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Abstract
This article explains why the Simplified Tax System came about. It considers the work of the Ralph Committee leading to the introduction of the Simplified Tax System. It then explains how the Simplified Tax System currently operates and includes a discussion of the recent amendments. It asks two main questions - has the Simplified Tax System (STS) simplified tax at all for Australian taxpayers, and if there are any worthwhile aspects about the Simplified Tax System, should it be extended any further?

THE SIMPLIFIED TAX SYSTEM - HAS IT SIMPLIFIED TAX AT ALL AND, IF SO, SHOULD IT BE EXTENDED?

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This article explains why the Simplified Tax System came about. It considers the work of the Ralph Committee leading to the introduction of the Simplified Tax System. It then explains how the Simplified Tax System currently operates and includes a discussion of the recent amendments. It asks two main questions - has the Simplified Tax System (STS) simplified tax at all for Australian taxpayers, and if there are any worthwhile aspects about the Simplified Tax System, should it be extended any further?

When it announced the introduction of the Simplified Tax System (STS), the government indicated that it expected some 95% of all businesses and 99% of all farming businesses would be eligible for the STS. This article explores how successful the system has been in terms of what percentage of all eligible taxpayers have chosen to enter the system and whether it has, in fact, led to a more simple and easier to understand tax system.

THE SIMPLIFIED TAX SYSTEM (STS)

The legislation to introduce the Simplified Tax System (STS) was contained in the *New Business Tax System (Simplified Tax System) Act 2001*. The Act inserted Division 328 into the *Income Tax Assessment Act 1997* (ITAA97)[1].

The STS arose from the Review of Business Taxation (RBT)[2]. The STS was designed to respond to the need to remove the additional and regressive compliance burden faced by small business[3] and to promote a simpler and more certain system of taxation. The RBT claimed that 95% of businesses and 99% of primary production businesses would be able to meet the STS criteria.[4] Many commentators have queried these sorts of estimates and also whether the benefits of STS would be more than just minimal to make any change worth the trouble.[5]

It seems these estimates of such a high eligibility take-up rate for STS are based on flawed data.[6]

That data comes from as long ago as 1993 and includes information from a large number of dormant businesses. These estimates also appear not to have taken into account the effect of the STS grouping rules.[7]

The STS began on 1 July 2001 as a system designed to reduce compliance costs for small business and to also provide other particular benefits to eligible small business taxpayers. It allows eligible small businesses to use so called 'simpler' accounting, depreciation and trading stock requirements to determine their taxable income.

The system arguably uses simpler methods, but also has scope for accelerated tax deductions for some businesses, which may in turn reduce taxable income and thereby improve business cash flows

1 All legislative references are to the *Income Tax Assessment Act 1997* (ITAA97,) unless otherwise stated.
2 Chapter 17 of *A Tax System Redesigned* (AGPS, Canberra, July 1999).
3 As reported in numerous research articles for example, C Evans, K Ritchie, B Tran-Nam and M Walpole, *A report into taxpayer costs of compliance* (1997, Commonwealth of Australia, Canberra) 51.
4 Explanatory Memorandum to the New Business Tax System (Simplified Tax System) Bill 2000 at 6.
5 L Wolfers and J Miller, 'The Simplified Tax System: Is this Government speak for 'complex'?' 35 (Feb 2001) *Taxation in Australia* 374.
6 1993 Australian Bureau of Statistics Publication.
7 Wolfers and Miller, above n 4, 375.

(by reducing tax payable). However, not all businesses eligible to use STS will necessarily benefit from it.[8]

In addition, it should be noted that, until the recently announced changes[9] to the STS system, STS was a 'package' and it was not possible to use only some aspects of STS. In other words, if a taxpayer had decided to enter STS, they were required to use all of its features, including the capital allowance rules (although the trading stock rules allowed some discretion).

REQUIREMENTS TO ENTER AND USE THE STS

The eligibility requirements to be a simplified tax system taxpayer are set out in s 328-365 of ITAA97. These original requirements from 2001 included the following:

(1) Carrying on a business in the year of income

In order to enter or remain in the STS the taxpayer must have been carrying on a business at some time during the year. This means therefore that investors, who are rental property owners, unless they are in the business of carrying on a rental property business, would not qualify for the STS.[10]

(2) STS average annual turnover of less than $1 million

The business must have an STS average turnover of less than $1 million. The STS average turnover is the sum of the taxpayer's 'STS group turnovers' for any 3 of the previous 4 income years, divided by 3 (s 328-370). This formula is adjusted if the taxpayer did not carry on business in each of the previous 4 years.

This turnover figure does not include GST[11] and is also comparable (but not identical) with the definition of turnover in the GST Act.[12] The definition of 'turnover' excludes supplies that are not made in the ordinary course of business, for instance, sales of capital assets, goods taken for own use or rent and transfers between grouped entities, insurance recoveries and dividends are also excluded.[13]

The rationale for this averaging is to ensure that a business does not fail the test only because it experiences unusually high turnover in any one particular year. However, this apparently simple test of calculating the average annual turnover of a business has a number of anomalies[14]. Quite apart from how arbitrary the $1 million limit is, it fails to allow for some small businesses with high turnover but low gross margins, such as service stations and liquor outlets.

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8 Generally speaking, a business will be better off entering STS in a year when it has a high level of debtors and a low level of creditors (as its taxable income will be lower). Also, a business with many depreciable assets that have high rates of depreciation (that is, rates above 30%, for example with computer equipment which has a rate of 37.5%) would not benefit by entering STS as the depreciation rates are only 15% for newly acquired assets in the first year rising to only 30% in subsequent years.

