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The 1999 Review of Business Taxation: Should We Fast Track Small Business Tax Reform?

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Abstract
This article examines the policy design processes associated with the 1999 Review of Business Taxation. Given the breadth of the Review's recommendations, this article focuses on two of its enacted proposals, the non-commercial loss (NCL) rules and the Simplified Tax System (STS). Whilst this legislation closely followed the Review's recommendations, the NCL and STS rules have been subject to much criticism by commentators, professional and government bodies. The STS proved to be very unpopular and was eventually scrapped on 30 June 2007. The NCL rules, though, have remained intact, notwithstanding the considerable angst of small business. This article analyses the Review's problem identification processes. Its proposed solutions are investigated in the light of the experience with the enacted reforms. The article highlights the shortcomings of the Review's problem identification and policy design processes. Taxation enquiries should adopt a more gradual, transparent and consultative approach in identifying and researching problems and in drafting taxation reform solutions. In particular there is a great need to carefully develop objectives for specific tax reforms and to build socio-economic modelling capabilities to forecast the fiscal adequacy, economic, equity and simplicity impacts, as well as to assess policy outcomes.

Keywords
Business taxation, small business tax reform

THE 1999 REVIEW OF BUSINESS TAXATION: SHOULD WE FAST TRACK SMALL BUSINESS TAX REFORM?

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This article examines the policy design processes associated with the 1999 *Review of Business Taxation.* Given the breadth of the *Review's* recommendations, this article focuses on two of its enacted proposals, the non-commercial loss (NCL) rules and the Simplified Tax System (STS). Whilst this legislation closely followed the *Review's* recommendations, the NCL and STS rules have been subject to much criticism by commentators, professional and government bodies. The STS proved to be very unpopular and was eventually scrapped on 30 June 2007. The NCL rules, though, have remained intact, notwithstanding the considerable angst of small business.

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INTRODUCTION

The 1999 *Review of Business Taxation* (the *Review*)[1] was charged with making wide ranging recommendations on the design of the Australian business tax system[2] and it managed to hand down its extensive report, *A Tax System Redesigned,* within a very short period of 12 months. This report consisted of eight parts[3] and made 280

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

2 Ibid v-vi.

3 Ibid xi-xii; the 8 parts are:
1. Building a strong foundation
2. Establishing a durable framework for income taxation
3. Reinforcing integrity and equity

recommendations. Subsequently, many of these reforms passed into law over a staggered time line since 1999.[4] Given the breadth of the *Review's* recommendations, this article focuses on two of its enacted proposals, the non-commercial loss (NCL) rules[5] and the Simplified Tax System (STS).[6] Whilst this legislation closely followed the *Review's* recommendations, the NCL[7] and STS[8] rules have been subject to much

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4. Applying the cash flow/tax value approach
5. Implementing a unified entity regime
6. Recognising direct investors and small business
7. Rewarding risk and innovation
8. Responding to globalisation.

4 Dirkis M and Ting A, 'Cataloguing Business Tax Reform Seven Years On' (2006) 21 Australian Tax Forum 601, 602: Notes that the Government introduced 144 taxation bills between June 1999 and October 12001; 44 taxation and superannuation related bills in 2002; 20 in 2003; 46 in 2004; 22 in 2005; and 14 by 14 September 2006.

5 Div 35 Income Tax Assessment Act 1997 (Cth) (ITAA 1997).

6 Div 328. The small business concessions were known as the 'Simplified Tax System' (STS) concessions up to 30 June 2007. From 1 July 2007 the concessions were renamed as small business entities (SBE) income tax accounting concessions, Tax Laws Amendment (Small Business) Act 2007.

