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ACCOUNTING PRINCIPLES AND TAXATION RULES FOR SMALL BUSINESS: THE IMPACT OF RALPH

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I INTRODUCTION

The income tax laws currently run to over 8000 pages of legislation in stark contrast to the relatively succinct accounting rules. This highlights the many differences between these rules in determining and calculating net income. The *Ralph Report*, however, sought to 'align more closely taxation law with accounting principles wherever possible'.¹ This article seeks to examine the appropriateness of such an approach, using the new Simplified Tax System² ('STS') for small business as a case study.

In doing so this article firstly provides a background to the STS provisions and sets out the eligibility requirements. Secondly, this article compares the tax accounting features of the STS system with both the non-STs income tax laws and the accounting rules. This comparison finds that the STS exacerbates departures between the accounting and tax rules. Additionally, this article examines the justification for the STS with regard to the taxation policy goals of simplicity, equity or efficiency. This article finds that the STS fails these generally accepted taxation policy benchmarks. The article concludes that it would be better for policy makers to work toward reducing the volume of income tax law for small business by aligning the income tax laws more closely with the accounting rules.

II BACKGROUND

Given the complexity burdens placed on small business from the massive income tax reforms flowing from the 1999 Ralph Report³ and the introduction of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) ('*GSTA 1999*'),⁴ the Government stated that it would also introduce measures to help simplify the tax system for small business:

1.4 The STS modifies the method of determining taxable income for certain businesses with straightforward, uncomplicated tax affairs. Eligible businesses that choose to use the STS will have access to simpler depreciation, trading stock and accounting arrangements (although the remaining tax rules apply outside these areas).

1.5 The Review of Business Taxations report *A Tax System Redesigned* recommended the STS and the Government supported that recommendation (Treasurers Press Release Nos. 58 and 59 of 21 September 1999). The Review of Business Taxation estimated that around 95% of all businesses, and 99% of farming businesses, would be eligible for the STS.

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¹ Review of Business Taxation (John Ralph, chair), *A Tax System Redesigned: more certain, equitable and durable* (Final Report, 1999) ('*Ralph Report*')155.

² *Income Tax Assessment Act 1997* (Cth) div 328.

³ *Ralph Report*, above n 1.

⁴ Note, however, this symmetry is far from perfect. The annual turnover for GST purposes per *GSTA YEAR* (Cth) div 188 is different to that defined as STS average turnover in s 328-375 of the *Income Tax Assessment Act 1997* (Cth).

1.6 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.

1.7 The object of the STS is to provide the following benefits to those businesses eligible to enter the STS:

- a reduction in effective tax burden; and
- simplified record keeping and reporting requirements.

The STS also contains integrity measures to ensure that ineligible businesses cannot structure or restructure their affairs to take advantage of these benefits. These measures reinforce that the STS is designed for small businesses with straightforward and uncomplicated affairs.⁵

Indeed the *ITAA 1997* states that STS would not only simplify the law but would reduce the tax burden for small business.⁶

III ELIGIBILITY TO JOIN THE 'SIMPLIFIED' TAX SYSTEM

The STS commenced on 1 July 2001 and is optional for small business taxpayers. To be eligible to join the STS⁷ a taxpayer must carry on a business during the year and meet the following two small business threshold tests.

The annual business turnover must be less than AUD 1 000 000 net of GST credits.⁸ Entities that are unable to meet this general eligibility test have the option of recalculating their STS average turnover by either using actual turnover for the current year, or estimating their group turnover for the current year plus the estimated group turnovers for the following two years.⁹ This provides some symmetry with the small business cash accounting turnover threshold of AUD 1 000 000 in *GSTA 1999* s 29-40.¹⁰ This calculation is far from simple as seen by draft taxation ruling TR 2002/11 which runs for some 125 paragraphs.

Additionally, there are anti-avoidance rules¹¹ to prevent large businesses dividing their businesses into smaller parts so as to claim the benefits of the STS. As commentators have noted, these rules are extremely complex.¹² For example, there are rules for: defining STS group turnover, defining the value of the business supplies, grouping of an entity's turnover, working out what entities are STS affiliates, defining control and indirect control of an entity, and working out STS group turnover. For an example of the complexity involved, see the rules for grouped entities in s 328-38 of the *ITAA 1997*.¹³ Further, the annual turnover test has a number of anomalies. Firstly, the AUD 1 000 000 threshold appears to be somewhat arbitrary. There will be some very small businesses with high turnover and low gross margins, such as service stations and liquor outlets, that will be ineligible.

⁵ Revised Explanatory Memorandum ('*Revised EM*'), *New Business Tax System (Simplified Tax System) Act 2000*, paras 1.4-1.7.

⁶ *Income Tax Assessment Act 1997* (Cth) s 328-50(1).

⁷ *Income Tax Assessment Act 1997* (Cth) s 328-365.

⁸ *Income Tax Assessment Act 1997* (Cth) s 328-365(1)(b).

⁹ *Income Tax Assessment Act 1997* (Cth) s 328-370.

¹⁰ Note, however, this symmetry is far from perfect. The annual turnover for GST purposes per *GSTA YEAR* (Cth) div 188 is different to that defined as STS average turnover in s 328-375 of the *Income Tax Assessment Act 1997* (Cth).

¹¹ *Income Tax Assessment Act 1997* (Cth) s 328-375 – 328-380.

¹² Robert Douglas and Roan Fryer, 'Tax simplification for small to medium business' (2000) (Taxation Institute of Australia, New South Wales State Division, Convention, 25 May 2000) 8, 10; Michael Hine, 'Small business tax system (STS)' (Taxation Institute of Australia, Western Australian Division, State Convention May 2001), 24, 29; Ian Snook, 'Simplified Tax System: a favourable current, a riptide or just plain dead calm?' Taxation Institute of Australia, South Australian Division, State Convention 3 May 2001, 75,75; Paul L Kenny, 'A "Simplified Tax System" for small business: Or, just another tax preference?' (2002) 6(1) *Taxation Specialist* 36, 43.