9 As contained in the Joint Press Release by the Treasurer and the Minister for Small Business and Tourism, Melbourne, 13 November 2006 and again more recently on 12 April 2007 (Treasurer Press Release entitled 'Reducing Red Tape and the Regulatory Burdens on Business').

10 Although a taxpayer who qualifies for STS and who also holds investments, can apply the STS rules to all income and deductions, whether they are business related or not: J Newby, 'Simplified Tax System: Oasis or Mirage?' paper presented to a seminar of the Taxation Institute of Australia (20 March 2001, Brisbane) 1.

11 As made clear by s 328-365(1)(b) of ITAA97.

12 As defined in ss 188-15 and 188-20 of the *A New Tax System (Goods and Services Tax) Act 1999*. STS annual turnover is only retrospective based and so is similar to the GST 'current annual turnover' but has no correlation to the GST 'projected annual turnover'.

13 Explanatory Memorandum to the New Business Tax System (Simplified Tax System) Bill 2000 at para 2.27.

14 As identified by a number of authors such as Kenny, P, in 'Why "small" is beautiful for small business: Aligning Income Tax Laws with Accounting Rules' 15th ATTA conference paper at 3.

THE SIMPLIFIED TAX SYSTEM (STS)

(2(a)) STS Grouping rules

The STS group turnover includes the turnover for the entity itself and those entities with which it is grouped for the purpose of this test. These so called 'grouping rules' are very broad in their application and complex in their operation.

The basic rule, as set out in s 328-380 of ITAA97, is that an entity is grouped with another entity if it controls the other entity or both entities are controlled by the same third entity or the entities are STS affiliates of each other.

The grouping rules are a tax integrity measure to ensure that large businesses do not artificially restructure their affairs (by splitting into several smaller businesses) in order to allow each of these 'split entities' to avail itself of the STS rules.

The grouping rules for STS are different from the general grouping rules in the income tax law or GST law and the rules for an STS affiliate are not identical to those of being a CGT small business affiliate for the purposes of access to the CGT small business concessions as set out in s 152-25.

This lack of symmetry between the grouping rules for STS and CGT and GST is enough of a factor alone to rule against the STS being a factor promoting the simplification of the Australian tax system. Furthermore, the STS grouping rules are themselves incredibly complex, a point noted by many commentators.[15]

The STS grouping rules provide that an entity (X) is an STS affiliate of another entity (Y) if it acts or could reasonably be expected to act in accordance with the directions of the other entity (Y) or in concert with the other entity (Y). The ATO has set out its views on the circumstances in which an entity will be taken to act in concert with another entity in Income Tax Ruling TR 2002/6.

For the purposes of these STS rules, an entity will be deemed to control a company or fixed trust if it and its STS affiliates legally or beneficially own or have the right to acquire the legal or beneficial ownership of interests that carry the right to receive at least 40% of the distributions of income or capital of the company or fixed trust.

Control of a non-fixed trust will be found where the trustee of the non-fixed trust has made a distribution in any of the last 4 income years (before the present year) of at least $100,000 to the entity or any of its STS affiliates either singly or combined. Control of a partnership will be found if the entity or its STS affiliates, individually or jointly, have the right to at least 40% of the partnership net income or have at least a 40% interest in the assets used in the partnership business.

The Commissioner has the discretion to determine that an entity does not control another entity where the entity and its STS affiliates have at leats a 40% control percentage but less than 50%. This discretion will only be exercised where it can be shown that the other entity is controlled by another entity other than the first entity or its STS affiliates.[16]

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[15] R Douglas, 'Tax simplification for small to medium business' (2000) Taxation Institute of Australia NSW State Convention Proceedings (May 2000) 8, 10; I Snook, 'Simplified Tax System: a favourable current, a riptide or just plain dead clam?' Taxation Institute of Australia, SA State Convention Proceedings (May 2001) 75, 75.

[16] In this respect the STS affiliate control rules over third parties mirror the CGT small business concession rules regarding connected entities as set out in s 152-30(3), where the same discretion is given to the Commissioner to ignore ownership interests of at least 40% but less than 50% where it can be shown that another entity controls the entity.

(3) Depreciating assets with an adjusted value of less than $3 million

It was also a requirement that the sum of the adjustable values (written down values) of all depreciating assets held by the taxpayer entity and their STS affiliates must be less than $3 million.[17]

NOTIFICATION TO COMMISSIONER

If a taxpayer meets all of these three requirements and they choose to enter the STS or remain within the STS, they must then notify the Commissioner in the approved form.[18]

THE 4 MAIN ELEMENTS OF STS

Having determined that a taxpayer is eligible to enter the STS system, what concessions does the STS offer?

(1) Cash accounting (subdivision 328-C)

Until 30 June 2005, all STS taxpayers had to recognise income and expenses on a cash basis. Income was generally only assessable when it had been received and expenses were generally only deductible once they were paid (there was no scope for accrual accounting). Of course, the timing rules for items of statutory income, such as capital gains,[19] and specific deductions (such as borrowing expenses[20]) were not affected.

However, as from 1 July 2005, the cash accounting requirements are no longer a feature of the STS. Taxpayers, otherwise eligible to use STS can use whatever accounting method is the most appropriate for them in their circumstances. Taxpayers are therefore free now to use whatever method of tax accounting that would give a 'substantially correct reflex of the taxpayer's true income'.[21]

When a taxpayer leaves the STS, the STS rules make it clear that any ordinary income that would have been derived before the changeover year (whilst the taxpayer was an STS taxpayer) and was not included in assessable income because it was not received (an the taxpayer accounted for the income on cash basis) is included in the taxpayer's assessable income in the next year.[22]

The legislation actually gives an example of Sonja's shoe shop, which in the 2003/04 year was an STS taxpayer but was ineligible in 2004/05 (due to increased turnover). As her customers owed Sonja $10,000 at the end of 2003/04 and as this was not included in her assessable income in 2003/04, as she was an STS taxpayer and accounted for her income on a cash basis, in the next year (2004/05) this amount of $10,000 is included in her assessable income.

