

TAX ACCOUNTING CONCESSIONS FOR SMALL BUSINESS ENTITIES: ONE SMALL STEP FOR SMALL BUSINESS

PAUL KENNY*

I INTRODUCTION

This paper examines the Small Business Entities (SBE) income tax accounting concessions (for prepaid expenses;¹ depreciating assets² and trading stock³) that commenced on 1 July 2007. These concessions originated from the former Simplified Tax System (STS).⁴ Given that the former STS was subject to much criticism by commentators, professional and government bodies⁵ this paper first tracks the origins of the STS in the 1999 *Review of Business Taxation's* (herein after called the 'Review') report,⁶ its implementation and the subsequent legislative fixes up to 30 June 2007. The paper then examines the SBE regime and finds that the new SBE framework retains many of the features of the former STS and thus is open to similar criticisms. The SBE regime though provides a more flexible framework for small

* Senior Lecturer in Taxation Law, Flinders Business School, Flinders University, Adelaide, South Australia.

1 s 82KZM Income Tax Assessment Act 1936 (ITAA 1936).

2 Subdiv 328-D Income Tax Assessment Act 1997 (ITAA 1997).

3 Subdiv 328-E.

4 s 82KZM ITAA 1936, Div 328 ITAA 1997.

5 Pizzacalla M, 'Australia's SME identity crisis' (2007) 22 Australian Tax Forum 19; Samarkovski Freudenberg above n 7; Tretola J (2007) 'The Simplified Tax System - Has It Simplified Tax At All And, If So, Should It Be Extended?' (2007) 17 Revenue Law Journal; McKerchar M, 'Is the Simplified Tax System Simple?' (2007) 10 The Tax Specialist 140; Burton M, 'The Australian Small Business Tax Concessions – Public Choice, Public Interest or Public Folly?' (2006) 21 Australian Tax Forum 71; CPA Australia, Small Business Survey: Compliance Burden (2006); Taxation Institute: Submission to the Taskforce on Reducing the Regulatory Burden on Business 28 November 2005 <www.regulationtaskforce.gov.au/submissions/sub078.rtf>; Institute of Chartered Accountants: Submission to the Taskforce on Reducing the Regulatory Burden on Business 28 November 2005; G Shaw, 'Changing to the Simplified Tax System' (2005) Taxpayers Australia 7 November 2005, 154; Dirkis M and Bondfield B, 'The RBT ANTS Bite: Small Business the First Casualty' (2004) 19 Australian Tax Forum 107; Walker G, 'The Simplified Tax System- the Good, the Bad and the Ugly' (2003) 7, 20 CCH Tax Week 95; Bondfield B, 'A Year on in the Simplified Tax System: has the reality matched the rhetoric?' (2002) 37 Taxation in Australia 253; Kenny P, 'A Simplified Tax System for Small Business: Or, Just Another Tax Preference?' (2002) 6 The Tax Specialist 36; Bondfield B, 'If there is an Art to Taxation the Simplified Tax System is a Dark Art' (2002) 17 Australian Tax Forum 313; Hine M, 'Small Business Tax System (STS)' Taxation Institute of Australia, Western Australian State Convention May 2001, 24; Snook I, 'Simplified Tax System: A Favourable Current, a Riptide or Just Plain Dead Calm?' Taxation Institute of Australia, South Australian State Convention May 2001, 75; Wolfers L and Miller J, 'The Simplified Tax System: Is this Government Speak for "Complex"?' (2001) 35 Taxation in Australia 374; Martin F, 'STS Implications' (2001) 36 Taxation in Australia 245; Douglas R, 'Tax Simplification for Small to Medium Business' (2000) Taxation Institute of Australia New South Wales State Convention May 2000, 8; Institute of Chartered Accountants (ICAA) Media Release 'Chartered Accountants Disappointed by Simplified Tax System Bill' 27 October 2000; Cooper G, 'The Government Response to the Ralph Report: An Initial Overview' (1999) 34 *Taxation in Australia* 232.

⁶ Review of Business Taxation, *A Tax System Redesigned, More Certain, Equitable and Durable, Report* (1999) (herein after called a *Tax System Redesigned*). The Report was the last in a series of four papers published by the Review of Business Taxation.

business and it is somewhat better integrated with other small business taxation concessions.

II BACKGROUND: THE FORMER STS

A The Review of Business Taxation's STS

The *Review's* first paper, *A Strong Foundation*⁷ and its report, *A Tax System Redesigned*⁸ both identified the general problem of onerous compliance costs for small business. For example, in 1996, the *Small Business Deregulation Taskforce* (herein after the *SBD Taskforce*)⁹ observed that tax loomed as the main regulatory compliance issue for small business.¹⁰ Notwithstanding the efforts of the *SBD Taskforce*, with the extensive tax reforms flowing from the *Review's* 1999 report¹¹ and the introduction of the goods and services tax on 1 July 2000,¹² the taxation laws expanded from some 3,000 odd pages of legislation in 1996 to over 10,000 pages in 2007. Moreover the costs of tax compliance for small business are highly regressive.¹³ As the *Review* noted, the limited resources of small businesses mean that such businesses work under the constraints of sub optimal systems and limited knowledge to comply with a mass of taxation regulations and record keeping requirements.¹⁴ Leading tax practitioner bodies have similarly argued that tax laws impose a significant burden on small business.¹⁵

However, the *Review*¹⁶ inappropriately attributed this problem to the perceived difficulties that small businesses were having with the following four income tax accounting issues: the accruals income tax accounting rules,¹⁷ the prepayment framework,¹⁸ the capital allowances regime¹⁹ and the trading stock rules.²⁰ Thus the

⁷ Review of Business Taxation, *A Strong Foundation Discussion Paper* (1998) (herein after called *A Strong Foundation*), 14-22.

⁸ *A Tax System Redesigned* above n 6, 575.

⁹ C Bell (Chair) *Time for Business: Report of the Small Business Deregulation Task Force*, AGPS, Canberra, 1 November 1996; Taxation Institute of Australia, 'Current Topic, Small Change' (1996) 31 TIA 174, 174-175.

¹⁰ Small Business Deregulation Task Force Background Paper 3, September 1996; House of Representatives Standing Committee on Industry, Science and Technology, D Beddall MP (Chair) *Small Business in Australia- Challenges, Problems and Opportunities; Recommendations and Main Conclusions*, AGPS, Canberra, January 1990.

¹¹ *A Tax System Redesigned* above n 6. For example small businesses were affected by the NCL provisions in Div 35 ITAA 1997 and the alienation of personal services provisions in Pt 2-42 (Divs 84-87).

¹² *A New Tax System (Goods and Services Tax) Act* 1999.

¹³ C Evans, K Ritchie, B Tran-Nam, M Walpole, *A report into taxpayer costs of compliance* (1997), 85. Smaller businesses have fewer resources to comply with tax legislation and thus their tax compliance costs expressed as a percentage of business revenue are far higher than larger businesses.

¹⁴ *A Tax System Redesigned* above n 6, 74.

¹⁵ S Harrison, (CEO) Institute of Chartered Accountants in Australia, Open Letter to Tax Commissioner Carmody, 13 August 2002, <http://www.icaa.com.au/news/index.cf?menu=226&id=A105289876>; R Regan, (President: National Tax & Accountants Association) NTAA supports call for tax practitioners to revolt, National Tax & Accountants Association Press Release 15 August 2002; G Levy Tax Crisis – Hard Times Call for Hard Actions, Taxation Institute of Australia Press Release, 13 August 2002, <http://www.taxinstitute.com.au/cda/media/1,1316,1,00.html>.

¹⁶ *A Tax System Redesigned* above n 6, 575.

¹⁷ ss 6-5, 8-1 ITAA 1997.

¹⁸ s 82KZM ITAA 1936

¹⁹ Div 40 ITAA 1997

Review introduced 'simplified' rules for small business for: a cash system of income tax accounting,²¹ treatment of prepaid expenses,²² capital allowances²³ and trading stock.²⁴ The cash accounting system proved to be unhelpful and was repealed on 30 June 2005.²⁵ It is evident from the following analysis that the non-STS income tax accounting rules for prepayments, capital allowances and trading stock did not greatly burden small business.

Taxpayers outside of the former STS that carried on a business could only generally claim a deduction for prepayments over the period to which the prepaid benefits related (eligible services period).²⁶ Such prepayments were apportioned over the lesser of 10 years or the eligible services period.²⁷ Such treatment broadly reflects proper financial accounting practice as such prepaid expenses should be accrued over the period that directly relates to the earning of income.²⁸ Thus, the impact of these prepayment rules on compliance and administration costs for small business is manageable.

Taxpayers outside of the STS could access the general capital allowance rules in Div 40 ITAA 1997. There are a few reasons why the compliance costs of Div 40 would not be overly onerous to small business taxpayers, tax practitioners and administrators. First, these depreciation provisions based on effective life broadly reflect proper financial accounting practice.²⁹ Secondly, Div 40 has operated since 1 July 2001 and thus this regime is now well established. Thirdly, given the widespread use of computers to calculate depreciation these costs appear to be manageable for small businesses. Fourthly, given the small scale of their operations many small businesses are likely to have relatively few depreciating assets and thus any compliance costs under Div 40 would be small.

For non-STS taxpayers the trading stock rules in Div 70 are well established³⁰ and are broadly similar to the accounting trading stock rules.³¹ Consequently, Div 70 is well understood by small businesses, tax practitioners and administrators. Overall, the trading stock compliance costs do not appear to be onerous for small business since these calculations are required for financial accounting³² as well as internal control³³ purposes.