¹³ See TR 2002/6 which explains the complexity of the grouping rules in some 177 paras.

Also, to join the STS, business depreciating assets must be less than AUD 3 000 000.¹⁴ The limit on the total value of depreciating assets that an entity and its grouped entities can have at the end of an income year will ensure that entities with low turnover in early years of operation, but with large investments in capital assets, are not eligible to enter the STS.¹⁵

The value of a depreciating asset for an income year means basically the cost of the asset less any amounts representing decline in value that have been deducted or are deductible against it under Division 40 or Division 328. In establishing whether the value of an entity's assets and its grouped entities total less than AUD 3 million, the closing pool balance of each pool will need to be added to the adjustable value of any depreciating assets of the entity and its grouped entities which have not been subject to the pooling arrangements.¹⁶ Again, these calculations could become very complicated for small business groups.

Entry into the system is optional and a business joins by completing an application to the Australian Taxation Office ('ATO').¹⁷ If you leave the system you must wait five years before you can re-enter and must apply to the ATO to rejoin.¹⁸ Complex entry and exit adjustment rules ensure that taxpayers in the STS do not double count or omit income and deductions.¹⁹

Comparison will be made below between the tax and accounting perspectives of the following features of the STS system: accounting method adopted for income and expenses; treatment of prepaid expenses; depreciation of plant, equipment and trading stock.

IV ACCOUNTING METHOD FOR INCOME AND EXPENSES

A *The 'Non-Simplified' Income Tax Regime*

Because the *ITAA 1997* is based on a tax income year ended 30 June,²⁰ it is necessary for taxpayers to allocate income and expenses to the appropriate tax year. The judicial interpretation of the Act's key words related to income and expense, namely 'derived' and 'incurred', has generally²¹ resulted in an accruals type system of tax accounting for business income and expenses as described below. Taxpayers do not have a choice between using cash or accruals accounting. Rather, the tax accounting method is dictated by such factors as the type and scale of the small business activity and the circumstances of the transactions.

1 *Timing of Income*

Business income is generally included as income in the accounting period when it is 'derived'.²² Derived is not defined in the *ITAA 1997*, so the method of accounting adopted must reflect the taxpayer's true income per *Commissioner of Taxes (SA) v The Executor, Trustee and Agency Company of South Australia Ltd* ('*Carden*');

¹⁴ *Income Tax Assessment Act 1997* (Cth) s 328-365(1)(c).

¹⁵ *Revised EM*, above n 5, para 2.7.

¹⁶ *Income Tax Assessment Act 1997* (Cth) s 328-365(2).

¹⁷ *Income Tax Assessment Act 1997* (Cth) s 328-435(b).

¹⁸ *Income Tax Assessment Act 1997* (Cth) s 328-440(3).

¹⁹ *Income Tax Assessment Act 1997* (Cth) s 328-110, 328-115.

²⁰ *Income Tax Assessment Act 1997* (Cth) s 4-10.

²¹ Paul Kenny, *Australian Tax 2004* (2004) 124. Note: there are exceptions. See, eg, *FCT v Woolcombers (WA) Pty Ltd* (1993) 47 FCR 561.

²² *Income Tax Assessment Act 1997* (Cth) s 6-5 includes most business income as assessable income, although there are exceptions to this rule. Eg, capital gains will be caught by the timing rules in Part 3-1.

derived is to be determined by the application of ordinary business and commercial principles and that the method of accounting to be adopted is that which is calculated to give a substantially correct reflex of the taxpayer's true income.²³

There are two principles that emerged from *Carden* in respect of the derivation of business income. The first is that accruals accounting basis is generally appropriate for business income. That is, income is derived not upon receipt but when it is earned.²⁴ This will generally²⁵ occur where a business issues an invoice to a customer or a customer enters a contract to make payments for goods or services supplied.²⁶

The second principle states that a cash receipts basis may be appropriate for the derivation of income for certain small sole professional practitioners.²⁷ Whilst there may be some difficulty in determining whether a small professional practice should use cash or accruals, it is submitted that this problem could not be considered as significant as it applies to relatively few taxpayers and is addressed by the Commissioner's taxation ruling TR 98/1.

2 Timing of Expenses

The timing of deductions for business are generally²⁸ governed by when an expense is 'incurred' under s 8-1. However, incurred is not defined in the *ITAA 1997* and the courts have consistently declined to give any exhaustive meaning of 'incurred'. Rather the courts have developed a number of principles governing the meaning of incurred. It is clear that an expense does not have to be paid to be incurred under s 8-1. In *Federal Commissioner of Taxation v James Flood Pty Ltd*²⁹ it was held that deductions were not incurred unless 'the taxpayer has completely subjected himself to them'.³⁰ In *New Zealand Flax Investments Ltd v Federal Commissioner of Taxation*³¹ Dixon J stated:

"Incurred" does not mean only defrayed, discharged, or borne, but rather it includes encountered, run into, or fallen upon. It is unsafe to attempt exhaustive definitions of a conception intended to have such a various or multifarious application. But it does not include a loss or expenditure which is no more than impending, threatened or expected.³²

*RACV Insurance Pty Ltd v Federal Commissioner of Taxation*³³ and *Commercial Union Assurance Co of Australia Ltd v Federal Commissioner of Taxation*³⁴ both involved insurance companies that were successful in obtaining deductions for estimated insurance claims since the liability had arisen in the income tax year.

²³ (1938) 63 CLR 108, 154; 5 ATD 98, 131.