(2) Simplified capital allowance rules (subdivision 328-D)

The capital allowance provisions for STS taxpayers provide an immediate write-off for depreciating assets costing less than $1,000 (s328-180). For other depreciating assets (assets costing more than $1,000) pooling arrangements apply.

There are two STS pools (ss 328-185):

- A general STS pool for depreciating assets with an effective life of less than 25 years;
- A long life STS pool for depreciating assets with an effective life of 25 years or more.

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17 This $3 million limit was an increase from the $2 million maximum value for depreciating assets originally set out in the Exposure Draft. From 1 July 2007, this depreciating asset limit will be abolished altogether.
18 Section 328-435(b) ITAA97. This is done, of course, on the relevant Tax Return itself.
19 Part 3-1 of ITAA97.
20 Section 25-25 of ITAA97.
21 *Commissioner of Taxes (SA) v Executor Trustee & Agency Co of South Australia Ltd (Carden's case)* (1938) 63 CLR 108, 154.
22 Section 328-115(2) ITAA 97.

The depreciation rate (decline in value) for assets in the general pool is 30% whilst the depreciation rate for assets in the long life pool is 5%.

For assets first acquired during a year the depreciation rate that applies is half the pool rate (so 15% for general STS pool assets and 2.5% for long life STS pool assets).

Certain assets are excluded from being admitted to STS pools, even if the taxpayer is an eligible STS taxpayer. Assets subject to the primary production depreciation rules such as water facilities, horticultural plants[23] and landcare operations[24] and assets such as buildings (unless they are subject to depreciation under Division 40) and software development pools are not eligible to be admitted into the STS pools.

The effect of using a STS pool is that the pool is regarded as a single depreciating asset. This is a one significant advantage of using STS, as it avoids the need to calculate depreciation on individual assets, which can each be depreciated at a multitude of various rates. Another simplifying feature of using the STS pools is that the need to calculate a profit or loss on the disposal of an asset is eliminated (so eliminating to a large extent the problems faced with crystallising balancing charges) as the sale proceeds of the asset (termination value) are deducted from the pool balance.

Unlike the operation of balancing adjustments, it is only when the closing value of the pool balance is negative will an amount need to be included in the assessable income of the taxpayer (s 328-215). Furthermore, another advantage of using the STS capital allowance rules is that for any asset added to a pool, although it is only depreciated at half the pool rate for that year, no time apportionment applies, so that even if the asset is acquired in late June for that year, it will still receive a full 15% depreciation rate deduction for that year (if it is a general STS pool asset).

To account for any private use on an asset, the amount added to the pool, for new assets, is adjusted to reflect this level of private use.

For example, if an asset cost $5,000 and there is a 20% expected private use, then the amount added to the pool (for the acquisition of this new asset) is $5,000 x .80 (80% business use) = $4,000. If the private use percentage later changes, then the pool balance will be adjusted to reflect this change in private use in the year that the private use changes.

If a taxpayer leaves the STS any items allocated to either the general or long-life pool, remain allocated to those respective pools.[25] Therefore, deductions can still be claimed on these existing assets under the STS rules (even though the taxpayer is no longer an STS taxpayer). However, no further assets can be allocated to these existing pools, after a taxpayer has left the STS.[26]

(3) Simplified trading stock rules (subdivision 328-E)

The STS legislation provides that where, upon a reasonable estimation, the difference in the value between the taxpayer's opening and closing trading stock is less than $5,000, a taxpayer does not have to account for this difference.[27] The aim of this provision is to prevent the need for a taxpayer to undertake an annual stock-take or to account for changes in trading stock. An obvious problem with this apparent concession is that an annual stock-take (or at least an annual reasonable estimation) will still be required in order to determine the difference in the value of trading stock.

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[23] As defined in subdivision 40-F of ITAA97.
[24] As defined in subdivision 40-G of ITAA97.
[25] Section 328-220(1) of ITAA97.
[26] Section 328-220(2) of ITAA97.
[27] Section 328-285(1)(b) of ITAA97.

(4) Prepaid expenditure

STS taxpayers are entitled to an immediate deduction for the full amount of prepaid expenses that have been paid up to 12 months in advance.[28]

Non-STS business taxpayers do not have this concession and so must apportion any prepayment, where it extends beyond the current tax year, over the service period to which it relates[29].

CHANGES TO STS FROM 1 JULY 2005

Five-year re-entry rule

Until 1 July 2005, taxpayers who had been in the STS system but had then chosen to leave[30] could not re-enter the STS system for five full years after exiting the system. However, this requirement has been removed and even taxpayers who had been forced to wait this five year time period (where they had left the STS system before 1 July 2005) no longer have to serve this exclusion period.

25% entrepreneur's offset

An entrepreneur's tax offset (ETO) was introduced effective from the 2005/06-taxation year, whereby an offset of up to 25% of the tax payable by an STS taxpayer is available where the STS taxpayer's turnover is less than $75,000 (subdivision 61-J).

The maximum offset applies when the annual turnover of the STS business is $50,000 or less. The offset is phased out where the turnover is in the range of $50,000 to $75,000.

In order to receive this ETO, a sole trader or company must have net STS income for the year. For a partner, trustee or beneficiary to receive the ETO, they must have a share of net STS income of the STS partnership or STS trust included in their assessable income. It may be possible for a taxpayer to receive more than one ETO where, for example, a taxpayer receives net STS income from more than one source. However, only one ETO is available where the entities are grouped entities under the STS grouping rules.

