ Turnier p 335

⁵¹ L Dana "A Goods And Services Tax (GST) and the small business sector: Some Canadian Reflections" Annual Journal of Public Administration Vol. 52, No.4 December 1993, p. 458.

When the turnover for the past 12 months exceed C\$30,000, the person must register for GST. There is no middle category for exemption in Canada.

6.3.2 Filing of Returns

In Canada, large firms have to file a GST return monthly. A large firm is one with an annual turnover of C\$6million. However, small firms with less than C\$6million turnover can opt to file a quarterly return. The very small firms, with less than C\$500,000 turnover can opt to file either a quarterly return or an annual return.

In Canada, returns are normally filed within one month of the reporting date. However, small firms with less than C\$500,000 turnover have three months after the reporting date to file the return. Small firms can benefit from this cash flow advantage, to offset the increased compliance cost. Also, a quarterly filing system means less filing costs for a small business.

6.3.3 Initial Costs on Introduction of GST

When GST was first introduced in Canada, registered small firms with sales of C\$2million or less received the following one off payment to offset compliance costs:

<u>Sales in C\$</u>	<u>Payment</u>
Up to \$600,000	\$300
\$600,000 – \$2 million	0.5% of sales, but not exceeding \$1000

Small firms which did not have cash registers to identify taxable and tax free items were given a 100% write off for income tax purposes, if they invested in the capital cost of such equipment during the years 1991 and 1992.

6.3.4 Simplified Accounting Method

Small firms who did not upgrade their equipment to account for GST properly could use one of the simplified accounting methods

Small businesses with sales of up to C\$200,000 can use the "Quick Method". Under this method, the businesses do not have to keep track of the GST charged on individual transactions, but instead remit a specified amount calculated by a formula based on average sales and expenses. Operators of grocery stores and convenience stores with turnover of up to C\$500,000 may also use the "Quick Method", if the zero rated basic groceries made up at least 25% of the sales.

Slightly larger businesses, with turnover of up to C\$6million, can use one of the "streamlined accounting method". Under this method the GST payments are based on inventory purchases and estimates of taxable sales, and there is no need to differentiate between taxable goods and zero rated goods at the checkout.

Wurtz⁵² notes that the take up rate of this concession has been low. The Plamandon study noted that the most frequent observations about why small businesses were not availing themselves of the method was that the remittance rate is too high, that they were unable to determine if there was a benefit and that they did not feel comfortable using an estimation method.

6.4 United Kingdom (UK)

The UK VAT has been in place since 1973 and is often renounced for its complexity. It offers a number of concessions for small business as follows:

6.4.1 Exemption from Registration

A taxable unit in UK is not a business, but the person who carries on the business.⁵³ Thus in order to decide whether the person must register for VAT, all taxable supplies made by that person must be aggregated. A partnership and an unincorporated association are regarded as

⁵² Brian Wurts *Report on the Plamandon Compliance Cost Study for Canadian GST in Taxation Compliance Costs Measurement and Policy* Sandford Ed 1995

⁵³ CCH *British Master Tax Guide* 196/97, p5017

persons for VAT although they do not have separate legal personality.⁵⁴ There are anti avoidance provisions in place to counter practices of splitting businesses among several legal entities to avoid registration.⁵⁵

A small trader whose taxable turnover for the past 12 months does not exceed the historical turnover limit of £47,000, and the expected turnover for the next 12 months will not exceed £45,000, does not have to register for VAT. This comparison between the taxable turnover and the historic turnover must be made at the end of each month. If the trader becomes liable to register for VAT, he must notify the revenue authority within 30 days from the end of the calendar month when the limits exceeded. However, a small trader can voluntarily register, if he so wishes, but this voluntary registration must then be maintained for at least 2 years.⁵⁶

According to Godwin⁵⁷, the original threshold was set at a level which was intended to exclude part time businesses, but with the widespread zero rating under the UK system, it is attractive for small businesses to seek voluntary registration.