²⁴ *Fincon (Constructions) Ltd v IRC (NZ)* [1970] NZLR 462; see taxation ruling TR98/1.

²⁵ Exceptions apply to invoices that carry a discount, ignore the discount as income: *Ballarat Brewing v FCT* (1951) 82 CLR 364. An invoiced amount may also not be income is subject to some future contingency or subject to a refund: *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314.

²⁶ *FCT v Australian Gas Light Co* 83 ATC 4800: ie, to be earned and therefore derived, a recoverable debt must be created such that a taxpayer is not required to take further steps before becoming entitled to payment.

²⁷ *Commissioner of Taxes (SA) v The Executor, Trustee and Agency Company of South Australia Ltd* (1938) 63 CLR 108 ('*Carden*'), *FCT v Firstenberg* 76 ATC 4141; *FCT v Dunn* 89 ATC 4141.

²⁸ Most business expenses are deductible under s 8-1 when incurred, although there are exceptions where a specific deductions provisions applies. For example, borrowing costs are deductible over the lesser of five years or the life of the loan per s 25-25.

²⁹ (1953) 10 ATD 240, 244.

³⁰ *Ibid.*

³¹ (1938) 61 CLR 179.

³² *Ibid.* 242.

³³ 74 ATC 4169.

³⁴ 77 ATC 4186.

3 *Prepaid Expenses*

Previously prepaid expenses were generally deductible when incurred under s 8-1³⁵ the Government moved to limit this timing loophole by limiting the deductibility of prepayments in 1988.³⁶ The prepayment rules were further amended in 1999.³⁷ For businesses that do not enter the STS and incur expenditure for doing a thing that is not to be done wholly within the income year in which the benefit is incurred, the expenditure is apportioned over the eligible service period.³⁸ This is the period over which the services are to be provided up to a maximum of ten years.

B *Accounting Treatment*

1 *Timing of Income*

The accounting conceptual framework calls for an accruals treatment of revenue and expenses. Statement of Accounting Concept SAC 4 *Definition and Recognition of the Elements of Financial Statements* ('SAC 4') requires that a revenue should be recognised in a reporting period when and only when:

- (a) it is probable that the inflow or other enhancement or saving in outflows of future economic benefits has occurred; and
- (b) the inflow or other enhancement or saving in outflows of future economic benefits can be measured reliably.³⁹

This correlates very closely with the non-STS income tax law requirements that ordinary income is generally derived when earned.

2 *Timing of Expenses*

SAC 4 requires that an expense be recognised in a reporting period when and only when:

- (a) it is probable that the consumption or loss of future economic benefits resulting in a reduction in assets and/ or an increase in liabilities has occurred; and
- (b) the consumption or loss of future economic benefits can be measured reliably.⁴⁰

The accounting treatment of timing of expenses thus generally equates with the income tax concept of 'incurred'.

3 *Prepaid Expenses*

Clearly a prepaid expense will fall outside an expense under SAC 4 since such 'expense' will be recognised as an asset under SAC 4. SAC 4 requires that an asset should be recognised in the statement of financial position when and only when:

- (a) it is probable that the future economic benefits embodied in the asset will eventuate; and
- (b) the asset possesses a cost or other value that can be measured reliably.⁴¹

³⁵ *FCT v Brand* 95 ATC 4633.

³⁶ *Income Tax Assessment Act 1936* (Cth) s 82KZM.

³⁷ *Income Tax Assessment Act 1936* (Cth) s 82KZMA – 82KZMD.

³⁸ *Income Tax Assessment Act 1936* (Cth) s 82KZMA – 82KZMD. Note transitional rules apply for expenditure incurred from 22 September 1998 to 21 September 2002.

³⁹ The Institute of Chartered Accountants in Australia, CPA Australia, *Accounting Handbook* (2001) 37.

⁴⁰ *Ibid.*

Again the accounting treatment will generally correlate with the non-STS income tax law requirements that an expense is generally deductible when incurred and that generally a prepaid expense be accrued over the relevant period of the prepayment.

C STS Rules

1 Timing of Income

Under the STS, a taxpayer is not be required to bring to account, at year end, income when it is derived under s 6-5;⁴² rather, ordinary income will be calculated on a cash basis.⁴³ Thus business sales for which payment has not been received will not constitute income. The cash accounting method does not apply to ordinary income if another provision of income tax law includes the amount at a different time.⁴⁴ Also, the cash accounting method does not extend to statutory income such as capital gains.

2 Timing of Expenses

Under the STS business expenses will only be deductible under ss 8-1 (general deductions), 25-5 (tax related expenses) and 25-10 (repairs), when paid.⁴⁵ Expenses owing at year end will not be deductible until paid. However, the cash accounting method does not apply to other specific deduction provisions.⁴⁶ As previously noted, entry adjustment rules ensure that when a business enters the STS and uses the new accounting arrangements business income and expenses affected by the new accounting arrangements are not recognised twice or omitted⁴⁷.

3 Prepaid Expenses

Under the new 12-month prepayments rule, an advance payment made by an STS taxpayer will be immediately deductible where it is incurred in respect of a period of service not exceeding 12 months and the period of service ends no later than the last day of the income year following the date on which the payment is made.⁴⁸ Small business taxpayers not entering the STS will move to the general scheme of the prepayments provisions.⁴⁹ This means that their deductions for incurred deductible prepayments expenditure will be apportioned over the service period or ten years, which ever is the lesser.

D Comparison

The non-STS accruals system of tax accounting substantially mirrors the treatment under accounting standards. The STS, however, produces a number of departures from accounting standards. Firstly, the cash system of tax accounting for income and expenses conflicts with SAC4. Secondly, the treatment of prepaid expenses also clashes with SAC4.