The ATO estimates that the ETO will provide benefits to small business of $790 million over the next two years.[31] As the eligibility for this ETO is set at a very low figure (no eligibility once annual turnover exceeds $75,000), it is likely that this offset can only benefit some small businesses in their start up stage and very small micro businesses such as those in the home-based sector.

TAX ACCOUNTING CHANGE

As noted above, also from 1 July 2005, the requirement to account on a cash basis (or use as the legislation puts it 'the STS accounting method'[32]) is no longer a feature of the STS. Taxpayers, otherwise eligible to use STS, can use whatever accounting method (cash or accruals) is the most appropriate for them in their circumstances.

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[28] As set out in s 82KZM(1) of the ITAA36.

[29] For non-STS business taxpayers, the rules governing the deductibility of pre-payments are set out in ss 82KZMA to 82KZMD of ITAA36. The pre-payment rules do not apply to excluded expenditure, as defined in s 82KZL of ITAA36, such as expenditure on salaries or wages. Since 2002, non-STS taxpayers are not able to claim any pre-payments that extend beyond the current income tax year (unless they are excluded expenditure as defined).

[30] This is obviously only relevant for taxpayers who chose to leave the STS voluntarily and so this rule did not apply where a taxpayer was ineligible to remain in STS due to their turnover increasing above the threshold requirement.

[31] As quoted by A Boyes, 'Policy and Government Liaison, ATO' in (May 2006) 40 *Taxation in Australia* 543.

[32] Section 328-105 of ITAA36.

PERIOD OF REVIEW

Changes made as a result of the Review of Self Assessment (RoSA) replaced the period of review from four years to two years (from the 2004/05 year onwards) for most STS taxpayers.

EXTENDING ROLLOVER RELIEF FOR PARTNERSHIPS

Previously, rollover relief was only available to STS partnerships for depreciating assets in STS pools where a balancing adjustment occurred as a result of a change in the partnership. This rollover relief has now been extended to all entities where there is a change in a business structure that creates a balancing adjustment.

CHANGES TO STS FROM 1 JULY 2007

As from 1 July 2007, the $1 million turnover threshold for eligibility will be increased to $2 million and the $3 million depreciating asset test will no longer apply.

HOW WAS THE SIMPLIFIED TAX SYSTEM GOING TO SIMPLIFY TAXATION?

The Treasurer in his Press Release[33] indicated that the use of cash accounting was an important feature in simplifying taxation for small businesses, he said:

> A straight forward and less costly cash accounting regime. That is, for income tax purposes, income and expense will need to be recognised only when they are received and paid.

John Ralph, in discussing the benefits of using a cash accounting system in STS, stated:

> Taxable income for enterprises electing to adopt the recommended system is calculated by deducting cash payments from cash receipts relating to business and then accounting for depreciation and trading stock on a much more simplified basis than currently.[34]

This statement was, of course, too simplistic. If followed literally, the receipt of a business loan would be treated as income and repayments as a deduction, which was never the intention.

The major simplification of using the cash accounting system in the STS is that debtors and creditors are largely ignored and work-in-progress is only taxed when realised. Whilst the write-off in full of assets acquired for $1,000 or less does make record keeping and accounting for these assets simpler, assets costing more than $1,000 are still subject to depreciation, although on a pooling basis.

All pre-payments are likewise not all deductible in full to STS taxpayers, only those that do not exceed a 12-month pre-payment period. Those that do are subject to accruals as is the case for non-STS taxpayers for all pre-payments (other than excluded expenditure). STS taxpayers are subject to the same rules on non-depreciating assets and liabilities as non-STS taxpayers.

The threshold for cash accounting for GST is similar, but not identical, to the STS turnover threshold. Both were set at $1 million and now are set at $2 million but the GST cash accounting threshold is calculated differently in that it uses both a prospective[35] and retrospective[36] basis, whereas the STS rules only use a retrospective basis.

The Ralph Review claimed, when promoting the attraction of businesses using the STS, that less than 25% of all STS businesses would have to account for trading stock when preparing an income tax

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[33] Treasurer, 'Small Business and Primary Producers to Benefit from the New Business Tax System' Press Release No 59 (21 September 1999).

[34] As quoted in the *Australian Financial Review*, 2 May 2000.

[35] The projected annual turnover as set out in s 188-20 of the *A New Tax System (Goods and Services Tax) Act 1999* is based on the turnover of the current month and the turnover of the next 11 months.

[36] The current annual turnover as set out in s 188-15 of the *A New Tax System (Goods and Services Tax) Act 1999* is based on the turnover of the current month and the turnover of the previous 11 months.

return. This comes about due to no adjustment being required, for changes in the levels of trading stock, when the change in the values of opening and closing trading stock are expected to be less than $5,000. It is therefore possible that a value for opening stock can be carried forward indefinitely until the amount of change in the value of trading stock exceeds $5,000. In the year that it does, the difference is included in, or deducted from, taxable income.

DO TAXPAYERS BENEFIT FROM ENTERING AND USING THE STS?

This apparently simple question is anything but certain. Every taxpayer needs to consider their own circumstances to determine whether STS will offer any real benefits to them. This is often cited as a key failing in the utility of the STS as in every case a detailed and individualised assessment is required in order to assess whether STS offers that taxpayer any real benefit.[37] The smaller the business, the easier it will be to determine this issue. As a general rule, STS would be more attractive to enter for businesses that have high levels of debtors and low levels of creditors in the year that entry to STS is sought (as if a cash accounting basis is chosen, then the debtors would not be counted as income for that year).