6.4.2 Retail Schemes

Small retailers who are unable to keep proper records can take advantage of the retail schemes. These are schemes to help a retailer calculate the output tax, since not every retail sale will be supported by a tax invoice. There are about 13 retail schemes in the U.K. The choice of the scheme will depend on the business records, the turnover estimate and whether services are supplied with the goods, and whether there are zero rated goods involved.⁵⁸

The Daily Gross Takings ("DGT"), is not just the money in the till, but includes the cash taken out from the takings. An example of a simple retail scheme when no zero rated goods are supplied is: Output Tax = $DGT \times 7/47$.⁵⁹

⁵⁴ CCH *British Master Tax Guide* 196/97, p5018

⁵⁵ CCH *British Master Tax Guide* 196/97, p5087

⁵⁶ CCH *British Master Tax Guide* 196/97, p5079

⁵⁷ Godwin *The Compliance Costs of the UK Tax System in Taxation Compliance Costs Measurement and Policy* Sandford Ed 1995

⁵⁸ Arnold Homer and Rita Burrows "Tolleys Tax Guide" 1995/96, p100.

⁵⁹ This fraction works out the VAT at the rate of 17.5%.

If zero rated goods are supplied, then the calculation of the output tax is
DGT - zero rated sales x 7/47.

6.4.3 Cash Accounting

Small businesses with turnover up to £350,000 can use the Cash Accounting scheme, whereby the VAT is calculated by reference to the payments made and received, rather than the supplies made and received.⁶⁰ This would help small businesses in not having to account for sales which turn out to be bad debts.

6.4.4 Annual Accounting

Small businesses with annual turnover of up to £300,000 and who have traded for at least 12 months can opt to use the annual accounting scheme, whereby the business will only have to file a return once a year. This scheme is only available to traders who normally end up making payments to the revenue authority, rather than traders who receive refunds.

Although the return is filed once a year, payments of VAT has to be made based on last years results and anticipated future results, as follows:

Business Turnover	Payment Schedule
Below £2,000	Once a year when return is filed
Below £100,000	Quarterly payments of 20% of liability
Above £100,000	9 monthly payments of 90% of liability starting in the fourth month.

The balance of the payment is due two months after the end of the year when the return is due.⁶¹

6.5 New Zealand

⁶⁰ CCH *British Master Tax Guide* 1996/97, p5093

6.5 1 Exemption from Registration

Any person with less than NZ\$30,000 taxable supplies does not have to register for GST, but may voluntarily do so.⁶²

6.5.2 Filing of Returns

In New Zealand the GST returns are normally filed every 2 months, with a choice of monthly returns, if the taxpayer prefers. The option of the monthly return can be useful for those businesses who mainly receive GST refunds. However, small firms with annual turnover of less than NZ\$250,000 can opt to file a return twice a year, and this can be timed to coincide with the accounts reporting date.⁶³ This would reduce the paperwork for a small firm.

7 CONCLUSION

There is ample evidence that small businesses need assistance in meeting the additional demands of compliance with a VAT, so the question is whether or not small business should receive some form of concession, and if so, what form that concession should take.

A summary of the comparative study with other countries shows that the main types of concession for small business are:

- Exemption from registration;
- Exemption from filing a return;
- VAT accounting using cash accounting rather than accruals basis;
- Flexible VAT return periods; and
- Flexible payment schedule.

⁶¹ *ibid.*

⁶² Roger S Muir "The Goods and Services Tax: Reflections on the New Zealand experience, six years on" (1993) 3 *Revenue Law Journal*, p17

⁶³ L Dana "A Goods And Services Tax (GST) and the small business sector: Some Canadian Reflections" *Annual Journal of Public Administration* Vol. 52, No.4 December 1993, p461.

If the decision is taken to provide a concession to small business, the threshold issue of accurately defining the intended target of relief is perhaps a more difficult decision than the form the concession should take. Care must be taken to ensure that any relief is not open to abuse, and perhaps also that transitional measures allow for phasing in of relief to prevent distortions at the threshold of the concession.

The most visible form of assistance is a full exemption, but there are significant disadvantages attached to this form of concession which may in fact outweigh the gains in terms of reduced administrative and compliance costs. Indeed when considering the compliance costs of small business, attention must also be paid to the benefits of compliance such as cash flow benefits and managerial benefits.

Although there are significant disadvantages attached to granting a full exemption, the government has to be realistic analyse the revenue gain as compared to the administrative and compliance costs. Even New Zealand whose GST is boasted as being simple with few exemptions, assists the very small business by allowing them to opt for an exemption.

There is precedent in Australia for a small business exemption under the existing wholesale sales tax, which exempts small business with a sales tax liability which does not exceed \$10,000. Failure to at least allow a comparable exemption under a GST will require small business who have never lodged sales tax returns to participate in the GST system.

In the event that a full exemption is not considered to be appropriate, some lesser form of concession could be provided. This could be a reduced tax rate for small business, or an administrative concession such as exemption from filing VAT returns or adjusted payment schedule.

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