⁴¹ Ibid 36.

⁴² *Income Tax Assessment Act 1997* (Cth) s 328-105(1)(a).

⁴³ *Income Tax Assessment Act 1997* (Cth) s 328-105(1)(a).

⁴⁴ *Income Tax Assessment Act 1997* (Cth) s 328-105(2)(a); eg, if s 385-135 applies to defer the profit on sale of a second wool clip.

⁴⁵ *Income Tax Assessment Act 1997* (Cth) s 328-105(1)(b).

⁴⁶ *Income Tax Assessment Act 1997* (Cth) s 328-105(2)(b).

⁴⁷ *Income Tax Assessment Act 1997* (Cth) s 328-110, 328-115.

⁴⁸ *Income Tax Assessment Act 1936* (Cth) s 82KZM.

⁴⁹ *Income Tax Assessment Act 1936* (Cth) s 82KZMA – 82KZMD.

V DEPRECIATION

A *The 'Non-Simplified' Income Tax Regime*

The uniform capital allowance system⁵⁰ applies to depreciating assets that are acquired or constructed on or after 1 July 2001. Under these rules depreciating assets can be written off as deductions generally over the effective life. For assets costing less than AUD 1000 ('low cost assets') taxpayers may depreciate assets at accelerated rates in a low value pool.⁵¹ Assets acquired prior to 1 July 2001 are transferred into the new system at the old depreciation rates. Under this system taxpayers have to work out: the effective life of assets; depreciation rates; provide annual depreciation calculations; and account for any disposal of depreciating assets.

B *Accounting Treatment*

Accounting Standard AASB 1021 provides the rules for calculating the depreciation for non-current depreciating assets as follows:⁵²

5.1 The depreciable amount of a depreciable asset must be allocated on a systematic basis over its useful life. The depreciation method applied to an asset must reflect the pattern in which the asset's future economic benefits are consumed or lost by the entity. The allocation of the depreciable amount must be recognised as an expense, except to the extent that the amount allocated is included in the carrying amount of another asset.

5.2 In estimating the useful life of a depreciable asset, consideration must be given to the following factors:

- (a) expected physical wear and tear;
- (b) obsolescence; and
- (c) legal or other limits on the use of the asset.

5.3 The depreciable amount must be allocated from the time when a depreciable asset is first put into use or held ready for use...

C *STS Rules*

Under the STS small business taxpayers can obtain 100 per cent deductions for depreciating assets costing less than AUD 1000 to the extent of taxable use.⁵³ Simplified pooling arrangements provide accelerated depreciation deductions for assets costing more than AUD 1000.⁵⁴ Under the pools, assets with less than a 25 year life use a 30 per cent diminishing value rate, and assets longer than 25 years use a 5 per cent rate.⁵⁵ A further benefit is provided for depreciating assets acquired during the year since those assets are depreciated at half the pool rate (either 15 per cent or 2.5 per cent).⁵⁶

A type of balancing charge offset is retained under the STS.⁵⁷ Under the STS sales proceeds from the disposal an asset are written off against the pool.⁵⁸ This will generally also result in assessable income if the proceeds exceed the pool balance.

⁵⁰ *Income Tax Assessment Act 1997* (Cth) div 40.

⁵¹ *Income Tax Assessment Act 1997* (Cth) s 40-420 to 40-445.

⁵² ICAA, above n 39, 826.

⁵³ *Income Tax Assessment Act 1997* (Cth) s 328-180.

⁵⁴ *Income Tax Assessment Act 1997* (Cth) div 328-D.

⁵⁵ *Income Tax Assessment Act 1997* (Cth) s 328-190.

⁵⁶ *Income Tax Assessment Act 1997* (Cth) s 328-190.

⁵⁷ *Income Tax Assessment Act 1997* (Cth) s 328-215.

⁵⁸ *Income Tax Assessment Act 1997* (Cth) s 328-215.

The rules governing in which pool an asset is to be placed, however, are complex.⁵⁹ Also, considerable complexity arises when a change in the business use of a depreciating asset occurs. For example, s 328-225(4) provides the following formula:⁶⁰

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

D Comparison

Again, the non-STS depreciation regime is very similar to the treatment under accounting standards, that is, depreciation is generally expensed over the effective life of an asset. The STS, however, results in departures from accounting standards with its accelerated depreciation regime conflicting with AASB 1021.

VI TRADING STOCK

A *The 'Non-Simplified' Tax Regime*

Under the trading stock provisions, if you carry on a business and have trading stock on hand, the excess of closing stock over opening stock is included in assessable income.⁶¹ If the value of opening stock exceeds closing stock, the excess is deductible.⁶² Thus business must carry out an annual physical stock-takes to account for trading stock, and must also make elections on the value of closing stock⁶³ and in revaluing obsolete stock.⁶⁴

B *Accounting Treatment*

Accounting Standard AASB 1019 provides the rules for accounting for inventory. Paragraph 5.1 requires that inventories must be measured at the lower of cost and net realisable value.⁶⁵ Further, para 9.1 requires that 'the carrying amount of inventories sold must be recognised as an expense in the financial year in which the related revenue is recognised'.⁶⁶ This means that excess of closing stock over opening stock will increase revenue and the excess of opening stock over closing stock will increase expenses.

⁵⁹ See Hine, above n 12, 34; *Income Tax Assessment Act 1997* (Cth) s 328-185.

⁶⁰ Lachlan R Wolfers and J Miller, 'The Simplified Tax System: Is this Governmentspeak for "complex"?' (2001) 35 *Taxation In Australia* (Taxation Institute of Australia) 374, 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.'

⁶¹ *Income Tax Assessment Act 1997* (Cth) s 70-35.

⁶² *Income Tax Assessment Act 1997* (Cth) s 70-35.