STS would also appear to favour those businesses that have high levels of depreciable low cost plant and equipment (such as farmers and miners), due to the immediate write-off of plant costing less than $1,000. Also, other taxpayers who can utilise the accelerated depreciation provisions also benefit.

As mentioned earlier, STS would also allow taxpayers to defer any balancing adjustment on the sale of any item in the pool, since a disposal only results in the pool closing balance being reduced with no tax payable on any gain made on the disposal until the pool closing balance is below zero. This provides a de facto rollover relief for plant and equipment disposals.

The inclusion of non-business affairs in STS (since if a taxpayer is eligible for STS, all of the taxpayer's affairs come into STS, including their non-business affairs) provides a simplicity dividend.[38]

The prepayment concession is an advantage over businesses not in STS[39] (since no pre-payment provisions apply to non-STS taxpayers).

However, as was clearly explained in a paper by Brett Bondfield,[40] there are considerable gaps between what the STS promises through its provisions as noted above and the commercial reality facing these small business taxpayers. For example, in terms of the pre-payment advantage, this is only truly useful if the business in question has the available funds and it makes commercial sense to prepay the expense in question. As a result Bondfield takes the view that 'STS is more image and perception management than a thought through policy that addresses the core issues that adversely impact on small businesses'.[41]

The removal of the requirement for taxpayers in STS to account on a cash basis removes one area where the STS lacked commercial reality as a recent survey indicated that between 60 and 75% of small to medium businesses used some form of accruals accounting.[42]

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37 B Bondfield, 'If there is an art to taxation the Simplified Tax System is a dark art' (2002) 17 *Australian Tax Forum* 313, 329.

38 B Bondfield, 'A year on in the Simplified Tax System: has the reality matched the rhetoric?' (2002) 17 *Taxation in Australia* 253.

39 Since 21 September 1999, the pre-payment rules ceased to apply to non-business taxpayers (a phased withdrawal period applied but this ended in 2002).

40 Above Bondfield, n 34, 328

41 Above Bondfield, n 34, 327.

42 ICAA Media Release, *Chartered Accountants Disappointed by Simplified Tax System Bill*, 27 October 2000.

DOES THE STS REDUCE COMPLIANCE COSTS?

The first Howard Government's initial focus on the small business compliance burden concluded in 1997:

> Dealing with our complex tax system was the number one compliance issue identified by small business.[43]

According to Robert Douglas[44] small businesses with an annual turnover of less than $1,000,000 (the original intended group of eligible taxpayers to use the STS) would represent over 850,000 businesses and over 95% of all small businesses in Australia.

These small businesses 'find the compliance costs associated with the tax system to be a major burden'.[45]

The Ralph Committee clearly had agreed with this last point as it stated:

> Not only do they (small business) incur considerable costs in respect of their own business income, but they are also required to collect taxes in respect of their employee's income and carry out other functions on behalf of Government.[46]

It is very doubtful whether the Coalition Government has, with its tax reform measures largely stemming from the Review of Business Taxation (RBT), contributed to any reduction in these compliance costs for small business. Indeed, as late as 2004, it has been stated that compliance costs are still the major taxation issue facing small businesses in Australia.[47]

The stated objectives of the RBT were to improve simplicity and transparency and to reduce the costs of compliance along with developing an approach that moved toward a 'greater commercial reality'.[48]

The previous Tax Commissioner, Michael Carmody, also expressed the view that:

> Tax Reform has brought another … breakthrough … We have now seen the first steps in the carve out of small business (with a turnover of less than $1 million) from the general business tax rules.
>
> An equity-based view has held that the principles of the law should apply across the board to all business operators. However, this view of equity carried with it the result that compliance costs fell more heavily on small business- an inequity in itself some would say …'[49]

The Treasurer, in trying to sell STS, issued a special Press Release that promoted STS due to its compliance cost benefits.[50]

It is arguable, however, that many small businesses have found that the STS system has exactly the same compliance costs (or indeed more) than the existing system. Many smaller businesses would already largely use cash accounting and would either have negligible or significant trading stock (making the $5,000 trading stock variation concession somewhat redundant).

Where small business would have found savings in compliance costs is in connection to the use of the 'pooling arrangements' for depreciation. However, tax compliance costs are a function of a tax system that is a sum of its individual parts and so for one subset (the STS) to reduce compliance costs overall

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43 Prime Ministerial Statement, *More Time for Business*, AGPS, Canberra, 24 March 1997 at iv.
44 Tax Consultant and former Director of Taxation of the National Farmers' Federation.
45 R Douglas, 'The Simplified Tax System for Small Businesses- An Overview', 1.
46 *Ralph Report: A New Tax System Redesigned Overview* at 73.
47 M Dirkis and B Bondfield, 'The RBT ANTS bite: small business the first casualty' (2004) 19 *Australian Tax Forum* 107.
48 *Review of Business Taxation* (Ralph, J chair), *A Tax System redesigned* (AGPS, Canberra, July 1999) v.
49 Speech given by Michael Carmody to the American Chamber of Commerce, 'Tax Reform: the lessons for tax administration in Australia' (2 May 2000, Sydney) 3.
50 Treasurer, 'Small Business and Primary Producers to Benefit from the New Business Tax System' (Press Release No 59, 21 September 1999).

is a very difficult undertaking.[51] Unfortunately, as other writers have previously noted,[52] there is still to date no empirical evidence on the total cost to the taxpayer of tax system compliance post the implementation of Ralph reforms such as GST and STS.

There is, however, anecdotal evidence at least that the post Ralph compliance burden is more onerous than the pre-Ralph burden.[53] This is certainly a view shared by many tax practitioners.[54]

DOES THE STS AID THE PROCESS OF TAX SIMPLIFICATION?