Overall, for small business taxpayers that were not part of the former STS concessions, the prepayment, depreciation and trading stock provisions would not have imposed any serious compliance costs since these measures are required for financial accounting, managerial accounting and internal control purposes. These tax

²⁰ Div 70.

²¹ Former subdiv 328-C.

²² s 82KZM ITAA 1936.

²³ Subdiv 328-D ITAA 1997.

²⁴ Subdiv 328-E.

²⁵ Explanatory Memorandum, *Tax Laws Amendment (2004 Measures No. 7) Act 2005*.

²⁶ s 82KZMD(2) ITAA 1936.

²⁷ *Ibid.*

²⁸ AASB *Framework for the Preparation and the Presentation of Financial Statements*, paras 22, 93.

²⁹ *Ibid* paras 22, 96, In recognising expenses associated with the using up of assets such as plant and equipment the expenses are recognised in the accounting period in which the economic benefits associated with these items are consumed or expire.

³⁰ Div 70 ITAA 1997 commenced on 1 July 1997.

³¹ AASB *Framework* above n 28, paras 22, 92-95, 101; AASB 102, IAS 2 Inventories.

³² *Ibid.*

³³ J Hoggett et al, *Financial Accounting*, (6th ed, 2006), 255: Stock takes are required to detect accounting errors, losses and theft.

accounting provisions are long established and thus appear to be well understood by small business, taxation practitioners and administrators.

In July 1999 the *Review* recommended that the STS be introduced to reduce the compliance costs faced by small businesses.³⁴ Eligible small businesses could elect to join if their annual turnover or annual receipts were less than \$1 million, exclusive of Goods and Service Tax, and where they derived less than 5 per cent of their income from a leasing activity.³⁵ Under the proposed STS, small business would use cash accounting for business income and day-to-day expenditure (including a special treatment for prepayments) as an alternative to an accruals based regime.³⁶ Also, a simplified depreciation regime utilising pools would apply as an alternative to the general depreciation regime.³⁷ Further, a simplified trading stock regime would apply as an alternative to undertaking stocktakes and stock valuation.³⁸ The *Review's* STS recommendations appear to have been the flagship of its reforms for small business, being one of its largest tax expenditures³⁹ that would help a great number of taxpayers.⁴⁰

B Implementation of the STS

Subsequent to the release of the *Review's* report in September 1999 the federal Government sought consultation on the *Review's* STS proposals by asking for submissions on its *Exposure Draft; Business Tax System (Simplified Tax System) Bill 2000*. However, consultation on this Bill was strictly limited.⁴¹ Submissions criticising the design and complexity of the STS were provided to the federal Government.⁴² For example, industry bodies pointed to its lack of commerciality and unsuccessfully requested a wider definition of small business (with higher annual turnover thresholds), simpler integrity measures for groups and optional treatment of the four elements of the STS concessions, rather than mandatory application.⁴³ These concerns were ignored.⁴⁴

³⁴ *A Tax System Redesigned* above n 6, 575.

³⁵ *Ibid.*

³⁶ *Ibid.*

³⁷ *Ibid.*

³⁸ *Ibid.*

³⁹ *A Tax System Redesigned* above n 6, 698, 721.

⁴⁰ *Ibid* 576, The *Review* referred to 1993 data from the Australian Bureau of Statistics that 95 per cent of businesses would be eligible to join the STS since their turnover was less than \$1 million. Given that the STS did not commence until 1 July 2001 this figure appears to be grossly inflated.

⁴¹ Commonwealth Treasury National Tax Liaison Group meeting 7 December 2000, <<http://www.ato.gov.au/content.asp?doc=/content/Professionals/13389.htm&page=3#H6>>, The National Tax Liaison Group meeting minutes noted that 'Treasury viewed the STS consultation as very close to 'ideal', but were concerned that professional bodies did not share this view.'

⁴² Taxation Institute of Australia, Submission on the *Exposure Draft; Business Tax System (Simplified Tax System) Bill 2000*, 17 November 2000, 8.

⁴³ Bondfield above n 5, 359 notes that these issues were raised in a joint response made by the Taxation Institute of Australia, CPA Australia, Farmer's Federation and Council of Small Business Organisations of Australia.

⁴⁴ Explanatory Memorandum, *New Business Tax System (Simplified Tax System) Act 2000* para 1.6 though asserted: 'Consistent with the Governments approach to business tax reform, the detailed design of the STS has benefited from extensive consultation with business representatives and professional bodies.'

Consequently, the federal Government generally agreed⁴⁵ with the STS recommendations as detailed in the *Review's* report and these rules provided the basis for STS legislation contained in Div 328 ITAA 1997 and s 82KZM ITAA 1936. As discussed below, it was only after the introduction of the STS and some years of experience with its difficulties that the federal Government moved to reinvent the STS.

In implementing the STS, there appears to have been some uncertainty as to the federal Government's policy goals.⁴⁶ In the STS Explanatory Memorandum the federal Government provided a rationale of simplification of record keeping and reporting for the small business sector.⁴⁷ However, the Explanatory Memorandum⁴⁸ and s 328-50(1) ITAA 1997 both provided a secondary rationale for the STS concessions, asserting that these provisions would reduce the effective tax burden for small business by reducing their tax. Thus the STS appeared to have had two policy goals.

The federal Government had in mind STS concessions that would appeal to most small businesses given that '95% of all businesses' would be eligible.⁴⁹ However, this 95 per cent figure was overstated, for example, only 14 per cent of eligible small business adopted the STS in the year ended 30 June 2002.⁵⁰ As a result, it is evident that the primary STS policy goal of simplification for the small business sector was undermined given the unpopularity of the STS concessions. The secondary goal of reducing taxation for small business would be similarly unattainable given the low number of adoptions by small business.

The former STS was introduced on 1 July 2001 and as noted above, it comprised of a package of four elements involving: accounting methods,⁵¹ prepaid expenses,⁵² capital allowances⁵³ and trading stock.⁵⁴

The STS contained a number of structural flaws. The STS eligibility criteria failed to provide an appropriate universal definition of a 'small business'. The *Review* did not point to any research to underpin its definition of small business.⁵⁵ This is a structural flaw since all small businesses and only small businesses needed to be included the STS concessions. To simplify taxation law such a definition of 'small business' is needed to replace all other definitions of small business contained in the various taxation laws. The STS definition of a small business was different from that

⁴⁵ The major difference replacement with the 'less than 5% leasing income' criterion (See the *Review's* recommendation 17.1 above) with exclusions for leased assets from the STS capital allowances regime. Another requirement was added with the \$3 million depreciating assets limit in the former s 328-365(1)(c). Some minor modifications were made to the capital allowances recommendations. For example, depreciating assets with an effective life of 25 years or were to be dealt with by the general capital allowances provisions in Div 40 (recommendation 17.3(iii)). This was changed to include these assets in an STS long life pool with a 5% depreciation rate.

⁴⁶ McKerchar above n 5, 140-141.

⁴⁷ Explanatory Memorandum, *New Business Tax System (Simplified Tax System) Act 2000* paras 1.5-1.7.

⁴⁸ *Ibid* para 1.7.

⁴⁹ *Ibid* para 1.5.

⁵⁰ ATO Tax Practitioners Forum Issues Log (register n, A27),

<www.ato.gov.au/taxprofessionals/contentasp?doc+/content/39983.htm&page=165&H28_1> on 29/11/06.

⁵¹ Former subdiv 328-C. Note that taxpayers who joined the STS prior to 30 June 2005 can still use the cash accounting system.

⁵² s 82KZM ITAA 1936.

⁵³ Subdiv 328-D ITAA 1997.

⁵⁴ Subdiv 328-E.

⁵⁵ *A Tax System Redesigned* above n 6, 575-586.

utilised by the GST,⁵⁶ capital gains tax⁵⁷ and fringe benefits tax⁵⁸ concessions for small business.

The STS proved to be inflexible and complex. The inflexibility of the STS was evident in the mandatory application of the cash accounting, prepayment and capital allowance concessions.⁵⁹ This would mean that taxpayers would have to make an annual overall calculation of the net benefit from these concessions to work out whether they should join or remain in the STS.⁶⁰

Further, under the STS, taxpayers were required to make an election to join or to leave the STS.⁶¹ As discussed below, joining or leaving the STS involved significant compliance costs associated with ascertaining eligibility and estimating the benefits of joining or leaving the STS.⁶²

1 STS Eligibility Criteria

Small business taxpayers could elect to join the STS from 1 July 2001, in the income year when the taxpayer became eligible to be an STS taxpayer,⁶³ and up to 30 June 2007 when the system was replaced by the SBE regime. The STS applied to all entities (individuals, partnerships, trusts and companies).⁶⁴ A STS taxpayer must have satisfied the following three small business requirements in a particular income tax year, as well as notifying the Commissioner of their choice to enter the STS in a particular income tax year.

Under the first requirement, the taxpayer must have carried on a business during the year,⁶⁵ thus passive investors were excluded. Ascertaining whether a taxpayer carried on a business could be very difficult. There is no definitive approach as to what constitutes a business. Rather, the determination of a business is the result of a process of weighing up a number of relevant factors.⁶⁶ This approach creates considerable difficulties for taxpayers with small hobby-type activities that have some elements of business and lifestyle characteristics. Consequently, the vagueness of this definition has resulted in a plethora of cases⁶⁷ on business activity and a number of taxation rulings from the ATO.⁶⁸

The second requirement stipulated that the year's STS average turnover of an STS taxpayer and its grouped entities must have been less than \$1,000,000 net of GST credits and decreasing adjustments.⁶⁹ Note this threshold was increased to \$2,000,000

⁵⁶ Div 188 *A New Tax System (Goods and Services Tax) Act 1999* (GSTA), in relation to the small business cash accounting concession.