⁶³ *Income Tax Assessment Act 1997* (Cth) s 70-45.

⁶⁴ *Income Tax Assessment Act 1997* (Cth) s 70-50.

⁶⁵ ICAA, above n 39, 695.

⁶⁶ *Ibid* 701.

C STS Rules

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 AUD 5000 or less, an STS taxpayer does not have to value each item of trading stock at year end and account for any changes in the value of trading stock.⁶⁷ If the change in trading stock is greater than AUD 5000 the normal trading stock rules apply.⁶⁸

D Comparison

The non-STs trading stock provisions are closely aligned to the treatment under accounting standards. The STS trading stock provisions again result in significant departures from accounting standards by ignoring trading stock variations in the calculation of income and expenses. This directly conflicts with the requirements of AASB 1019.

VII POLICY JUSTIFICATION FOR STS

Ideally the STS provisions should substantially meet the requirements of the three canons of good taxation policy: equity, economic efficiency and simplicity. As the *Ralph Report* notes, because the tax system ‘can significantly influence the efficiency with which Australia’s natural resources, capital and labour are used’, economic efficiency is important.⁶⁹ On equity the Report asserts it is ‘a basic criterion for community acceptance of the tax system’.⁷⁰ In respect of simplicity:

A major consideration in the formulation of the Review’s recommendations has been to remove anomalies and inequities between the treatment of economically similar transactions. This will allow significant simplification of the tax system.⁷¹

A Equity

Tax equity is generally defined in terms of horizontal equity and vertical equity.⁷² Horizontal equity demands equal treatment for people in similar circumstances.⁷³ This requires the determination of a tax base which is able to determine ‘similar circumstances’ so that an appropriate amount of tax can be imposed on a taxpayer. Accordingly, most commentators⁷⁴ have defined the tax base in terms of a taxpayer’s ‘ability to pay’.

Thus horizontal equity requires those having an equal ability to pay bear an equal tax burden.⁷⁵ Because horizontal equity concerns the equal treatment of equals, as a corollary, vertical equity is required to ensure that tax imposed on people in different circumstances is also fair. Most countries have progressive rates of income tax⁷⁶ so as to try to ensure that a person with a greater ability to pay, pays not only more tax, but at a higher income tax rate.

⁶⁷ *Income Tax Assessment Act 1997* (Cth) sub-div 328-E.

⁶⁸ *Income Tax Assessment Act 1997* (Cth) s 328-90.

⁶⁹ *Ralph Report*, above n 1, 13.

⁷⁰ *Ibid* 105.

⁷¹ *Ibid* 16.

⁷² Jeffrey Waincymer, *Australian Income Tax: principles and policy* (2nd edition, 1993) 30.

⁷³ P L Kenny, ‘Capital gains taxation for New Zealand’ (2001) 7(4) *New Zealand Journal of Taxation Law and Policy* 265, 269.

⁷⁴ David F Bradford, *Untangling the Income Tax* (1986) 150–1.

⁷⁵ Noël B Cunningham and Deborah H Schenk, ‘The Case for a Capital Gains Preference’ (1993) 48 *Tax Law Review* 319, 365.

⁷⁶ J Norregaard, ‘The Progressivity of Personal Income Tax Systems’ in P Shome (ed), *Tax Policy Handbook* (1995) 130.

Vertical equity requires both progressive income tax rates and a tax based on the ‘ability to pay’. It is apparent from the following analysis of winners and losers that the STS breaches horizontal and vertical equity.

Certain small businesses, however, are clear winners under STS. For example, businesses that satisfy the eligibility criteria are ahead because they can choose whether to enter the STS and thus optimise their tax planning opportunities. In particular, capital intensive small businesses appear to have the most to gain through accessing the accelerated depreciation regime. As set out above, the STS general pooled depreciation rate is 30 per cent for assets with a less than 25 year expected life use. For example, farmer outlays for tractors and harvesters will enjoy a 30 per cent depreciation rate under STS as opposed to a 22.5 per cent non-STs rate.⁷⁷ Under the STS, an immediate deduction is available for assets costing less than AUD 1,000.⁷⁸ Further, businesses can acquire an asset on the last day of an income tax year and obtain an immediate 15 per cent deduction. Miners, manufacturers and tradespeople are also among those likely to benefit from higher depreciation rates under the STS.⁷⁹

Taxpayers with large amounts of debtors compared to creditors will also benefit from the STS given the tax deferral from cash accounting. Previously, business income included debtors; under the STS only cash receipts are included as business income.⁸⁰ This benefit, however, will generally only provide a one-off cash saving for small business. Certainly this will be the case where small business retains a similar debt profile. For example, grape growers that are paid in three instalments over April, July and September will defer income on a cash basis.⁸¹ Builders, professional firms and manufacturers are also likely to be in the same situation.⁸² This tax deferral benefit, however, is ameliorated to some extent by the Pay As You Go (‘PAYG’) instalment regime.

Further, such taxpayers can take advantage of the 12 month prepayment rule that provides full deductions for prepaid expenses incurred in respect of a period of service not exceeding 12 months.⁸³ For taxpayers outside the STS such prepayments are subject to restrictions and deductions must be apportioned. The trading stock rules, however, will only provide a benefit to very small businesses given the AUD 5000 trading stock variation threshold.⁸⁴

Of course, the greater the amount of depreciable assets, debtors and prepayments that a business has, the greater the tax savings under the STS. Well-established and larger small businesses in certain industries emerge as the clear winners under the STS.