The former Commissioner of Taxation has stated that taxation laws are inherently complex due to the complexity of the social and commercial environment in which they operate.[55]

Time for Business noted in 1996[56] that much of the complexity of the tax system is due to the tax system being used for social and economic goals outside of revenue raising.[57]

It has been said that simplicity is an attribute that appears to have never sat very well with taxation laws[58] and is a difficult concept to define.[59] Is simplicity in tax rules therefore possible and is it even desirable?

Simplicity is a desirable feature as it has been argued by many academic commentators as one of 3 key tax policy objectives, along with efficiency and equity.[60] In this sense, simplicity has been defined in terms of costs of the government and the compliance costs of taxpayers.[61] If tax laws are not simple enough to understand and apply, this will lead inevitably to high compliance costs, high administrative costs and costly tax litigation. If new rules (such as STS), are introduced that add to the complexities of the tax system, then the total costs of the tax system rise, since these total costs are the sum of compliance costs and administrative costs borne primarily by the ATO.[62]

On one view, by providing arguably simpler depreciation rules (due to the pooling of assets), the STS has assisted the process of tax simplification, at least from the point of a view of a business using the STS.

However, even these 'simpler' STS depreciation rules have their complexity. For example, where there is a private use component, due to integrity measures, pooling is not straightforward.

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51 Above Bondfield, n 35, 252.

52 Above Dirkis and Bondfield, n 44, 114.

53 R Conwell, a former President of the Taxation Institute of Australia, was quoted by Alessandro Fabro in the *Australian Financial Review* on 2 September 2002 at 5 as saying that 'instead of simplifying the compliance to the law, [the RBT reforms] actually increased the burden significantly'.

54 R Regan, (President of National Tax & Accountants Association), 'NTAA calls for tax practitioners to revolt' (NTAA Press Release, 15 August 2002).

55 M Carmody, 'Issues Confronting Australia's Tax System' Speech to Financial Review Leaders' Luncheon 29 July 2002.

56 C Bell (Chair), *Time for Business: Report of the Small Business Deregulation Task Force* (AGPS, Canberra, 1 November 1996).

57 For instance, HELP and Child Support measures.

58 United Kingdom Parliament *Hansard*, 27 May 1853: col. 722.

59 BI Bittker, 'Tax reform and simplification' (1974) 29 *University of Miami Law Review* 1, 1.

60 For example, G Lehmann and C Coleman, *Taxation in Australia* (5th ed, 1998) 65, R Woellner et al, *Australian Taxation Law* (13th ed, 2003) 26-37 and R Fisher, 'Ralph Review: reform by name but not nature?' (2003) 7 *Tax Specialist* 61, 62.

61 R Woellner, S Barkoczy, S Murphy, *2002 Australian Taxation Law* (CCH, Sydney) 32.

62 C Evans et al in *A Report into Taxpayer Costs of Compliance* (1997) and C Sandford, 'International Comparisons of Administrative and Compliance Costs of Taxation' (1994) 11 *Australian Tax Forum* 291, 301.

There are complex calculations required when an asset has both private and business use and these calculations become even more complex, when that proportion changes over the life of the asset.[63] Therefore the simplicity advantages of pooling assets that STS provides are largely lost for assets that have some private use as these assets have to be individually tracked until they are disposed.

The single largest argument against the STS improving the simplicity of the Australian tax system is that by introducing another set of rules for some businesses (those who are eligible and who elect to use the STS); it has in fact added further complexity to the Australian tax system.

The STS has its own definition of 'small business', in terms of its eligibility requirements, for example, the STS turnover requirement of not exceeding $1 million (changed to $2 million from 1 July 2007).

However, as other taxes and concessions have their own measures and limits on 'eligible small businesses', which are often very different from those of STS, this then results in there being considerable additional complexity from both an adviser's and the taxpayer's viewpoint in trying to understand what concessions and what rules potentially apply.

For instance, the GST has a cash accounting threshold of $1 million ($2 million from 1 July 2007) , so that taxpayers with an annual turnover of less than $1 million can elect to account for the GST on a cash basis.[64] This is not the same as the STS turnover threshold, as the STS figure does not have any prospective operation.

The small business CGT concessions, although they have no annual business turnover requirements, have another eligibility rule requiring the net assets of the business and of the taxpayer, their CGT small business affiliates and any connected entities to be less than $5 million ($6 million from 1 July 2007).[65]

STS may appear to be simple to understand, there being just three main eligibility requirements but in the 3 main eligibility requirements,[66] there are 11 defined terms, some of which themselves contain defined terms. If further clarification of policy issues or the operation of STS is required, there is then the Explanatory Memorandum, which is some 84 pages long, and two key Tax Rulings on the operation of the STS: TR 2002/6: *Income Tax: Simplified Tax System: eligibility-grouping rules* (which runs to 38 pages) and TR 2002/11: *Income Tax: Simplified Tax System eligibility-STS average turnover* (which runs to 33 pages). The length of this material hardly suggests we are dealing with a simple and easy system.

Furthermore, the grouping rules for the STS are not the same rules as apply for GST, State payroll taxes or consolidations. This fact alone adds considerable complexity to the Australian tax system and consequent additional compliance costs (in determining whether other entities are to be counted for the purposes of each of these rules).

Some commentators have taken the view that STS is just an add-on to the cost of running the tax system.[67] As an add-on it does not simplify the present system but rather adds another layer of complexity to the Australian Tax system. As Brett Bondfield put it in a recent paper looking back on the STS after its first 12 months:

> The basic problem is that STS is a concept that is in effect a separate concessional system within a large and complex system.[68]

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63 About a third of the subdivision, 328-D of ITAA97, which deals with capital allowances under STS, relates to rules about the calculation and operation of the private use component.