⁵⁷ Subdiv 152-A ITAA 1997, in relation to the small business CGT concession.

⁵⁸ s 58GA *Fringe Benefits Tax Assessment Act 1986*, in relation to the small business car parking fringe benefit concession.

⁵⁹ *A Tax System Redesigned* above n 6, 575-577.

⁶⁰ Former subdiv 328-F ITAA 1997.

⁶¹ Former subdiv 328-G.

⁶² Former subdivs 328-F, 328-G.

⁶³ Former s 328-435.

⁶⁴ Former s 328-365.

⁶⁵ Former s 328-365(1)(a).

⁶⁶ *Evans v FCT* (1989) 20 ATR 922; AAT CASE 12,860 *Re DAFF and FCT* (1998) 39 ATR 1042.

⁶⁷ *Martin v FCT* (1953) 90 CLR 470; *Ferguson v FCT* 79 ATC 4261; *FCT v Walker* 85 ATC 4179; *FCT v Stone* 2005 ATC 4234; *Puzey v FCT* [2002] FCA 1171; *FCT v Sleight* [2004] FCAFC 94.

⁶⁸ TR 97/11 'Income tax: Am I carrying on a Business of Primary Production?'; TR 2005/1 'Income tax: carrying on business as a professional artist'; TR 2003/4 'Income Tax: Boat hire arrangements'.

⁶⁹ Former s 328-365(1)(b).

from 1 July 2007 with the advent of the SBE regime.⁷⁰ This grouping rule prevented large businesses from splitting or restructuring into numerous entities so they were eligible to join the STS.⁷¹ Given its low turnover threshold, the STS favoured small business. Successful STS businesses were penalised though as they grew in size they were no longer eligible for the STS concessions. These eligibility requirements contained intricate rules for defining STS group turnover, defining the value of the business supplies, calculating grouping of an entity's turnover, working out who is an STS affiliate, defining control and indirect control of an entity and working out STS group turnover.⁷² Unfortunately, the STS grouping rules differed from the grouping rules for GST and this greatly added to its complexity for small business groups.⁷³

Thirdly, the total adjustable values⁷⁴ of depreciating assets⁷⁵ held at year end by the STS taxpayer and its grouped entities and deductible under Div 40 or subdiv 328-D, must have been less than \$3,000,000⁷⁶ (up until 30 June 2007).⁷⁷ The limit on the total value of depreciating assets that an entity and its grouped entities could have at the end of an income year ensured that large entities with low turnovers in early years of operation, but with large investments in capital assets, were not eligible to enter the STS.⁷⁸

The complexity of the eligibility rules for small business is evident from the need to satisfy the above three requirements. In particular, the detailed turnover and grouping rules will impose significant compliance costs on many small businesses.

2 Entering and Leaving

Entry into the STS was optional and that choice was usually made by notifying the Commissioner in the taxpayer's income tax return.⁷⁹ Notice may also have been given in an objection⁸⁰ or in an income tax assessment amendment request.⁸¹ A taxpayer, who notified the Commissioner to join in an income year could not revoke entry in that income year.⁸² Once a taxpayer joined the STS, however, the cash accounting, prepayment and depreciation rules were mandatory.⁸³ Only the trading stock rules were optional.⁸⁴ As noted previously, as a system, the STS was inflexible given the mandatory application of most of its features.

Additionally, joining the STS involved significant compliance costs associated with ascertaining eligibility and estimating the benefits of joining the STS as noted previously. STS taxpayers also needed to adjust their accounting systems for the uptake of cash accounting, prepayment deductions, pooled depreciation and for the

⁷⁰ s 328-110(1)(b).

⁷¹ Explanatory Memorandum *New Business Tax System (Simplified Tax System) Act 2001*, para 1.7.

⁷² s 328-365 – 328-380.

⁷³ s 328-365 – 328-380 ITAA 1997; Div 48 GST Act.

⁷⁴ s 40-85 ITAA 1997.

⁷⁵ s 40-30.

⁷⁶ Former s 328-365(1)(c).

⁷⁷ The former s 328-365(1)(c) was abolished on 1 July 2007 with advent of the SBE regime.

⁷⁸ Explanatory Memorandum *New Business Tax System (Simplified Tax System) Act 2001*, para 2.7.

⁷⁹ Former s 328-435 ITAA 1997.

⁸⁰ *Ibid*; TD 2003/31 'Income tax: Simplified Tax System: can an entity notify the Commissioner of its choice to become, or stop being, an STS taxpayer for an income year, after it has lodged that year's income tax return?' para 1.3.4.

⁸¹ s 170(5) ITAA 1936.

⁸² TD 2003/31.

⁸³ Former s 328-105(1), s 328-175(1) ITAA 1997, s 82KZM(1) ITAA 1936.

⁸⁴ s 328-285 ITAA 1997.

estimation of trading stock on hand if they chose the simplified trading stock rules. Adjustments to assessable income or deductions in the year of making the change may have significantly increased or decreased taxable income and hence income tax payable.

A taxpayer left the STS when the eligibility criteria did not apply in that particular year and the taxpayer notified the Commissioner, or when a taxpayer opted out and notified the Commissioner of a decision to leave the STS.⁸⁵ Notice of exiting the STS may have been given after the income tax year with an income tax assessment amendment request.⁸⁶

Accordingly, if a taxpayer left the STS because the business failed to satisfy the eligibility criteria or ceased to exist, then the taxpayer must exit the STS at the end of that income year.⁸⁷ In these situations, though, a taxpayer could immediately re-enter when the business satisfied the criteria⁸⁸ by applying to the Commissioner to rejoin the STS.⁸⁹

If a taxpayer chose to leave the STS the taxpayer needed to wait five years before re-entering and the taxpayer must have applied to the ATO to rejoin.⁹⁰ Additionally, that exit choice once made could not be revoked.⁹¹ The five-year period ran from the last income year in which the taxpayer was an STS taxpayer.⁹² The five-year rule did not apply to taxpayers re-entering who voluntarily exited before the 2005-06 income year.⁹³ The five-year rule, though, applied to taxpayers exiting in the 2005-06 income year.⁹⁴ Consequently, the STS five-year rule may have resulted in some game-playing as taxpayers rendered themselves ineligible for the STS so they did not have to wait five years to return.⁹⁵ However, with the introduction of the SBE regime on 1 July 2007 the five-year STS rule was abolished.⁹⁶

Leaving the STS conceivably created significant compliance costs associated with estimating the costs and benefits of leaving. In such circumstances, the accounting systems would have been altered for the non-STS environment. Adjustments to assessable income or deductions in the year of making the change may have significantly increased or decreased taxable income. Once in, an STS a taxpayer may have been unable to exit as a result of the income tax payable in doing so.

⁸⁵ s 328-440.

⁸⁶ TD 20003/31; s 170(5) ITAA 1936, note that a four year time limit applies.

⁸⁷ s 328-440(1)(b) ITAA 1997.

⁸⁸ See note at the former s 328-440(3).

⁸⁹ Former s 328-435.

⁹⁰ Former s 328-440(3).

⁹¹ TD 20003/29 'Income tax: Simplified Tax System: can an entity that has notified the Commissioner of its choice to stop being an STS taxpayer for an income year, later cancel that choice for that year'.

⁹² ATO ID 2003/38.

⁹³ *Income Tax (Transitional Provisions) Act 1997* (ITTPA) s32-440; Given the termination of mandatory cash accounting from 1 July 2005, this enables former STS taxpayers who left because of the cash accounting regime to immediately re-enter.

⁹⁴ Former s 328-440 ITAA 1997.

⁹⁵ Hine above n 5, 31.

⁹⁶ Explanatory Memorandum *Tax Laws Amendment (Small Business) Act 2007* para 4.32. Although, a similar five year exit requirement was introduced in the SBE depreciation regime, see para 5.7.3.

3 Other Issues

Additionally, STS taxpayers needed to adjust their accounting systems for the uptake or cessation of cash accounting, prepayment deductions, pooled depreciation and for the estimation of trading stock on hand if they chose the simplified trading stock rules. Adjustments to assessable income or deductions in the year of making the change may have significantly increased or decreased taxable income and hence income tax payable. Once in the STS, a taxpayer may not be able to afford to leave given the income tax consequences. Further, where a taxpayer chose to leave, the taxpayer then needed to wait five years before re-entering.⁹⁷

Some of the complexity arose from the way that the four STS income tax accounting concessions ignored the commercial reality that most small businesses use accruals accounting.⁹⁸ This meant that small business in the STS would have had to run and adjust for two sets of accounts, one for tax purposes and another for financial reporting purposes.

Then there was the high level of detail in the STS. This is evident in the eligibility requirements discussed above. Additionally, the STS provided highly detailed rules for its cash accounting, capital allowance and trading stock concessions.⁹⁹ This is also considered to be a structural flaw given that the STS was designed to simplify or lower compliance costs for small business.