7 Samarkovski L and Freudenberg B, 'TLIP: Lip Service or in Service? A Review of the Non-Commercial Loss and STS Measures Against the TLIP principles' (2006) 21 Australian Tax Forum 387; Kenny P, 'The Non Commercial Loss Restrictions: A Very Blunt Instrument for Micro Business' (2006) 21 Australian Tax Forum 573; Greenleaf L, 'The Non-commercial loss Provisions: A Lesson in Collateral Damage?' (2006) 21 Australian Tax Forum 669; Rural Industries Research and Development Corporation, Economic Effects of Income Tax Law on Investments in Australian Agriculture, With Particular Reference to New and Emerging Industries, January 2006, <http://www.rirdc.gov.au/fullreports>; Board of Taxation, Post-implementation Review of the Quality and Effectiveness of the Non-commercial Losses Provisions in Division 35 of the Income Tax Assessment Act 1997, A Report to the Treasurer, June 2004 <www.taxboard.gov.au>; Submissions to the Board of Taxation's 'Post-implementation Review of the Quality and Effectiveness of the Non-commercial Losses Provisions in Division 35 of the Income Tax Assessment Act 1997, from: Artists Foundation of WA; Arts Law Centre of Australia; Arts Law Centre of Queensland Inc; Australia Council for the Arts; Australian Dance Council — Ausdance Inc; Australian Film Commission; Australian Forest Growers; Australian Society of Authors; Blanckensee, Jane; Dunne, Ian — Lowe Lippmann, Chartered Accountants; Institute of Chartered Accountants in Australia; Leung, Bill — Lowenstein Sharp Pty Ltd, Certified Practising Accountants; Lowensteins Arts Management Pty Ltd, Certified Practising Accountants; Metcalf, Ronald Wayne — Metcalf Spahn, Certified Practising Accountants; Music Council of Australia; National Association for the Visual Arts Ltd; National Association of Forest Industries; National Tax and Accountants' Association Ltd; O'Brien, Peter — Hogg Lawson; Painters and Sculptors Association of Australia Ltd; Taxation Institute of Australia; Taxpayers Australia Inc. — Tasmanian Divisional Council; Tucker, Brian, Certified Practicing

criticism by commentators and professional and government bodies. The STS proved to be very unpopular, with only a 14 % small business take up rate in the year ended

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Accountant; Tree Farm Investment Managers Australia; Watson, Alistair, A Report to the Treasurer' June 2004 <www.taxboard.gov.au>; BDO Kendall, Report to the Board of Taxation Post-implementation Review on an Evaluation of Non-commercial Losses Against the Board's Review Criteria <http://www.taxboard.gov.au/content/noncommercial_losses/Chapter_5.asp>; Australian Taxation Studies Program (ATAX), Law Faculty of The University of New South Wales, Report to the Board of Taxation Post-implementation Review on the Operating Costs of Non-commercial Losses <http://www.taxboard.gov.au/content/noncommercial_losses/Chapter_5.asp>; Douglas R, 'Farmers Nil, Commissioner Nil. Thanks, Ralph Great Result' (2001) 35 *Taxation in Australia* 387; Cooper G, 'Tax Reform: Non Commercial Losses' (2000) 35 *Taxation in Australia* 160.

8 Hodgson H, 'Small business simplification – yet again?' (2007) 11 *The Tax Specialist* 140; Pizzacalla M, 'Australia's SME identity crisis' (2007) 22 *Australian Tax Forum* 19; Samarkovski Freudenberg above n 7; Tretola J (2007) 'The Simplified Tax System - Has It Simplified Tax At All And, If So, Should It Be Extended?' (2007) 17 *Revenue Law Journal*; McKerchar M, 'Is the Simplified Tax System Simple?' (2007) 10 *The Tax Specialist* 140; Burton M, 'The Australian Small Business Tax Concessions – Public Choice, Public Interest or Public Folly?' (2006) 21 *Australian Tax Forum* 71; CPA Australia, Small Business Survey: Compliance Burden (2006); Taxation Institute: Submission to the Taskforce on Reducing the Regulatory Burden on Business 28 November 2005 <www.regulationtaskforce.gov.au/submissions/sub078.rtf>; Institute of Chartered Accountants: Submission to the Taskforce on Reducing the Regulatory Burden on Business 28 November 2005; G Shaw, 'Changing to the Simplified Tax System' (2005) Taxpayers Australia 7 November 2005, 154; Dirkis M and Bondfield B, 'The RBT ANTS Bite: Small Business the First Casualty' (2004) 19 *Australian Tax Forum* 107; Walker G, 'The Simplified Tax System- the Good, the Bad and the Ugly' (2003) 7, 20 *CCH Tax Week* 95; Bondfield B, 'A Year on in the Simplified Tax System: has the reality matched the rhetoric?' (2002) 37 *Taxation in Australia* 253; Kenny P, 'A Simplified Tax System for Small Business: Or, Just Another Tax Preference?' (2002) 6 *The Tax Specialist* 36; Bondfield B, 'If there is an Art to Taxation the Simplified Tax System is a Dark Art' (2002) 17 *Australian Tax Forum* 313; Hine M, 'Small Business Tax System (STS)' Taxation Institute of Australia, Western Australian State Convention May 2001, 24; Snook I, 'Simplified Tax System: A Favourable Current, a Riptide or Just Plain Dead Calm?' Taxation Institute of Australia, South Australian State Convention May 2001, 75; Wolfers L and Miller J, 'The Simplified Tax System: Is this Government Speak for "Complex"?' (2001) 35 *Taxation in Australia* 374; Martin F, 'STS Implications' (2001) 36 Taxation in Australia 245; Douglas R, 'Tax Simplification for Small to Medium Business' (2000) Taxation Institute of Australia New South Wales State Convention May 2000, 8; Institute of Chartered Accountants (ICAA) Media Release 'Chartered Accountants Disappointed by Simplified Tax System Bill' 27 October 2000; Cooper G, 'The Government Response to the Ralph Report: An Initial Overview' (1999) 34 *Taxation in Australia* 232.