64 Sections 29-40 of the GST Act.

65 Section 152-15 of ITAA97.

66 Sections 328-365 of ITAA97.

67 Above Bondfield, n 34 at 328.

68 Above Bondfield, n 35, 252.

RECENT ANNOUNCEMENTS- NEW SMALL BUSINESS FRAMEWORK

On 13 November 2006, the Treasurer announced that a new small business framework would be introduced from 1 July 2007.[69] This new small business framework means that any business with an annual turnover of less than $2 million will be able to access the cash accounting basis for GST, the STS, the CGT small business concessions, FBT car parking concessions and PAYG instalments (based on the taxpayer's notional tax). At the time of writing, we are still to see this new legislation.

What this new measure will mean is that the added complexity caused by having different definitions of an eligible small business will now be largely reduced and simplified (although not totally removed).

If you believe the Press Release hype, eligible small businesses will now (from 1 July 2007) only have to apply one eligibility test to access a range of small business concessions and any business meeting the new small business definition will be able to choose the concessions which best meet its business needs. However, as at the time of writing (September 2007), we are still yet to see the new legislation dealing with this new small business framework.

SHOULD THE STS BE EXTENDED ANY FURTHER?

It has been the overriding conclusion of this article that the Simplified Tax System has done anything but simplify taxation for Australian taxpayers. To the contrary, it has added yet another layer of complexity to a tax system that is already complex and cumbersome in its operation. It is hardly likely that a recommendation can be rationally made to further extend the Simplified Tax System.

Having said that, however, it is readily acknowledged that the STS has some useful features such as a simplified capital allowance system and prepayment rules. If this is true, should not these features be extended further to encompass a wider range of taxpayers?

Apart from some obvious costs to the revenue of such a proposal,[70] the issue is raised as to why further consistency in the application of tax rules and concessions cannot be further developed and these rules and concessions also be made to apply to all taxpayers.

Since the $2 million turnover threshold is, at any rate, an arbitrary figure, why have a turnover threshold at all? If a turnover threshold is required, perhaps then a much higher turnover threshold should be considered, say at $5 million per annum.

This would be much more commercially realistic and would enable a much wider range of taxpayers to be eligible and therefore make the various small business measures, such as the STS, more useful in practice.

In terms of the capital allowance rules, why could not the pooling option be extended to all taxpayers? Why should taxpayers (not in STS) have to use separate rates of depreciation for each separate asset? By extending this pooling option (which only at present applies to STS taxpayers and also to non-STS taxpayers for low-value pool assets) to all taxpayers, will, at one stroke, immensely simplify the calculation of depreciation and balancing adjustments.

In addition, consideration should be given to allowing all taxpayers an immediate capital allowance write-off for assets costing less than $1,000. This would greatly assist administrative and economic efficiency for taxpayers, especially business non-STS taxpayers who presently can only immediately write-off capital assets costing less than $100[71], and thereby also reduce the compliance burden, since

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[69] As contained in the Joint Press Release by the Treasurer and the Minister for Small Business and Tourism, Melbourne, 13 November 2006.

[70] The author acknowledges that he is not in a position to provide these revenue costings.

[71] Of course, for non-STS taxpayers, for assets costing less than $1,000, s 40-420 of ITAA97 does allow the use of low-value pooling.

individual depreciation calculations would for the most part not be required any longer on these assets.

Removing anomalies and inequities between the treatment of economically similar transactions was a major recommendation of the Ralph report[72] and so by extending some of the STS concessions, such as these accelerated capital allowance provisions, to all, or at least a much wider range of taxpayers than at present, would go a long way to furthering this objective.

Similarly, by extending the prepayment rules to all taxpayers and not just STS taxpayers, the level of understanding and simplicity in the tax system would be enhanced. There used to be a 13-month prepayment rule for all small business taxpayers,[73] which was altered when the STS rules came in, could not this rule be extended again to cover all 'small businesses', regardless of whether they are using the STS system or not?

A further improvement could see some features of the STS - such as the trading stock concession of ignoring changes in the level of inventory of less than $5,000 from a base year, since they have dubious value in a practical sense (for reasons already noted in this paper[74]) - be scrapped altogether.

It is doubtful that the 25% entrepreneur's tax offset has been of any real value to the Australian business taxpayer community, because of the very restrictive turnover limit applicable (currently set at $75,000 annual turnover). Therefore, one can question the value of retaining this tax offset, at least in respect to its present restricted operation.

Finally, as one of the government's goals in introducing the STS was to provide some compensation to small business for the regressive compliance costs of the new tax system, a more efficient result, from the point of view of small business, to alleviate in some way these added compliance costs, would instead be a direct government grant.[75]

CONCLUSION

The STS promised it would help around 95% of all small businesses and 99% of all primary producers by reducing the compliance burden of these small business taxpayers. The take-up rate of STS has been well below that. Available figures as at 17 April 2003 (based on data disclosed in 2002 tax returns), disclose that only 14% of eligible business taxpayers had opted to enter the STS.[76] Data gleaned from 2005 tax returns[77] suggests the take-up rate was approximately 25-30% of all eligible small businesses.[78]

An increase in the STS take-up rate is expected for 2006 and later years, due largely to the abolition of the cash accounting requirement, which has removed a large compliance cost obstacle as anecdotal evidence has suggested that a significant reason for the low take-up rate for STS in the past has been

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[72] J Ralph, (Chairman of Committee) Review of Business Taxation, *Final Report, A Tax System Redesigned*, (1999, AGPS) fn 2 at 13.

[73] Contained in s 82KZM(1)(b) ITAA36, which provided for a deduction for prepayments where they did not exceed a 13-month period for all 'small business taxpayers'. For this purpose, small business taxpayer was defined in s 960-335 of ITAA97 as a business taxpayer where the average annual turnover was less than $1,000,000.