Further, the STS favoured a minority of capital intensive small businesses given that the main concession involves temporary depreciation relief.¹⁰⁰ This is also a structural problem since the STS was designed to benefit the majority of small businesses yet it was poorly targeted. Additionally, the STS's aim of reducing the effective tax burden for small business was not achieved given the nature of the modest STS timing benefits from the temporary deferral of income tax and its unpopularity. A number of commentators queried the merits of these concessions finding that there were few (if any) simplicity benefits.¹⁰¹

C Phase One Reforms of the STS

In response to these concerns the federal Government implemented a series of amendments to the STS to make it more attractive to small business. The mandatory STS cash accounting basis created a number of problems for many small businesses that utilised accruals accounting and / or obtained little benefit from the concessions.¹⁰² Consequently, the system was abandoned from 1 July 2005.¹⁰³ STS

⁹⁷ Former s 328-440(3).

⁹⁸ ICAA Media Release 'Chartered Accountants Disappointed by Simplified Tax System Bill' 27 October 2000, notes that a recent survey had shown that between 60 and 75 per cent of small to medium business used accrual accounting.

⁹⁹ Former subdivs 328-C, 328-D, 328-E ITAA 1997, s 82KZM ITAA 1936.

¹⁰⁰ *A Tax System Redesigned* above n 6, 721. The *Review* estimated that the STS accelerated depreciation concession would be the most costly to tax revenue, with an estimated loss of in its first year of operation of \$240 million as opposed to the total revenue loss of \$520 m in that year.

¹⁰¹ Hine above n 5; Kenny above n 5; Snook above n 5; Wolfers, Miller above n 5; Martin above n 5; Douglas above n 5; Tretola above n 5; Bondfield above n 5; McKerchar above n 5.

¹⁰² Tretola above n 5, 14; Kenny 'A Simplified Tax System for Small Business' above n 5, 37; Snook above n 5, 77-78; Wolfers Miller above n 5, 376; Douglas above n 5, 11; Bondfield above n 5, 332-334.

¹⁰³ *Tax Laws Amendment (2004 Measures No. 7) Act 2005*, Sch 2.

taxpayers that joined before 1 July 2005 though can continue to use the cash accounting basis.¹⁰⁴

The STS capital allowance rules did not originally provide for any roll over relief (unlike the general depreciation regime in Div 40) for depreciating assets. To encourage the uptake of the STS,¹⁰⁵ optional roll-over relief was provided for partial changes in the ownership of an asset held by STS partnerships.¹⁰⁶ This change was applied retrospectively from the start of the STS, 1 July 2001.¹⁰⁷

Subsequently s 328-240 was repealed as result of new extended roll-over relief provisions contained in ss 328-243, 328-245 that applied from 1 July 2005. The requirement in the former s 328-240 that both entities must be partnerships was also changed. Only one of the entities needed to be a partnership under the new rules.¹⁰⁸

Additionally, new STS concessions were introduced with the STS exemption from the indirect value shifting rules,¹⁰⁹ the STS entrepreneurs discount¹¹⁰ and STS limited amendment periods.¹¹¹

In summary, whilst these amendments may have improved the attractiveness of the STS for small business these changes did not address the underlying structural problems in the STS. The amendments failed to provide an appropriate universal definition of a 'small business'. Further, a great deal of inflexibility and complexity remained with the three STS income tax accounting concessions. Additionally, these concessions continued to favour a minority of small businesses and only provided a timing benefit from the temporary deferral of income tax.

D Phase Two Reforms of the STS

On 12 October 2005 the Government established a taskforce chaired by Gary Banks (*Banks Taskforce*) to reduce the regulatory burden on small business.¹¹² The *Banks Taskforce's* report *Rethinking Regulation* was provided to the federal Government on 31 January 2006.¹¹³ The submissions to the *Banks Taskforce* called for a consistent definition of small business.¹¹⁴ The *Banks Taskforce* also found that there was a need to harmonise taxation law definitions and recommended that the definition of a small business be aligned or rationalised.¹¹⁵ Consequently, on 1 July 2007 the federal Government renamed and modified the STS in Div 328 as part of the new SBE regime¹¹⁶ so as to simplify tax law for small business.

¹⁰⁴ s 328-100 *Income Tax Transitional Provisions) Act 1997* (ITTPA 1997).

¹⁰⁵ Explanatory Memorandum, *Taxation Laws Amendment Act (No. 2) 2004* No. 20, para 7.5 states 'Roll-over relief is not currently available for reconstitutions of partnerships operating under the STS (i.e. STS partnerships), deterring some taxpayers from joining the STS. This measure will allow optional roll-over relief for STS partnerships subject to certain conditions.'

¹⁰⁶ The former s 328-240 ITAA 1997.

¹⁰⁷ Ibid.

¹⁰⁸ s 328-243.

¹⁰⁹ s 727-470.

¹¹⁰ Subdiv 61-J.

¹¹¹ s 170(1) ITAA 1936.

¹¹² Taskforce on Reducing the Regulatory Burden on Business (Chairman, Gary Banks) *Rethinking Regulation* 31 January 2006, <http://www.regulationtaskforce.gov.au/finalreport/>.

¹¹³ Ibid.

¹¹⁴ Ibid.

¹¹⁵ Ibid 169-170, Recommendation 5.43.

¹¹⁶ *Tax Laws Amendment (Small Business) Act 2007*.

III THE SMALL BUSINESS ENTITIES RULES

Helpfully for small business the new SBE definition of a small business aligned a number of small business taxation definitions.¹¹⁷ Apart from the former STS income tax accounting concessions, the SBE test applies to the following small business concessions:¹¹⁸

- CGT 15-year asset exemption subdiv 152-B;
- CGT 50% active asset reduction subdiv 152-C;
- CGT retirement exemption subdiv 152-D;
- CGT roll-over subdiv 152-E;
- Accounting for GST on a cash basis s 29-40 GSTA 1999;
- Annual apportionment of input tax credits for acquisitions and importations that are partly creditable s 131-5 GSTA 1999;
- Paying GST by quarterly instalments s 162-5 GSTA;
- FBT car parking exemption s 58GA of the FBTA 1986;
- PAYG instalments based on GDP-adjusted notional tax s 45-130 of Schedule 1 TAA 1953;
- Standard 2-year period for amending your assessment applies under s 170 ITAA 1936.

Additionally, these rules provide greater flexibility for small business. From 1 July 2007, SBE have the choice to apply any of the above SBE concessions since they are no longer compulsory,¹¹⁹ unlike most of the former STS concessions.¹²⁰ Under the SBE rules there is no need to lodge an election with the Australian Taxation Office to access the concessions and this would also reduce compliance costs.¹²¹ The former \$1 million STS average turnover threshold¹²² was replaced with a \$2 million aggregate turnover threshold¹²³ and the former STS \$3 million depreciating assets test was abolished.¹²⁴

The increase in the turnover threshold though will lead to some inequity as the larger small businesses will gain the most from the SBE regime. The removal of the depreciating asset limit requirement improves simplicity but structurally damages the integrity of the SBE definition of a small business. Under this SBE definition large and medium sized businesses (such as start up mining companies) will constitute SBE during their start up periods when they will satisfy the \$2 million turnover threshold.

Amendments were made to the above concessions to introduce the new term of SBE and to replace all former small business references (such as 'STS taxpayers'). However, some of the above concessions impose alternative tests to the SBE requirements. This undermines the simplicity benefit that could have been achieved from having a single definition of small business.¹²⁵ For example, the small business

¹¹⁷ Subdiv 328-C ITAA 1997.

¹¹⁸ s 328-10(1). Note that the concessions (dot pointed above) are outside the scope of this paper which focuses on the SBE income tax accounting concessions (the prepayment, depreciation and trading stock concessions).

¹¹⁹ s 328-110(1).

¹²⁰ Former subdivs 328-C, 328-D ITAA 1997, s82KZM ITAA 1936.

¹²¹ Subdivs 328-D, 328-E ITAA 1997, s82KZM ITAA 1936.

¹²² Former s 328-365(1)(b) ITAA 1997.

¹²³ s 328-110(1)(b).

¹²⁴ s 328-110(1).

¹²⁵ Hodgson H, 'Small business simplification – yet again?' (2007) 11 *The Tax Specialist* 140, 140.

capital gains tax concessions utilise an alternative \$6 million net assets test.¹²⁶ This breaches the *Review's* recommendation of an integrated tax code having 'a common dictionary to ensure consistency and greater standardisation of concepts across the Code'.¹²⁷

The former STS entry and exit rules in subdivs 328-F and 328-G were repealed as they are unnecessary under the fully optional SBE regime.¹²⁸ Complex transitional rules, though, were introduced to cater for the move from the STS to the SBE regime.¹²⁹

A Defining SBE

The SBE regime shares similar levels of complexity with the STS, with its complex annual eligibility criteria and aggregation rules.¹³⁰ An entity is a SBE if it carries on a business¹³¹ and satisfies the \$2 million aggregated turnover test¹³² as set out in the flow chart at figure 1.¹³³

1 Aggregated turnover test

The intricacy of the above flow chart is indicative of the complexity involved with the new SBE requirements. The flow chart shows how an entity will satisfy the \$2 million aggregated turnover test if any of the following three requirements are satisfied:¹³⁴

- the entity's aggregated turnover for the previous income year was less than \$2 million;¹³⁵
- the entity's aggregated turnover for the current income year is likely to be less than \$2 million, calculated as at the first day of the income year;¹³⁶ or
- the entity's actual aggregated turnover for the current income year was less than \$2 million, calculated as at the end of the income year.¹³⁷

A few modifications apply to the second and third criteria. The second requirement excludes businesses that have aggregated turnovers of more than \$2 million in each of the two income years before the current year.¹³⁸ SBE that only satisfy the third requirement are further restricted as they cannot choose the concessions for PAYG instalments,¹³⁹ GST cash accounting,¹⁴⁰ annual apportionment of input tax credits,¹⁴¹ or GST quarterly instalment concessions.¹⁴² This all means that small business will

¹²⁶ s 152-15.