30 June 2002,[9] and whilst attempts were made to prop it up by the introduction of additional concessions,[10] it was eventually scrapped on 30 June 2007.[11] The NCL rules, though, have remained intact, notwithstanding the considerable angst of small business.

This article first provides an overview of the *Review's* terms of reference and its publications. Secondly, it analyses the *Review's* problem identification processes. Finally, the *Review's* proposed solutions are investigated in the light of the experience with the enacted reforms. The central theme concerns shortcomings at the *Review's* problem identification and policy design processes. Taxation enquiries should adopt a more gradual, transparent and consultative approach in identifying and researching problems and in drafting taxation reform solutions. In particular, there is a great need to carefully develop objectives for specific tax reforms and to build socio-economic modeling capabilities so as to forecast the fiscal adequacy, economic, equity and simplicity impacts as well as to assess policy outcomes.

BACKGROUND: THE REVIEW OF BUSINESS TAXATION

Terms of reference

In 1997 the Prime Minister John Howard announced major reforms of the Australian taxation system and a *Taxation Task Force* was established in August 1997.[12] The

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9 ATO Tax Practitioners Forum Issues Log (register n, A27), <www.ato.gov.au/taxprofessionals/contentasp?doc+/content/39983.htm&page=165&H28_1 > at 29 November 2006.

10 Modifications made to the system to make it more attractive to small business: the introduction of the entrepreneurs discount (Subdiv 61-J ITAA 1997), extended roll-over relief available for partnerships (ss 328-220 , 328-243, 328-247, 328-250, 328-253, 328-255), changes to STS accounting (ss 328-115 to 328-120, 328-440), and limited amendment periods (s 170(1) ITAA 1936).

11 Tax Laws Amendment (Small Business) Act 2007.

12 Howard J (Prime Minister), 'Transcript of the Prime Minister the Hon John Howard MP Address to Bradfield Federal Electorate Autumn Lunch, Bradfield' (Sydney 25 May 1997). The release stated 'The Government has instructed its Taxation Task Force to prepare options for reform of the taxation system. The broad guidance given to the Task Force is:
   a. there should be no increase in the overall tax burden;
   b. any new taxation system should involve major reductions in personal income tax with special regard for the taxation treatment of families;
   c. consideration should be given to a broad based, indirect tax to replace some or all of the existing indirect taxes;
   d. there should be appropriate compensation for those deserving of special consideration; and

Taxation Task Force consisted of representatives from the Prime Minister and Cabinet Department, the Cabinet Policy Unit, the Australian Taxation Office and the Treasurer's office.[13] After a brief three month period the *Taxation Task Force* was required to prepare options for taxation reform.[14]