[74] Since businesses in any event have to undertake a reasonable estimation of trading stock each year and the threshold (of only $5,000) for not adjusting for any change in value is not considered economically significant.

[75] Above Kenny, n 11, 17.

[76] Above, Dirkis and Bondfield, n 44, 136 and 144.

[77] The Compliance Plan indicated that in Australia in 2004/05 there were around 1.8 million micro-businesses (defined as businesses with an annual turnover of less than $2 million) and that 25 to 30% of these had entered STS up to and including the 2005 year of income.

[78] As observed from M McKerchar, 'Is the Simplified Tax System simple' Taxation Institute of Australia, (2007) 10 *The TAX specialist* 146.

this cash accounting requirement. This cash accounting requirement would have meant that, by entering STS, businesses would have to have accounted on a cash basis (for STS) and, since their accounts were largely being prepared on an accruals basis, this would have meant many business would have had to keep two sets of accounts, which would have added to their overall compliance costs .[79]

Since the features of STS have not until now been optional (other than the trading stock concession), taxpayers are required to undertake a detailed complex calculation to determine whether they are better off by entering STS.[80] Many commentators note that, given the complexities of the STS and the trade-offs involved, there may be little benefit at all to small business.[81] Some commentators therefore think that the STS has only been useful at the small end of small business (in other words just for micro-businesses).[82]

Certainly, those taxpayers eligible to enter STS are, in one sense, better off, as they can at least determine whether STS is an advantage to them or not and thereby maximise their tax planning opportunities. However, the need for taxpayers to have to reconsider their position on an annual basis for entering or staying within the STS system of itself adds another compliance cost to small business. This would necessitate the use of the tax adviser and would add additional professional advisory costs.

The Simplified Tax System, at least in its title, suggests that it will improve the simplification of the tax system, but the reality is that by adding a new concession system within an existing tax system, all the STS has really done is added further layers of complexity to an already cumbersome Australian taxation system. The system involves complex eligibility criteria, including unnecessarily complex grouping provisions and the system adds another layer of complexity to the depreciating asset provisions, particularly where the taxpayer opts out of the STS system (after being an STS taxpayer) as then the taxpayer must maintain two different depreciation systems.[83]

The STS has been labelled a system within a system. It has been developed without sufficient debate or research on has relied on perception management.[84]

This can indeed be a criticism of the entire Ralph review process as the Ralph Committee was instructed with the task of devising measures aimed at increasing the efficiency of all Australian businesses and in particular to improve simplicity and reduce compliance costs.[85]

With the spate of new tax measures flowing out of Ralph Committee recommendations and their inherent inconsistency,[86] it is very doubtful that the Ralph Committee has gone anywhere near to achieving these stated objectives. In fact, the opposite is true.[87] Introducing new and further tax preferences, such as that inherent in the STS, far from assisting tax simplification, instead has added to the volume and complexity of tax law and damaged equity and efficiency.[88]

Indeed, the fact that there has been no consistency in the eligibility requirements for small businesses under STS, when compared to other provisions of the tax legislation, such as the CGT small business concessions and GST cash accounting rules, coupled with having different grouping rules for STS and

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79 G Shaw, 'Changing to the Simplified Tax System' Taxpayers Australia, 7 November 2005, 154.
80 P Kenny, 'A 'Simplified Tax System' for small business' (2002) 6 *The Tax Specialist* 40.
81 M Hine, 'Small Business tax system (STS)' TIA, WA State Convention, May 2001; also, Wolfers and Miller, above n 4, 374.
82 G Walker, 'The Simplified Tax System-the good, the bad and the ugly' *CCH Tax Week*, Issue 7, 20 February 2003 at 95.
83 Depreciation systems under both STS and Division 40.
84 Above n 78, 145.
85 Dirkis and Bondfield, above n 44, 110.
86 As discussed elsewhere in this article.
87 This was also the conclusion reached by Dirkis and Bondfield in their paper, above n 44, 112.
88 Kenny, above n 11, 17.

GST, the CGT small business concessions and consolidations has clearly not enhanced the simplification of the Australian tax system. It is hoped that the Government's announced new small business framework will go a long way to addressing issues of lack of consistency in eligibility rules and will thereby enhance understanding of the Australian tax system by taxpayers and their advisors.

Although tax professionals and taxpayers alike have experienced varying degrees of 'tax reform fatigue' since the advent of the Ralph reform measures, the comparative lull in tax reform measures over the immediate last couple of years perhaps gives some opportunity to consider other meaningful tax reform options.

Should the STS be expanded? Since the STS does have some attractive features, such as the depreciation pooling rules, immediate write-off of assets costing less than $1,000, deductibility of expenditure for pre-payments up to 12 months in advance and reduced trading stock requirements, there is a valid argument for further widening the eligibility to enter STS (beyond the changes to apply from 1 July 2007).

Alternatively, perhaps just some of the more useful concessions provided by the STS, such as the prepayment and capital allowance provisions, could be further extended, to encompass not just STS taxpayers but all business and even possibly to non-business taxpayers. Perhaps there is also scope to further simplify the turnover provisions and/or increase the immediate write-off thresholds.[89]

The recent Government announcements[90] on ways to 'standardise' the eligibility requirements for the various 'small business' concessions in the tax rules are a welcome development but as is often the case with planned policy changes, the 'devil' is likely to again be in the detail of these new eligibility rules.

At this stage, we can only await their introduction.

89 For example, to $5,000 instead of $1,000.

90 On 13 November 2006 and again on 12 April 2007 (Treasurer Press Release entitled 'Reducing Red Tape and the Regulatory Burdens on Business').