¹²⁷ *A Tax System Redesigned* above n 6, 129.

¹²⁸ Explanatory Memorandum *Tax Laws Amendment (Small Business) Act 2007* para 4.33.

¹²⁹ *Tax Laws Amendment (Small Business) Act 2007* pp 49-56.

¹³⁰ Hodgson above n 94, 137

¹³¹ s 328-110(1)(a).

¹³² s 328-110(1)(b).

¹³³ Explanatory Memorandum, *Tax Laws Amendment (Small Business) Act 2007*, Diagram 1.1, 9.

¹³⁴ s 328-110.

¹³⁵ s 328-110(1)(b)(i).

¹³⁶ s 328-110(1)(b)(ii), 328-110(2).

¹³⁷ s 328-110(4).

¹³⁸ s 328-110(3).

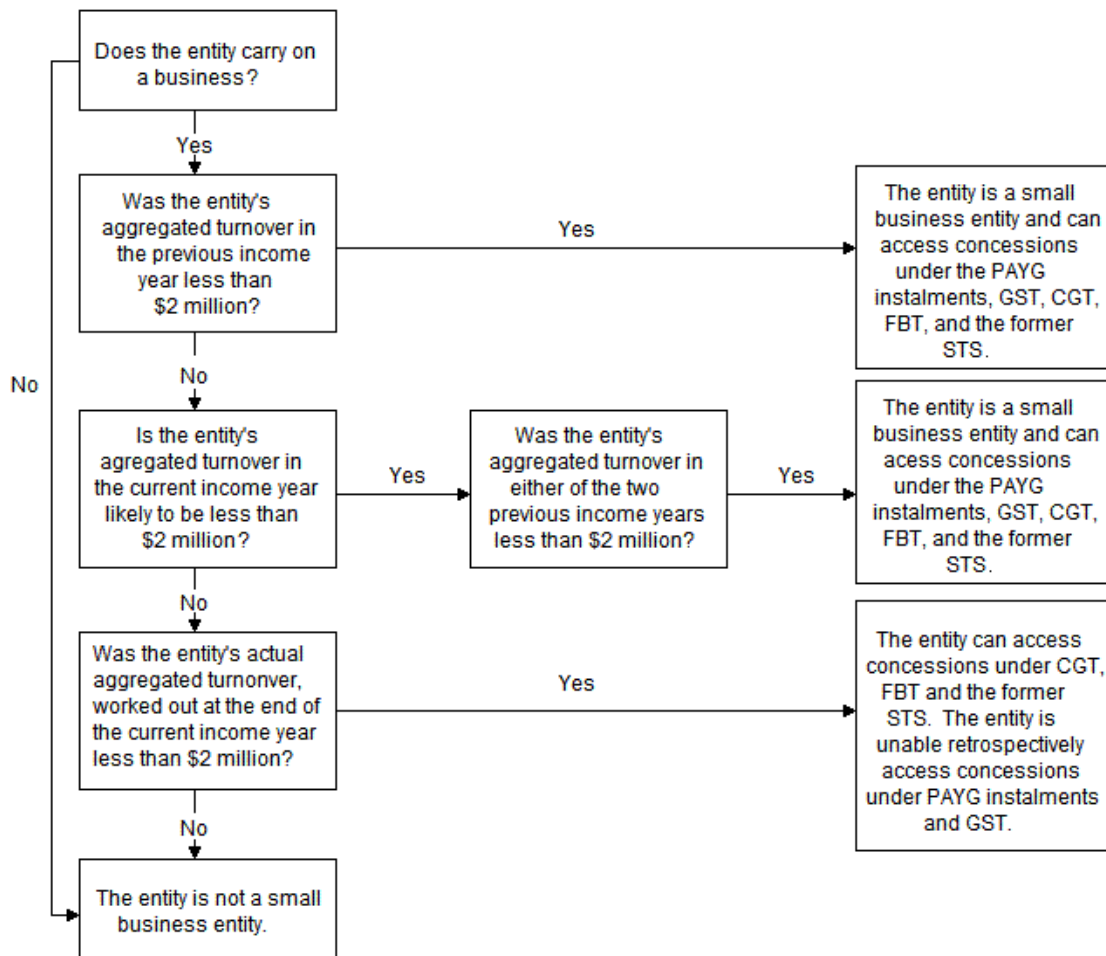
¹³⁹ s 45-130 of Sched 1 *Taxation Administration Act 1953*.

¹⁴⁰ s 29-40 GSTA.

¹⁴¹ s 131-5 GSTA.

¹⁴² s 162-5 GSTA

Figure 1: Defining a Small Business Entity
**Explanatory Memorandum, *Tax Laws Amendment (Small Business) Act 2007*,
 Diagram 1.1**



have to closely pay attention to these requirements to ensure that they are first eligible and secondly, that they satisfy at least one of the first two criteria so as to maximise their benefits under SBE regime.

2 Aggregated turnover

Aggregated turnover consists of an entity’s annual turnover plus the turnover of all other entities that need to be aggregated with it.¹⁴³ Working out aggregated turnover involves calculating an entity’s annual turnover, then applying the aggregation rules and finally adding up the aggregated turnover. Aggregated turnover excludes transactions between connected or affiliated entities.¹⁴⁴

¹⁴³ s 328-115(1),(2) ITAA 1997. Thus an entity's aggregated turnover will be the same as its annual turnover if no other entities are aggregated.

¹⁴⁴ s 328-115(3).

3 Annual turnover

An entity's annual turnover for an income year is generally the total ordinary income that the entity derives in the income year in the ordinary course of carrying on a business¹⁴⁵ excluding amounts that relate to GST¹⁴⁶ and amounts derived from sales of retail fuel.¹⁴⁷ Any ordinary income that an entity derives from any dealing with an associate of the entity is stipulated as the amount of ordinary income the entity would derive from the dealing as if it were at arm's length.¹⁴⁸

If a business is carried on for part of the income year only, the entity's annual turnover for the income year must be worked out using a reasonable estimate of what the entity's annual turnover for the income year would be if the entity carried on a business for the whole of the income year.¹⁴⁹ Regulations may allow a different calculation of annual turnover for particular entities.¹⁵⁰ The annual turnover exclusions and the need to make estimates for part year activities both add to the complexity of the SBE regime.

4 Aggregation Rules

The annual turnover of other entities needs to be aggregated with an entity if it is an affiliate of another entity, or if it is connected with another entity.¹⁵¹

(a) Affiliate

An individual or company is an affiliate of an entity where that individual or company acts, or could reasonably be expected to act in accordance with the entity's directions or wishes in relation to the affairs of that individual or company's business, or in concert with the entity in relation to the affairs of the individual or company's business.¹⁵² An individual or a company, though, is not an affiliate of an entity merely because of the nature of the business relationship the entity and the individual or company shares.¹⁵³

(b) Connected with another entity

An entity is connected with another entity if one of the entities controls the other entity, or if the two entities are controlled by the same third entity.¹⁵⁴ The control rules apply first to all entities except discretionary trusts.¹⁵⁵ Further rules apply to discretionary trusts.¹⁵⁶

¹⁴⁵ s 328-120(1).

¹⁴⁶ s 328-120(2).

¹⁴⁷ s 328-120(3).

¹⁴⁸ s 328-120(4): Amounts derived in an income year from any dealings between an entity and an associate that is a relevant entity within the meaning of section 328-115 are not included in the entity's aggregated turnover for that year: see subsection 328-115(3).

¹⁴⁹ s 328-120(5).

¹⁵⁰ s 328-120(6).

¹⁵¹ s 328-115(2).

¹⁵² s 328-130(1).

¹⁵³ s 328-130(2).

¹⁵⁴ s 328-125(1).

¹⁵⁵ s 328-125(2).

¹⁵⁶ s 328-125(3).

For entities other than discretionary trusts, an entity controls another entity where the first entity or its affiliates, or the first entity and its affiliates between them beneficially own, or have the right to acquire the beneficial ownership of, interests in the other entity that between them give the right to receive at least 40 per cent of any distribution of either income or capital.¹⁵⁷

For control of companies an alternative test applies. Where an entity alone or together with affiliates beneficially own, or has the right to acquire beneficial ownership of, interests in the company with at least 40 per cent of the voting power in the company then the entity will control the company.¹⁵⁸

An entity can control a discretionary trust in the following two situations. First, under the 40 per cent ownership test¹⁵⁹ an entity is taken to control a discretionary trust for an income year if, for any of the four income years before that income year the trustee paid any income or capital of the trust to or for the benefit of the first entity, its affiliates, or the first entity and its affiliates¹⁶⁰ and the amount paid or applied to the entity and/or its affiliates is at least 40 per cent of the total amount of income or capital paid or applied by the trustee for that income year.¹⁶¹ Secondly, control of a discretionary trust will occur where the trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of the entity.¹⁶²

An indirect control test also applies to all entities. If an entity (the first entity) directly controls a second entity, and that second entity also controls (whether directly or indirectly) a third entity, the first entity is taken to control the third entity.¹⁶³

Special rules may apply where an entity's interest in another entity is at least 40 per cent but less than 50 per cent. In this situation the Commissioner may choose to ignore the interest of that entity in the other entity if the Commissioner determines that a third entity actually controls the other entity.¹⁶⁴

The above overview of the SBE aggregation rules demonstrates a high level of complexity as seen in the former STS grouping provisions. Under the SBE regime changes have been made from the former STS small business definitions of turnover and slight changes have been made to the control tests. Hodgson notes that the SBE aggregation rules provide some minor improvement over the former STS rules.¹⁶⁵ Overall, these SBE rules are very difficult for small business to understand as evident in the 62 paragraphs of explanation provided in the Explanatory Memorandum accompanying these changes.¹⁶⁶

B Prepaid Expenses

For SBE taxpayers that choose the SBE prepayments rules, prepayments are immediately deductible if the eligible service period (the period of the benefit) of the

¹⁵⁷ s 328-125(2)(a).