The *Taxation Task Force* was aided by a Liberal party committee chaired by Senator Brian Gibson (known as the *Tax Reform Consultative Task Force*).[15] The *Tax Reform Consultative Task Force* received submissions from the public which it forwarded to the *Taxation Task Force*.[16] Consequently, the federal Government published the document *Tax reform, Not a new tax, A New Tax System* (herein after called ANTS), in August 1998.[17] ANTS recommended a goods and services tax and that trusts be taxed as companies.[18]

To assist with consultation with its business tax proposals arising from ANTS to make recommendations on reforms to the Australian tax system the federal Government established the *Review* in August 1998.[19] The *Review* was to be assisted by the *Treasury Tax Reform Task Force*, and was required to provide its report by 31 March 1999.[20] The *Review's* head committee consisted of three leading corporate businessmen, John Ralph (Chairman), Rick Allert and Bob Joss. Under the terms of reference the committee's objectives were broadly to 'make recommendations on the fundamental design of the business tax system, the processes of ongoing policy making, drafting of legislation and the administration of business taxation.' [21]

The review of business taxation's first paper: a strong foundation discussion paper

The *Review's* first report, *A Strong Foundation Discussion Paper*[22] was released in November 1998 and asserted that the business tax system was built on a deficient

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e. reform of Commonwealth/State financial relations must be addressed.'

13 Howard J (Prime Minister), Taxation Reform (Press Release, 13 August 1997).

14 Ibid.

15 Costello P (Treasurer), Tax Consultative Task Force, Tax Reform, Press Conference, 23 October 1997.

16 Ibid.

17 Costello P (Treasurer), A New Tax System for all Australians (Press Release No 79, 13 August 1998).

18 Ibid.

19 A Tax System Redesigned above n 1, v-vii.

20 Dirkis and Ting, above n 4, 604.

21 A Tax System Redesigned, above n 1, v-vi.

22 Review of Business Taxation, A Strong Foundation Discussion Paper (1998) (A Strong Foundation).

foundation,[23] and relevantly to its small business reforms, this paper set out the following key tax policy objectives:

In meeting the Commonwealth's revenue targets, the business tax system should be designed to meet three national objectives: optimising economic growth, ensuring equity and facilitating simplification.[24]

The review of business taxation's second paper: an international perspective discussion paper

In the second paper, *An International Perspective Discussion Paper, Examining how other countries approach business taxation*,[25] the *Review* gave guidance on how other countries structure their business taxation systems. This paper was prepared by an accounting firm, Arthur Andersen and provided a comparison of Australia's business tax system with those of 26 other countries.[26] However, this paper did not focus on the *Review's* NCL or STS proposals.

The review of business taxation's third paper: a platform for consultation

The *Review's* third paper, *A Platform for Consultation*[27] *Discussion Paper 2, Building on a Strong Foundation*, consisted of two volumes. The first volume dealt with possible reforms to the taxation of investments. The second volume considered possible reforms to the taxation of entities, international taxation and the taxation of fringe benefits. This third paper invited the public to make submissions in response to the issues raised.[28] Further, the paper asserted that the *Review* would discuss these issues with the community and such input would assist the *Review* in preparing its final report to the federal Government.[29] However, this paper provided little or any details about the Review's proposed NCL and STS regimes, thus effectively curtailing any consultation.

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23 Ibid, 13.

24 Ibid, 60.

25 Review of Business Taxation, An International Perspective Discussion Paper, Examining how other countries approach business taxation (1998) (herein after called An International Perspective).

26 Ibid, iii.

27 Review of Business Taxation, A Platform for Consultation Discussion Paper 2, Building on a strong foundation, (1999) (herein after called Platform for Consultation).

28 Ibid, 5-7.

29 Ibid.

The review of business taxation's report: a tax system redesigned

The Review in Recommendation 7.5 called for the introduction of non-commercial loss restrictions on small business and detailed its proposed NCL rules.[30] Consequently, the federal Government enacted the NCL rules in Div 35 of the Income Tax Assessment Act 1997 (Cth) (ITAA 1997). Additionally, recommendations 17.1-17.4 advocated new income tax accounting concessions for small business (the STS). The federal Government subsequently enacted the Review's STS into Div 328 ITAA 1997 and s 82KZM Income Tax Assessment Act 1936 (Cth) (ITAA 1936).