Other small businesses are losers in the STS. Businesses that fail the eligibility criteria cannot take advantage of the tax savings from the STS. For example, small business with an annual business turnover of AUD 1 000 000 or greater cannot take advantage of the STS.⁸⁵ Also, highly capital intensive small businesses with depreciating assets of AUD 3 000 000 or more do not qualify.⁸⁶

Taxpayers with large numbers of creditors compared to debtors will incur a cash flow problem from entering the STS because deductions for creditors are generally excluded.⁸⁷

⁷⁷ Snook, above n 12, 89–90; Fiona Martin, ‘STS Implications’ (2001) 36 *Taxation In Australia* 245, 251.

⁷⁸ Accounting Standard AASB 1019, para 5.3.

⁷⁹ *Ibid.*

⁸⁰ *Ibid* para 4.3.

⁸¹ Snook, above n 12, 89–90; Martin, above n 77, 251.

⁸² *Ibid.*

⁸³ Accounting Standard AASB 1019, para 4.3.

⁸⁴ *Ibid* para 6.3.

⁸⁵ Eg, Small businesses with high turnover and low margin are affected, such as liquor outlets and service stations.

⁸⁶ Accounting Standard AASB 1019, para 3.

⁸⁷ *Ibid* para 4.3.

Many retailers will fit into this situation.⁸⁸ For taxpayers that have a number of entities and complex structures the grouping rules may be so complex that compliance costs outweigh any benefits.⁸⁹ Additionally taxpayers with capital gains on pre- 21 September 1999 depreciable assets will lose any indexation benefit when such assets are placed into the STS depreciation pool.⁹⁰

Businesses with low levels of depreciable assets, debtors and prepayments will obtain little benefit from the STS. Thus small retailers, new small businesses and struggling small business emerge as the losers under the STS.

Horizontal equity is violated, as can be seen in the following example that compares a small business with high levels of depreciable assets (A) and a small business with low levels of depreciable assets (B). Outside the STS provisions, these two small business taxpayers (A and B) have the same taxable income, AUD 100 000, and pay the same amount of income tax. Under the STS regime, however, A elects to join and obtain depreciation benefits that reduce the taxable income to AUD 80 000. B obtains no depreciation benefits under the STS. This is inequitable since both taxpayers have the same ability to pay but now pay different amounts of income tax. The STS rules also breach horizontal equity between small businesses within the same industry. A clothing retailer with AUD 900 000 of sales income is eligible to join, whilst a nearby competitor with AUD 1 100 000 falls outside the STS. Further, horizontal equity is also breached since the STS regime excludes taxpayers who are not carrying on a business.

Vertical equity is also damaged because a taxpayer on the top marginal tax bracket obtains a greater benefit from the STS rules than a lower income taxpayer. STS benefits that reduce assessable income by AUD 20 000 for a top marginal rate taxpayer would save AUD 9700 income tax. Whereas for a taxpayer with a taxable income of AUD 50 000 would only save AUD 6300 income tax from the same STS benefit. Given that most larger small businesses would be operated by the high income and wealthier taxpayers,⁹¹ the breach of vertical equity must be substantial. The STS provisions clearly damage the integrity of the tax laws.

B *Economic Efficiency*

There is an extensive body of research that demonstrates the economic virtues of a neutral tax system and the ideal of a *comprehensive* income tax base.⁹² The *Ralph Report*'s business taxation design principles advocated that 'the tax base adopted should be as close as possible to comprehensive income'.⁹³ Similarly, the 1975 *Asprey Report*⁹⁴ and Government's 1985 *Draft White Paper*⁹⁵ preferred this tax base.

⁸⁸ Snook, above n 12, 89–90; Martin, above n 77, 251.

⁸⁹ Accounting Standard AASB 1019, para 3.

⁹⁰ *Income Tax Assessment Act 1997* (Cth) s 328-185(7).

⁹¹ Simon Kelly, 'Wealth on Retirement – Latest Estimates for Australia' (Paper presented to the 9th Annual Colloquium of Superannuation Researchers, University of New South Wales, 9–10 July 2001) 15, avail NATSEM (National Centre for Economic Modelling), Online Conference Paper - CP2001_004, <www.natsem.canberra.edu.au> at October 2005. The top 10% of the Australian population have 43% of the total wealth, while the wealthiest 50% have 90% of the wealth: Paul Kenny, 'Australian Taxation, Ethics and Social Capital' (2002) 21 (3) & (4) *Business and Professional Ethics Journal* (Florida) 109, 112–13.

⁹² *Ralph Report*, above n 1, 112: comprehensive income, defined as the sum, over an annual period, of a taxpayer's current revenue less current costs, and the net change in value of the taxpayer's assets and liabilities; Graeme S Cooper, 'An optimal or comprehensive income tax?' (1995) 22 *Federal Law Review* 414, avail <<http://uniserve.edu.au/law/pub/edinst/anu/flrv22/anoptima.htm>> at 27 June 2002.

⁹³ *Ralph Report*, above n 1, 111–12; however, the Report states:

The preferential tax treatment of depreciation by allowing accelerated depreciation rates and other concessions under STS impedes economic efficiency as it provides departures from the taxation of comprehensive income. This is evident from the above analysis of winners and losers under STS. The *Ralph Report*⁹⁶ noted that accelerated depreciation provides significant benefits to capital intensive industries, such as mining and manufacturing, rather than service industries. Thus it also distorts the economy as scarce resources are diverted away from activities that would have otherwise attracted them. This breaches neutrality because the STS tax system favours capital intensive small businesses. Further, the cash accounting and prepayments rules will also result in a further tax preference because certain small businesses will have a once-off tax saving from the tax deferred. It is submitted that the trading stock provisions, however, would have an insignificant impact given the low threshold of AUD 5000.