¹⁵⁸ s 328-115(2)(b).

¹⁵⁹ s 328-125(4).

¹⁶⁰ s 328-125(4)(a).

¹⁶¹ s 328-125(4)(b).

¹⁶² s 328-125(3).

¹⁶³ s 328-125(7).

¹⁶⁴ s 328-125(6).

¹⁶⁵ Hodgson above n 125, 136-137. Noting that the control tests in relation to partnerships have been simplified.

¹⁶⁶ Explanatory Memorandum *Tax Laws Amendment (Small Business) Act 2007*, paras 1.11 – 1.73.

prepayment is 12 months or less and where the prepayment is otherwise deductible under s 8-1 ITAA 1997 or ss 73B, 73BA, 73BH or 73Y ITAA 1936.¹⁶⁷ Where the prepayments do not meet this requirement s 82KZM applies to pro rata deductions over the lesser of eligible service period or 10 years.

There are a number of exceptions to this general rule. An immediate deduction is available to all taxpayers (including SBE) for any excluded expenditure.¹⁶⁸ Excluded expenditure includes: expenses of less than \$1,000, expenses required to be incurred by law,¹⁶⁹ or by an order of a court or expenses of salary or wages made under a contract of service.¹⁷⁰ Tax shelter¹⁷¹ and plantation forestry operation prepayments¹⁷² are governed by their own prepayment regimes.

1 Further Issues

The STS / SBE prepayment rules were introduced to strengthen the rules for prepaid expenses¹⁷³ and to provide simplification benefits.¹⁷⁴ Rather than strengthen income tax law, these prepayment rules breach the principles for prepayments laid down in the *Review's* recommendations, namely, that prepaid expenses should be amortised over the period of benefit.¹⁷⁵ Whilst the prepayment rules provide SBE with a small timing benefit from the deferral of income tax and remove the need to account for certain prepayments as assets, it is not clear that there are any significant simplification benefits. This is seen by the way that these rules contradict accounting practices that require the accrual of prepaid expenses over the period in which the income that was directly related to those expenses was earned.¹⁷⁶ This may increase compliance costs as taxpayers would have needed to adjust their accounting records given the immediate deduction obtained for prepaid expenses for income tax purposes.

C Capital Allowances

SBE can opt to calculate deductions for their depreciating assets in accordance with subdiv 328-D,¹⁷⁷ rather than the general depreciation rules in Div 40. Under the SBE regime, depreciating assets are depreciated by using a pool as a single depreciating asset.¹⁷⁸ There are two types of pools. A general small business pool for depreciating assets with an effective life of less than 25 years¹⁷⁹ and a long life small business pool for depreciating assets with an effective life of 25 years or more.¹⁸⁰ An

¹⁶⁷ Ibid.

¹⁶⁸ s 82KZM(1)(b) ITAA 1936.

¹⁶⁹ ATO ID 20046/218 prepaid fees incurred by a company for the audit of its financial reports, were not an amount of expenditure required to be incurred by a law of the Commonwealth, a State or a Territory and thus not 'excluded expenditure.

¹⁷⁰ s 82KZL(1).

¹⁷¹ s 82KZME. The tax shelter rules require that the prepayment be amortised over the period during which the thing is to be done under the arrangement (the eligible service period).

¹⁷² s 82KZMG.

¹⁷³ Explanatory Memorandum *New Business Tax System (Simplified Tax System) Act 2001*, para 7.9.

¹⁷⁴ Ibid para 8.19.

¹⁷⁵ *A Tax System Redesigned* above n 6, 168-172.

¹⁷⁶ Hogettt above n 33, 130; AASB *Framework* above n 28, para 94, 95.

¹⁷⁷ s 328-175(1) ITAA 1997.

¹⁷⁸ s 328-185(1).

¹⁷⁹ s 328-185(2)(a).

¹⁸⁰ s 328-185(2)(b).

immediate write-off applies to depreciating assets costing less than \$1,000¹⁸¹ The *Review* argued that the simplified depreciation regime would mean substantial savings in compliance costs from the lesser record keeping in pooling assets and from the simpler rules for disposing of depreciating assets.¹⁸²

The SBE capital allowance rules helpfully retain many of the definitions used in the general capital allowance rules in Div 40, such as: depreciating asset,¹⁸³ effective life,¹⁸⁴ taxable purpose,¹⁸⁵ cost,¹⁸⁶ adjustable value,¹⁸⁷ low cost asset,¹⁸⁸ balancing adjustment event¹⁸⁹ and termination value.¹⁹⁰

1 *Excluded Assets*

Assets excluded from depreciation deductions under the general depreciation regime by s 40-45 are excluded from the SBE rules as well.¹⁹¹ This includes capital works deductible under Div 43, expenditure on certain IRUs¹⁹² relating to international submarine cables and film expenditure deductible under Div 10BA in Pt III of ITAA 1936 or film copyright expenditure under Div 10B in Pt III of ITAA 1936.¹⁹³ Additionally, horticultural plants are excepted.¹⁹⁴

Assets let or that are reasonably expected to be let predominantly on depreciating asset leases are excluded as well.¹⁹⁵ ATO Interpretive Decision ID 2004/651 provided guidance on the time at which it is necessary to determine, in respect of an asset that has not yet been let, whether there was a reasonable expectation that it would be let predominantly on a depreciating asset lease. For an asset held before joining the SBE, this decision must have been made in the first SBE year. If the asset was acquired whilst a SBE taxpayer, the decision must have been made at the end of the year of acquisition.

Assets placed in a low value pool under subdiv 40-E, or to a pool under former subdiv 42-L before the holder became a SBE are excepted.¹⁹⁶ Expenditure on in-house software allocated to a software development pool under subdiv 40-E is excluded as well.¹⁹⁷ Thus for software development pools used by taxpayers prior to entering the STS / SBE regimes, any future software development expenditure must

¹⁸¹ s 328-180(1).

¹⁸² *A Tax System Redesigned* above n 6, 582.

¹⁸³ s 40-30.

¹⁸⁴ ss 40-95 to 40-110.

¹⁸⁵ s 40-25(7).

¹⁸⁶ Subdiv 40-C.

¹⁸⁷ s 40-85.

¹⁸⁸ s 40-425(2).

¹⁸⁹ Subdiv 40-D.

¹⁹⁰ s 40-300.

¹⁹¹ s 328-175(2); ATO ID 2004/481 found that an STS taxpayer who built a farm shed on pastoral land could pool the construction expenditure in an STS pool as the shed constituted plant under Div 40.

¹⁹² s 995-1, an IRU is an indefeasible right to use a telecommunication cable system.

¹⁹³ s 40-45.

¹⁹⁴ s 328-175(5).

¹⁹⁵ s 328-175(6); Thus depreciating assets used in rental properties are excluded from the subdiv 328-D since the assets are part of property that is subject to a depreciating asset lease; In ATO ID 2003/375 an STS taxpayer could not claim a deduction under ss 328-180(1) or s 328-185 for an appliance, as the appliance was being let predominantly on depreciating asset lease rather than short-term hire agreement.

¹⁹⁶ s 328-175(7).

¹⁹⁷ *Ibid.*

continue to be allocated to the software development pool.¹⁹⁸ However, if a SBE taxpayer did not have a software development pool upon entry to the SBE then any new software development expenditure is deducted under a software development pool under Div 40, or the depreciating asset and the software are allocated to a small business pool.¹⁹⁹ Further, research and development assets depreciated under s 73BA of ITAA 1936, or for which a tax offset is chosen under s 73I are excluded.²⁰⁰

Additionally, SBE can choose whether the SBE capital allowance regime applies to the following assets. Primary producers in the SBE regime using depreciating assets which are deductible under subdiv 40-F or subdiv 40-G ITAA 1997 can choose between claiming deductions under those subdivisions or under subdiv 328-D.²⁰¹ This choice must be made in respect of each depreciating asset in respect of the first income year in which the taxpayer entered, or last joined the SBE regime, or in respect of the first year of use of the asset.²⁰² This choice is irrevocable.²⁰³ Where a transferor partnership makes a choice under s 328-175(3) for an asset, this choice also applies to the transferee partnership if roll-over relief under s 328-240 is chosen.²⁰⁴

In making these choices for subdiv 40-F or subdiv 40-G primary production assets, a SBE taxpayer needs to compare the depreciation deductions to those available under SBE so as to ascertain the optimal taxation position. However, the number of these exclusions and their optionality results in considerable complexity for small business especially where two or more methods of depreciation are utilised.