THE REVIEW'S PROBLEM IDENTIFICATION PROCESSES

Non-commercial losses

It was not until the *Review's* third paper, *Platform for Consultation*[31] and its report, *A Tax System Redesigned*[32] that the *Review* identified the problem of taxpayers claiming losses from hobby/lifestyle activities as tax deductions. The third paper briefly recognised the problem of tax revenue losses resulting from hobby/lifestyle activities.[33] This problem is evident in the following analysis of the pre NCL income tax regime.

The former regime

Prior to the NCL rules loss making business activities run by individuals were deductible against other assessable income even if those individuals knew that they were going to make a loss.[34] There was no need for those individuals to even have a reasonable prospect of making a profit.[35] Further, the Commissioner could not dictate taxpayers how to run their business affairs even if the business operations remained unprofitable.[36] Thus taxpayers were permitted to claim deductions for losses on business and investment activities and such losses could be offset against other assessable income.[37] This, however, created the following problems.

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30 A Tax System Redesigned above n 1, 294-300.

31 Platform for Consultation above n 27, 57.

32 A Tax System Redesigned above n 1, 295-296.

33 Platform for Consultation above n 27, 57.

34 *Ferguson v FCT* 79 ATC 4261; *FCT v Walker* 85 ATC 4179.

35 *Tweddle v FCT* (1942) 180 CLR 1; 2 AITR 360; 7 ATD 186.

36 Ibid, 7 ATD 186, 190.

37 The main exception to this rule applied to losses from negatively geared rental property from 17 July 1985 to 30 June 1987, sub-div G of Div 3 of Part III Income Tax Assessment Act 1936 [ITAA 1936].

Firstly, it proved difficult for taxpayers, tax practitioners and tax administrators to determine whether certain small scale businesses were genuine businesses as opposed to hobby/lifestyle type activities. This is important as deductibility for business expenses under the general deduction provision, s 8-1 ITAA 1997 rests on the premise that the taxpayer is carrying on a business. The difficulty in ascertaining whether a business existed arose from the nature of the tests applied to determine whether a business is being carried on.

The ITAA 1997 defines a 'business' to include 'any profession, trade, employment, vocation or calling, but does not include occupation as an employee.' [38] This definition is merely inclusive and does not provide any guidance for determining whether a particular activity constitutes a business. [39] In *Ferguson v FCT*[40] the Full Federal Court provided guiding principles as to whether a taxpayer is carrying on a business.[41] However, it is evident that these factors are not exhaustive.[42] Accordingly, there is no definitive approach as to what constitutes a business. Rather, the determination of a business is the result of a process of weighing up of a number of relevant factors.[43] This approach still creates great difficulty for taxpayers with small hobby type activities that have some elements of business and lifestyle characteristics. Consequently, the vagueness of this definition resulted in a plethora

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38 Section 995-1 ITAA 1997.

39 *FCT v St Hubert's Island Pty Ltd* (1978) 8 ATR 452, 455 (Stephen J).

40 79 ATC 4261, 4264-4265 (Bowen CJ, Franki J); 'The nature of the activities, particularly whether they have the purpose of profit-making, may be important. However, an immediate purpose of profit-making in a particular income year does not appear to be essential. Certainly it may be held a person is carrying on business notwithstanding his profit is small or even where he is making a loss. Repetition and regularity of the activities is also important. However, every business has to begin, and even isolated activities may in the circumstances be held to be the commencement of carrying on business. Again, organization of activities in a businesslike manner, the keeping of books, records and the use of system may all serve to indicate that a business is being carried on. The fact that, concurrently with the activities in question, the taxpayer carries on the practice of a profession or another business, does not preclude a finding that his additional activities constitute the carrying on of a business. The volume of his operations and the amount of capital employed by him may be significant. However, if what he is doing is more properly described as the pursuit of a hobby or recreation or an addiction to a sport, he will not be held to be carrying on a business, even though his operations are fairly substantial.'

41 These principles have been applied in a number of subsequent cases including: *Walker, FCT v Radnor Pty Ltd* (1991) 22 ATR 344, *Stone v FCT* [2002] FCA 1492.