C Simplicity

Simplicity is an attribute that appears to have never sat very well with taxation laws⁹⁷ and is a difficult concept to define.⁹⁸ There is however, general agreement that simplicity is considered in terms of administration costs of the government and the compliance costs of taxpayers.⁹⁹

1 Compliance Costs

Compliance costs can be defined as the costs ‘incurred by taxpayers, or third parties such as businesses, in meeting the requirements laid upon them in complying with a given structure and level of tax’.¹⁰⁰ These costs will include the costs of keeping records, preparing taxation financial statements and taxation returns, obtaining tax advice, undergoing tax audits, tax planning and disputes. Taxes, however, can provide a number of benefits to taxpayers that may offset these costs.

Managerial benefits are provided as a result of improved business decision-making flowing from tax law compliance.¹⁰¹ The record keeping and financial information requirements of the tax laws provide taxpayers with better information to make business and

While the comprehensive income tax base may never be implemented in practice, most successful market economies use that base in designing and evaluating the performance of their operating income tax systems.....Not surprisingly, the prospect of unbridled application of the conceptual comprehensive income tax base in all circumstances attracts taxpayer concern – especially in relation to liquidity, valuation, volatility, loss offset and effects on international competitiveness. (at 2)

⁹⁴ Commonwealth Taxation Review Committee (K W Asprey, chair), *Full Report* (1975) (*Asprey Report*) paras 3.23–3.26.

⁹⁵ Australian Government, *Reform of the Australian Taxation System, Draft White Paper, Reform of the Australian Taxation system* (1985) 15.

⁹⁶ *Ralph Report*, above n 1, 305–6.

⁹⁷ See, eg, United Kingdom Parliament, *Parliamentary Debates*, 27 May 1853, col. 722. Gladstone said:

the Honourable Gentleman said that laws of this kind ought to be made intelligible to all persons who has not received a legal education. To bring the construction of these laws within the reach of such persons, was no doubt extremely desirable, but very far from being easy ... The nature of property in this country, and its very complicated forms, rendered it almost impossible to deal with it for the purpose of the income tax in a very simple manner.

See also: H H Monroe, QC, ‘Intolerable inquisition? Reflections on the law of tax’ (1981) 33 where the United Kingdom Special Commissioner of Taxation is quoted as stating in 1980 that: ‘the plea today is that it would be some advance if laws of this kind were intelligible to those who have received a legal education’.

⁹⁸ Boris I Bittker, ‘Tax reform and simplification’ (1974) 29 *University of Miami Law Review* 1, 1.

⁹⁹ Ruth Woellner, Stephen Barkoczy and Shirley Murphy, *Australian Taxation Law* (12th ed, 2002) 32.

¹⁰⁰ C Sandford, M Godwin and P Hardwick, *Administrative and compliance costs of taxation* (1989), 10.

¹⁰¹ Binh Tran-Nam, Chris Evans, Michael Walpole and Katherine Ritchie, ‘Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia’ (2000) 53 *National Tax Journal* 229, 232–3.

investment decisions although, notably, this information falls short of proper accounting reports. Additionally, taxpayers obtain a benefit since these compliance costs are generally tax deductible¹⁰² under ss 8-1 and 25-5.

There will also be cash flow benefits¹⁰³ to taxpayers that are able to defer the payment of tax. These tax savings to one section of the community, however, create substantial on-costs for other taxpayers. This includes: higher levels of taxes for other taxpayers (the need for this having been created by tax revenue leakage), diversion of investment to tax-advantaged arrangements, promotion of possible corruption, creation of case law complexity and taxation ruling complexity, greater numbers of disputes, ‘ring fencing’¹⁰⁴ and the loss of integrity to the tax system.

The following analysis shows that the STS does not appear to bring any considerable compliance cost reduction for small business.

(a) *STS Eligibility*

Generally, ascertaining eligibility to join will be quite simple for many small business taxpayers who easily fall within the STS parameters. Taxpayers at the margin, however, will encounter considerable complexities in dealing with the threshold tests and grouping rules.

Aside from the trading stock rules, the features of the STS are not optional, thus many taxpayers will have to make a rather complex calculation of the costs and benefits of joining. For example, a capital intensive business may obtain depreciation benefits as set out previously,¹⁰⁵ but will have to adopt cash accounting and prepayment rules even though they may obtain little benefit and incur greater compliance costs. Commentators¹⁰⁶ note that given the complexities of the STS and the trade-offs involved, there may be little benefit at all to small business.

(b) *Entering and Leaving*

Entering and leaving the STS is not a simple matter: taxpayers leaving must apply to rejoin the STS; for businesses voluntarily leaving the STS they have to wait five years to rejoin; taxpayers will plan to become ineligible taxpayers rather than leave voluntarily;¹⁰⁷ once in the STS a taxpayer may have difficulty in leaving the system because the debtors will now have to be brought to account;¹⁰⁸ and a small business may not be able to afford the cash flow costs of opting out.

(c) *Cash Accounting*

The cash accounting change will remove much of the need to account to debtors, creditors and work in progress until realisation. It is submitted that this will not result in a significant compliance saving for a number of reasons. Firstly, many small businesses prepare accounting reports on an accruals basis; using a cash accounting basis will only increase their compliance costs. Secondly, under the STS, businesses will not operate on a pure cash basis because accruals will apply to certain amounts of income and expenses as detailed above.

¹⁰² Ibid.

¹⁰³ Ibid.

¹⁰⁴ ‘Ring fencing’ refers to a government’s practice of introducing a growing number of complex, specific anti-avoidance rules to combat the manipulation of tax loopholes.

¹⁰⁵ Accounting Standard AASB 1019, para 5.3.

¹⁰⁶ Hine, above n 12, 31; Wolfers and Miller, above n 60, 374.

¹⁰⁷ Hine, above n 12, 1.

¹⁰⁸ *Income Tax Assessment Act 1997* (Cth) s 328-115(2).