2 *Low cost assets*

The taxable (business) purpose proportion of the adjustable value of a low cost asset is immediately deductible for SBE.²⁰⁵ A low cost asset is a depreciating asset whose total cost is less than \$1,000 as at the end of the income year in which the taxpayer started to use it, or had it installed ready for use, for a taxable purpose.²⁰⁶ The taxpayer, though, must have been a SBE in the year of the deduction and in the year in which the taxpayer started to hold the asset.²⁰⁷

The taxable purpose proportion of the second element costs of low cost assets is immediately deductible where the taxpayer deducts an amount under s 328-180(1).²⁰⁸ A second cost element is the amount the taxpayer is taken to have paid to bring the asset to its present condition and location.²⁰⁹ The second element amount must be less than \$1,000 and the taxpayer must have started to use the asset, or had it installed ready for use, for a taxable purpose during an earlier income year.²¹⁰

Second cost elements of low-cost assets deducted under s 328-180 are allocated to the general small business pool in two situations.²¹¹ First, the costs are allocated

¹⁹⁸ Ibid See Note.

¹⁹⁹ s 328-175(8).

²⁰⁰ s 328-175(9).

²⁰¹ s 328-175(3).

²⁰² s 328-175(4).

²⁰³ Ibid.

²⁰⁴ s 328-245(3).

²⁰⁵ s 328-180(1).

²⁰⁶ s 40-425(2).

²⁰⁷ s 328-180(1).

²⁰⁸ s 328-180(2).

²⁰⁹ s 40-190.

²¹⁰ s 328-180(2).

²¹¹ s 328-180(3).

where the second element of the asset's cost exceed \$1,000.²¹² Secondly, where any amount is included in the second element of the asset's cost and the taxpayer deducts or could have deducted an amount under s 328-180(2) for an amount previously included in the second element of the asset's cost.²¹³

When a low cost asset that has been immediately written off is subject to a balancing adjustment event,²¹⁴ then the termination value²¹⁵ of the asset is included in the taxpayer's assessable income, to the extent of the business use.²¹⁶

Since immediate SBE deductions for low cost assets are restricted to assets acquired when a taxpayer is a SBE taxpayer,²¹⁷ then any low cost assets acquired prior to that time and allocated to a Div 40 low value pool²¹⁸ remain in that pool.²¹⁹ This write off is helpful for small business as it excludes many of their depreciating assets from taxation depreciation schedules. This benefit, though, is offset by the need to produce financial accounting reports that require depreciation schedules.²²⁰

3 Pooled Depreciating Assets

Depreciating assets with less than a 25 year effective life²²¹ are allocated to the general pool and use an accelerated diminishing value depreciation rate of 30 per cent.²²² Depreciating assets with an effective life longer than 25 years²²³ are allocated to the long life pool and use an accelerated diminishing value depreciation rate of 5 per cent.²²⁴ As discussed above, the use of two pools may simplify depreciation for certain small businesses.

However, much complexity is inherent in the pooling rules.²²⁵ Once the allocation is made to the pool this is irrevocable.²²⁶ Further, when a taxpayer leaves the SBE regime and subsequently re-enters, the assets remain in the pool.²²⁷ Depreciating assets acquired by the taxpayer outside of the SBE rules, though, can not be allocated to the pools until the taxpayer re-enters.²²⁸ Further, as noted above, under the pools a number of assets are excluded and other assets are optional under the SBE. This means that small businesses have to determine the optimal depreciation method and they may need to employ two or more methods of depreciation calculation. This adds to complexity.

²¹² s 328-180(3)(a).

²¹³ s 328-180(3)(b).

²¹⁴ s 40-295.

²¹⁵ s 40-300.

²¹⁶ s 328-215(4).

²¹⁷ Unless the item is 100 per cent deductible for a non-business taxpayer under s 40-80(2).

²¹⁸ Subdiv 40-E.

²¹⁹ s 328-180(1).

²²⁰ Hogettt above n 33, 130; AASB *Framework* above n 28, para 94, 95.

²²¹ ss 328-185(2)(a), (3), (4), s 328-180(3); ATO ID 2004/209 advises that a taxpayer should allocate a pre STS long life asset to their long life pool for the purposes of s328-185 where that asset has a remaining effective life of less than 25 years.

²²² s 328-190(1)(a).

²²³ ss 328-185(2)(b), (3),(4),(5),(6).

²²⁴ s 328-190(1)(b).

²²⁵ Hine above n 5, 34; Bondfield above n 5, 331-332; Kenny above n 5, 40; McKerchar above n 5, 142-144.

²²⁶ s 328-185(7).

²²⁷ s 328-220(1).

²²⁸ s 328-220(2).

4 Pool Depreciation Calculations

SBE can claim a capital allowance deduction for a depreciating asset they hold and start to use or have installed ready for use, for a taxable purpose during or before the income year.²²⁹ A deduction for pooled depreciation for an income year is based on the opening pool balance multiplied by the pool rate for the general pool and the long life pool.²³⁰ Depreciating assets and second element costs added by a SBE taxpayer during the income year to the general pool attract a 15 per cent rate and additions to the long life pool attract a 2.5 per cent rate.²³¹ This, though, provides scope for manipulation given the significant accelerated depreciation tax deduction for depreciating assets acquired (or second cost amounts incurred) on or near the end of the income tax year.

5 Opening Pool Balance

When a taxpayer enters the SBE regime the opening pool balance is the sum of the taxable purpose proportions of the adjustable values of each depreciating asset held immediately prior to joining.²³² However, a problem occurs for taxpayers with capital gains on pre 21 September 1999 depreciable assets as they lose any indexation benefit when placed into the SBE depreciation pool.²³³ Another problem arises for assets allocated to an SBE pool since they can not be included in the value of assets for the purposes of the NCL 'Other assets' test in s 35-45 (as the table in s 35-45(2) only lists assets deductible under Div 40). These rules work to deter small businesses from entering the SBE regime.

The opening pool balance for the next income year is the taxpayer's closing pool balance from the previous income year, unless an adjustment is made for a variation in the taxable use of an asset.²³⁴

For taxpayers who leave the SBE and re-enter, any assets acquired in the absence from the SBE are added into the pool upon re-entry.²³⁵ Thus the opening pool balance is the closing balance from the previous year plus the taxable purpose proportion of the adjustable values²³⁶ of assets used for a taxable purpose when absent from the SBE rules.²³⁷

²²⁹ s 328-175(1); In ATO ID 2004/208 an STS taxpayer was not able to claim a capital allowance deduction for a depreciating asset they previously leased, and subsequently acquired seconds before they sold the asset, as the asset was not used or installed ready for use, in the year in question per s 328-175(1).

²³⁰ s 328-190(1)

²³¹ ss 328-190(2)-(4).

²³² s 328-195(1).

²³³ s 118-24(1) exempts Div 328 depreciating assets from the capital gains tax rules. Thus the SBE depreciation rules will govern the assessability of the disposal of such SBE depreciating assets.

²³⁴ s 328-195(2).

²³⁵ s 328-195(3).

²³⁶ s 40-85.

²³⁷ Ibid.

6 *Estimate of Taxable Use*

Subsequent to joining the SBE depreciation regime, a taxpayer must make a reasonable estimate of the taxable use of assets added to the pools.²³⁸ If the estimate of taxable purpose is more than 10 per cent different from the most recent estimate, the taxpayer needs to change the opening pool balance accordingly.²³⁹ Considerable complexity arises when a change in the business use of a depreciating asset occurs. For example, s 328-225(4)(a) provides the following complex formula:²⁴⁰

(4) The reduction factor in the formula in subsection (3) is:

(a) for a depreciating asset you started to use, or have installed ready for use, for a taxable purpose while you were an STS taxpayer:

$$[1 - (\text{rate}/2)] \times [1 - \text{rate}]^{n-1}$$

This variation though is not required in a general pool if the change in taxable purpose occurred three years or more after the income year in which the asset was allocated to the pool.²⁴¹ For long life pools the variation is not required if the change in taxable purpose occurred twenty years or more after the income year.²⁴² Averaging rules apply for calculating the taxable purpose proportion of a depreciating asset's termination value according to whether the asset was allocated to a general or long life pool.²⁴³ As this overview shows, such individual calculations offset the compliance cost benefits of pooling assets.²⁴⁴

7 *Closing Pool Balance*

The closing pool balances for the two pools are calculated as the opening pool balances for the income year and adding the business use proportion of the adjustable value of new asset additions or improvements first used in that year, less the following amounts.²⁴⁵ The business use proportion of the termination value of pooled depreciating asset disposed in the income year; the s 328-190(1) deductions allowed for the pool's depreciation for the income year; and the deductions for depreciation on an asset or improvement to the pool and first used, or installed ready for use, for a taxable purpose in that year.²⁴⁶ This provides for a simpler depreciation calculation since calculations do need to be made for individual assets (unless the assets are excluded and subject to another depreciation regime, or have an element of non-

²³⁸ s 328-205(1), 328-225; ATO ID 2004/89 provides that an STS taxpayer estimates the taxable use proportion of a pre STS asset under s 328-205 at the end of the income year the asset is allocated to an STS pool.

²³⁹ s 328-225(1A).

²⁴⁰ Wolfers Miller above n 5, 374, the authors stated 'Maybe for a mathematically gifted small business operator, a formula such as this provides no challenge. However, for the average lawyer with a limited mathematical knowledge, it is not so simple.'

²⁴¹ s 328-225(5)(a)(i).

²⁴² s 328-225(5)(a)(ii).

²⁴³ s 328-205(4).

²⁴⁴ Also, see McKerchar above n 5, 143.

²⁴⁵ s 328-200.