42 *London Australia Investment Co Ltd v FCT* (1977) 138 CLR 106.

43 *Evans v FCT* (1989) 20 ATR 922; 89 ATC 4540; AAT CASE 12,860 Re DAFF and FCT (1998) 39 ATR 1042.

of cases[44] on business activity and a number of taxation rulings from the Australian Taxation Office.[45]

Secondly, under the self assessment system of income taxation certain taxpayers took advantage of the uncertainty of what constitutes a business and claimed deductions for losses on small business type activities that really amounted to hobby or lifestyle choices.[46] This provided an effective tax shelter for taxpayers facing the top marginal income tax rate of 46.5 per cent[47] that conducted loss making lifestyle activities such as hobby farms. The pursuit of such activities sometimes lacked any genuine intention to make a profit and appeared to have been conducted with some business flavour sufficient to pass the scrutiny of the Australian Taxation Office. As a result the Australian Taxation Office had considerable difficulty in differentiating between genuine business and hobby farms given its resource constraints.[48] This is evident from the time intensive nature of such audit work and dispute resolution.[49] Further a number of liberal interpretations by the courts in accepting small scale primary production activities as businesses hampered the Australian Taxation Office's efforts in preventing such tax avoidance. [50]

Relevantly, apart from the primary production tax scheme cases,[51] the Australian Taxation Office does not appear to have ever evoked the general anti avoidance provisions in Part IVA ITAA 1936 against such hobby businesses. Part IVA would have potentially applied to many of these hobby activities given the lack of commercial purpose and the considerable tax benefits obtained in deductible losses.

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44 *Martin v FCT* (1953) 90 CLR 470; Ferguson; *FCT v Walker* 85 ATC 4179; *FCT v Stone* 2005 ATC 4234; *Puzey v FCT [*2002] FCA 1171, 50 ATR 595; *FCT v Sleight* [2004] FCAFC 94, 55 ATR 555.

45 Australian Taxation Office, Taxation Ruling (herein after referred to as TR) TR 97/11 'Income tax: Am I carrying on a Business of Primary Production?' <www.ato.gov.au>; TR 2005/1 'Income tax: carrying on business as a professional artist'; TR 2003/4 'Income Tax: Boat hire arrangements'.

46 Australian Treasurer Media Release 074, The New Business Tax System Stage 2 response, Attachment A Treatment of Losses from Non-Commercial Activities 11 November 1999 http://www.treasurer.gov.au/tsr/content/pressreleases/1999/074.asp.

47 Including medicare levy for the income year ending 30 June 2007.

48 Australian Treasurer Media Release 074, above n 46.

49 Ibid.

50 In Walker, a taxpayer with only one Angora goat was held to amount to a primary production business activity and in Ferguson, a taxpayer owning as few as five cows was held to be carrying on a business.

51 Although Part IVA ITAA 1936 was successfully applied in primary production investment scheme cases in *Puzey, Sleight and Iddles v FCT* (2005) 60 ATR 1187.

The federal Labor Government's *Draft White Paper* proposed restrictions for primary production losses given the use of tax shelters such as farms and the consequential losses of tax revenue.[52] The Treasurer, Paul Keating announced that amendments would be introduced in the 1986-87 years to restrict such losses.[53] These reforms though met fierce resistance from farmers who held demonstrations in MacKay, Townsville and Brisbane.[54] Consequently, the federal Government abandoned the primary production loss quarantining rules.[55] The federal Government asserted that an alternative approach would be taken.[56] However, the federal Labor Government took no further action.

Further issues

Whilst the Review correctly identified the problem of hobby / lifestyle losses, it failed to refer to any small business tax research to facilitate its problem identification.[57] A vital issue concerned what constitutes a non-commercial business (so genuine businesses would be unaffected). The Review though made no reference to any research as to what constitutes a non-commercial business. Another issue concerned the identification of the specific sectors of the community that principally claim hobby / lifestyle activity losses to allow better targeting of specific tax reforms. The Review, though, did not refer to any small business tax research that identified the sectors of the community that created this problem. Further, the Review did not examine the lack of use of Part IVA as a contributing factor to the NCL problem.