Also, the GST cash accounting thresholds are different to the STS thresholds this may result in a taxpayer running two accounting systems, one for GST and one for income tax.

(d) *Prepayment*

Prepayment provisions may make the tax accounting process slightly easier because such expenses would not need to be accrued. This provides no real benefit, given that a business will still need to accrue such expenses for accounting reporting reasons and that these are only transitional benefits.

(e) *Capital Allowances*

The pooling system for depreciable assets will remove the need to calculate the depreciation separately for each individual asset and provide some simplicity. This, however, appears to be offset by a number of factors: the benefit is insignificant as business will still need to use effective life depreciation for accounting reporting reasons; and complex depreciation rules apply for pooling assets and for calculating changes in the private use of depreciable assets.

(f) *Trading Stock*

There may be a small simplicity benefit in the cost savings from not having to account for trading stock. This benefit, however, is considered to be minute for the following reasons:

- Many small businesses have no or insignificant levels of trading stock and thus the benefit is negligible.
- Businesses with trading stock will still have to calculate a reasonable estimate of trading stock each year. How is this done without a stocktake?¹⁰⁹
- Most small business with trading stock will have variations in opening and closing stock that exceed AUD 5000, and so this provision may have little impact.

(g) *Managerial Benefits to Taxpayers*

There appear to be few managerial benefits from better record keeping and accounting flowing from the STS. The STS — by using a cash basis instead of accruals, accelerated depreciation instead of effective life, and by not carrying out stock-takes — encourages taxpayers to abandon proper financial reporting. Yet, for example, small business will still be required to furnish financial accounts in order to obtain finance. Additionally, where a small business elects to take up the STS it will still have to use accruals for most types of statutory income and deductions. Using both cash and accruals will only add to complexity. Small business involved in primary production, for example, will be affected, given the multitude of special primary production provisions in respect of income and expenses.¹¹⁰

(h) *Tax Deductibility Benefits*

If the STS results in greater compliance costs, this will be offset by the tax deductions obtained. Conversely, if the STS achieves its aim and reduces compliance costs, the tax deduction benefit will fall.

(i) *Cash Savings From Tax Preferences*

¹⁰⁹ Snook, above n 12, 84.

¹¹⁰ See, eg, special capital allowance write-offs in div 40.

The primary compliance benefit for small business taxpayers appears to be cash flow savings from tax deferral by utilising the cash accounting and accelerated depreciation rules. There will also be tax savings for STS taxpayers with significant levels of prepaid expenses. Indeed the Revised Explanatory Memorandum to the *New Business Tax System (Simplified Tax System) Act 2000* estimates these savings to be AUD 280 million in the 2001/02 year increasing to AUD 337 million in the 2004/05 year.¹¹¹

(j) *On-Costs of Tax Preferences*

The STS however, imposes considerable on costs for non-STS taxpayers.¹¹² Firstly, the tax saved will only result in higher levels of taxes or additional taxes for non-STS taxpayers. Secondly, the STS integrity rules add to the ring fencing in the *ITAA*.¹¹³ As noted above, businesses will try to work around these integrity rules to maximise the benefits of the STS. Affluent taxpayers engage in a ‘tax audit lottery’, exploiting grey areas of tax law and risking the chances of being audited. It also encourages corruption in the administration and practice of tax law. Further, under the STS, it will be likely that case law complexity will increase because the STS brings new terminology into the tax laws¹¹⁴ and provides many borderlines for turnover, trading stock and depreciable asset thresholds. The sheer complexity of the anti-avoidance measures are likely to lead to disputes. Indeed the Australian Taxation Office has produced two long and complex taxation rulings on the integrity measures in the STS.¹¹⁵

2 *Administration Costs*

The STS imposes costs on a Government aside from the loss of a significant amount of tax revenue. Loopholes damage the integrity of the tax system, encourage avoidance and evasion as taxpayers seek to exploit the depreciation and cash accounting tax benefits. This leads to disputes, increased case law complexity, taxation ruling complexity and ‘ring fencing’ as noted above.

Furthermore, the STS results in considerable set up costs of bringing in the new legislation. The Australian Taxation Office also needs to provide ongoing private rulings, fact sheets, taxpayer advice, educational seminars and incur costs of dispute resolution associated with the STS. Also, entering and leaving the STS is not a simple matter and brings significant maintenance costs to the Australian Taxation Office because the STS requires that taxpayers make application to the Australian Taxation Office to re-enter the STS.

VIII CONCLUSION

The STS experience provides a number of valuable lessons for policy makers. Firstly, such tax preferences add to the volume and complexity of tax law and damage equity and efficiency. Secondly, aligning the income tax laws more closely with accounting rules achieves real simplification and would remove tax law anomalies and inequities. If the

¹¹¹ *Revised EM*, above n 5, 1–2.

¹¹² Jonas Agell, Peter Englund and Jan Södersten, ‘Tax reform of the century – the Swedish experiment’ (1996) 49 *National Tax Journal* 643, 659. Such transactional costs are reflected in the results of a 1994 survey on the 1991 Swedish tax reforms that broadened the tax base and lowered income tax rates. The survey found that households actually spent less time on tax compliance in the years after the tax reforms. The more comprehensive the income tax base and fewer the tax preferences, the lower the compliance costs.

¹¹³ See *Income Tax Assessment Act 1997* (Cth) s 328-375 to 328-380.

¹¹⁴ Eg, *Income Tax Assessment Act 1997* (Cth) s 328-205(3) (‘taxable purpose proportion’), s 328-370(1) (‘STS average turnover’).

¹¹⁵ TR 2002/6; TR 2002/D3.

government's goal is to compensate small business for the regressive compliance costs of the new tax system, then a direct government grant is a superior method of assisting all small business.