²⁴⁶ Ibid.

business use). This benefit, though, is offset by the need to produce financial accounting reports that require individual calculations.²⁴⁷

8 *Low Value Pool Write Off*

If the value of the small business pool was \$1,000 or lower then the balance is immediately deductible.²⁴⁸ This value is determined by the pool's opening value plus the business proportion of assets acquired during the income year and deducting the business proportion of assets disposed during the income year.²⁴⁹ This will simplify tax depreciation for micro businesses that have very few low cost assets. Again, this benefit is offset by financial accounting requirements that require depreciation schedules.²⁵⁰

9 *Asset Disposals*

Upon the disposal of a low cost depreciating asset (costing less than \$1,000), the business proportion of the asset's termination value must be returned as income.²⁵¹

In relation to the disposal of pooled assets the business proportion of the asset's termination value must be subtracted from the pool balance at the end of the income year.²⁵² If the disposal produces a negative pool balance then this amount is included as assessable income in that income year²⁵³ and the closing pool balance is zero.²⁵⁴

This will simplify tax depreciation for small business where there is a disposal of an asset given that a balancing adjustment²⁵⁵ will not need to be calculated. However, this benefit is offset by financial accounting requirements that require depreciation schedules.²⁵⁶

10 *Leaving the SBE regime*

When a taxpayer leaves the SBE depreciation regime the entity must wait five years after opting out to re-enter.²⁵⁷ If an entity chooses to use subdiv 328-D, the entity must retain the small business pools even after the entity stops being a SBE or chooses not to use subdiv 328-D.²⁵⁸ This lack of flexibility offsets the simplification benefits.

²⁴⁷ Hogettt above n 33, 130; AASB *Framework* above n 28, para 94, 95.

²⁴⁸ s 328-210(1).

²⁴⁹ s 328-210(2).

²⁵⁰ Hogettt above n 33, 130; AASB *Framework* above n 28, para 94, 95.

²⁵¹ s 328-215(4).

²⁵² s 328-215(2); ATO ID 2004/363 provides that s40-370 does not apply to STS taxpayers that sell a car for which car expense deductions have been calculated under Div 28 using the one-third of actual expenses method and the 12 per cent of original value method for different income years, rather the STS rules in subdiv 328-D apply.

²⁵³ *Ibid.*

²⁵⁴ s 328-215(3).

²⁵⁵ s 40-295.

²⁵⁶ Hogettt above n 33, 130; AASB *Framework* above n 28, para 94, 95.

²⁵⁷ s 328-175(10).

²⁵⁸ s 328-185(7) see note, s 328-220.

11 *Further Issues*

The STS / SBE depreciation regime was designed to reduce compliance costs by the pooling of depreciating assets²⁵⁹ and to reduce the tax burden of small business.²⁶⁰ Whilst there will be reduced record keeping and simpler accounting for depreciating asset disposals for certain small businesses, there are a number of reasons why these benefits are limited.

First, the SBE accelerated depreciation rates mainly benefit a minority of small businesses that have high cost depreciating assets. Secondly, this benefit has been reduced by the re-introduction of accelerated depreciation into Div 40. This is particularly so for businesses having significant depreciating assets with effective lives of 6 2/3 years or less. The same applies for businesses having significant depreciating assets with effective lives of between 25-40 years. For such assets the accelerated depreciation rates are much higher under the Div 40 capital allowance rules as seen by the example shown in table 1.

Table 1: Comparison of Diminishing Value (DV) depreciation rates under Div 40 and Subdiv 328-D
(The higher of the Div 40 or the STS DV rates are outlined in bold)

| Asset | Effective Life Years | STS / SBE DV rate | Div 40 DV rate Post-10 May 2006 assets |
|-----------------|----------------------|-------------------|--|
| Iron tank stand | 33.33 | 5% | 6% |
| Fence | 20 | 30% | 10% |
| Truck | 15 | 30% | 13.33% |
| Log trailer | 10 | 30% | 22.5% |
| Tractor | 6 2/3 | 30% | 30% |
| Taxis | 4 | 30% | 50% |

Thirdly, the inflexibility and complexity of the SBE depreciation regime would appear to offset the simplification gains. Fourthly, the widespread use of computer software packages to calculate depreciation under Div 40 would produce few difficulties in updating depreciation calculations. Fifthly, given that many small businesses are likely to own relatively few depreciating assets then any compliance savings from subdiv 328-D would be small. Finally, the SBE treatment is contrary to accounting practices where depreciable assets are required to be amortised over the period in which the income that is directly related to those assets is earned.²⁶¹ This means small business will have to prepare two sets of accounts, for taxation and financial accounting purposes.

²⁵⁹ Explanatory Memorandum *New Business Tax System (Simplified Tax System) Act 2001*, paras 5.6 – 5.8.

²⁶⁰ *Ibid* para 1.7.

²⁶¹ Hoggett above n 33, 130; AASB *Framework* above n 28, para 94, 95.

D *Trading Stock*

Under the SBE trading stock regime taxpayers have a choice in adopting the simplified trading stock regime or utilising the normal trading stock rules in Div 70.²⁶² In the SBE regime, where the difference between the value of the trading stock on hand at the start of an income year and the reasonably estimated value at the end of the year is less than \$5,000, SBE do not have to value each item of trading stock at year end and account for any changes in the value of trading stock.²⁶³ The opening value of trading stock is deemed to equal the closing value of trading stock.²⁶⁴ If the change in trading stock is greater than \$5,000 the normal trading stock rules apply.²⁶⁵ In 1999, the *Review* considered that 75 per cent of small business would be able to use this exemption and that the removal of the need to account for trading stock would simplify small business tax accounting.²⁶⁶

E *Further Issues*

The rationale for the special STS / SBE trading stock rule was one of simplification for small business.²⁶⁷ Avoiding a stock take under the SBE rules, though, can result in significant costs for small business as follows. First, there is the difficult problem of working out what constitutes a 'reasonable estimate' of trading stock in s 328-285(1)(b). Secondly, it appears that the general trading stock rules in Div 70 also apply to taxpayers electing to use the SBE trading stock rules, thus further complicating subdiv 328-E.²⁶⁸ Thirdly, most small businesses will nevertheless need to carry out a stock take for financial accounting and internal control purposes.²⁶⁹ Finally, the \$5,000 limit recommended in 1999 has not been indexed for inflation and given the low take up of the STS, many small businesses carrying trading stock would not appear to be affected by subdiv 328-E. As commentators noted in respect of the STS trading stock rules, the non tax benefits of stock takes exceeded the costs of undertaking stock takes.²⁷⁰

F *Summary*

The great number of small businesses eligible for the SBE concessions means that considerable resources are employed by small businesses in annually calculating their eligibility and the net benefits from the various concessions. Given the complexity of the SBE income tax accounting concessions, this is likely to be a very time intensive process and costly for taxpayers who prepare their own tax returns. Many of these taxpayers will simply choose to ignore the concessions given their complexity. Other

²⁶² s 328-285(2).

²⁶³ s 328-285(1).

²⁶⁴ s 328-295(1).

²⁶⁵ s 328-290.

²⁶⁶ *A Tax System Redesigned* above n 6, 586.

²⁶⁷ Explanatory Memorandum *New Business Tax System (Simplified Tax System) Act 2001*, para 6.2.

²⁶⁸ In ATO Interpretive Decision ID 2003/90 the Commissioner asserted that an STS taxpayer could make an election under s 70-100(4) to treat their trading stock as disposed of at a closing value other than market value, provided the conditions in s 70-100 were satisfied.

²⁶⁹ *AASB Framework* above n 28, paras 22, 92-95, 101; AASB 102, IAS 2 Inventories.

²⁷⁰ Hine above n 5, 3-38; Bondfield above n 5, 334; Kenny above n 5, 41-42; McKerchar above n 5, 144.

taxpayers who rely on tax practitioners will incur extra costs in accessing the concessions given their complexities.

The structural problems in the former STS of inflexibility, complexity and the poor targeting of small business, all re-appear in the SBE regime. The SBE rules are too complicated and provide too few benefits for small business.

IV CONCLUSION

The SBE regime attempts to fix some of the problems that arose from the former STS. The streamlining the definition of a small business for the various taxation concessions and the improved flexibility are steps in the right direction but other problems remain.

The SBE regime does not address the underlying structural problems in the STS. That is, the new rules fail to provide an appropriate universal definition of a 'small business'. The various small business taxation concessions still have a number of additional or alternative requirements that negate the benefit of the SBE definition. This breaches the *Review's* recommendation of an integrated tax code having a common dictionary.

Further, the removal of the \$3 million depreciating asset limit damages the integrity of the SBE definition of a small business since larger capital intensive businesses will constitute SBE during their start up periods when they will satisfy the \$2 million turnover threshold. The increase in the turnover threshold will lead to further inequity as larger small businesses gain the most from the SBE regime. The question of what constitutes a small business still remains to be answered. The taxation laws need an appropriate and universal definition of small business.

The optional treatment of the three SBE income tax accounting concessions appears to provide some improvement to simplicity for small business. However, the SBE eligibility rules and the depreciation, prepayment and trading stock concessions share similar complex technical issues as the former STS provisions. Adjusting to the new rules also involved transitional costs.

Additionally, the SBE income tax accounting concessions are a blunt policy device as they continue to favour a minority of small businesses and only provide a timing benefit from the temporary deferral of income tax. Overall, these three SBE income tax accounting concessions do not appear to offset the compliance costs for the small business sector by reducing the effective tax burden for small business. Future publication by the Australian Taxation Office of the take up of the SBE income tax accounting concessions by small business will provide very important feedback to policy makers as to the success of these reforms.