Simplified tax system

The *Review's* first paper, *A Strong Foundation*[58] and its report, *A Tax System Redesigned*[59] both correctly identified the general problem of onerous compliance costs for small business.

For example, in 1996 the Australian federal Government embarked on a campaign to help free Australia's then 860,000 small businesses from the constraints of crippling taxes and red tape with the establishment of the *Small Business Deregulation Taskforce*

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52 Keating P (Treasurer), Reform of the Australian Tax System: Statement by the Treasurer (AGPS Canberra 1985) 42.

53 Ibid 14.

54 House of Representatives, Hansard (17 April 1986) <www.aph.gov.au>.

55 Ibid 2502.

56 Ibid.

57 A Tax System Redesigned above n 1, 294-300.

58 A Strong Foundation above n 22, 14-22.

59 A Tax System Redesigned above n 1, 575.

(the *SBD Taskforce*).[60] As the *SBD Taskforce* observed, tax loomed as the main regulatory compliance issue for small business.[61] Notwithstanding the efforts of the *SBD Taskforce*, with the voluminous tax reforms flowing from the *Review's* 1999 *report*[62] and the introduction of the goods and services tax on 1 July 2000,[63] the taxation laws expanded from some 3,000 odd pages of legislation in 1996 to over 10,000 pages in 2008. Moreover the costs of tax compliance for small business are highly regressive.[64] As the *Review* noted, the limited resources of small businesses mean that such businesses work under the constraints of sub optimal systems and limited knowledge to comply with a mass of taxation regulations and record keeping requirements.[65] Leading tax practitioner bodies have similarly argued that tax laws impose an intolerable burden on small business.[66]

It was not until its report,[67] that the *Review* attributed this compliance costs problem to perceived difficulties that small businesses were having with the following four income tax accounting issues: the accruals income tax accounting rules,[68] the deductions prepayment framework,[69] the capital allowances regime[70] and the trading

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60 Bell C (Chair), Time for Business: Report of the Small Business Deregulation Task Force, AGPS, Canberra, 1 November 1996; Taxation Institute of Australia, 'Current Topic, Small Change' (1996) 31 TIA 174, 174-5.

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

62 A Tax System Redesigned above n 1. For example small businesses were affected by the NCL provisions in Div 35 ITAA 1997 and the alienation of personal services provisions in Pt 2-42 (Divs 84-87).

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

64 Evans C, Ritchie K, Tran-Nam B and Walpole M, A Report into Taxpayer Costs of Compliance, (1997) Australian Government Publishing Service, 85. Smaller businesses have fewer resources to comply with tax legislation and thus their tax compliance costs expressed as a percentage of business revenue are far higher than larger businesses.

65 A Tax System Redesigned above n 1, 74.

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

67 A Tax System Redesigned above n 1, 294-300.

68 Sections 6-5, 8-1 ITAA 1997.

69 Section 82KZM ITAA 1936.

stock rules.[71] Thus, the *Review's* third paper ignored the impact of these income tax accounting rules on small business compliance costs.[72] This paper merely noted the 'systemic problems underlying the evident complexity of the business tax system'.[73] As a result, a valuable opportunity for community feedback was missed. Further, the *Review* appears to have identified the problem of income tax accounting rules for small business within a very short period of five months,[74] and without any community consultation.

Consequently, the *Review* proposed 'simplified' STS rules for small business for income tax accounting, prepaid expenses, capital allowances and trading stock.[75] It is evident from the following analysis, though, that the general income tax accounting rules do not greatly burden small business.

Income tax accounting rules

Importantly the income tax timing rules for the 'derivation' of ordinary business income[76] and the 'incurring' of deductions[77] broadly equate with the accruals accounting system. Since most small businesses use accruals accounting[78] these

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70 Div 40 ITAA 1997.

71 Div 70.

72 Platform for Consultation, above n 27.

73 Ibid 8.

74 Sometime after the third paper (February 1999) and prior to the report, (July 1999).

75 A Tax System Redesigned above n 1, 575, Recommendation 17.1.

76 The approach of the courts in interpreting 'derived' in s 6-5 for businesses is similar to the accounting treatment, which also requires the accruals basis. See *Commissioner of Taxes (SA) v The Executor, Trustee and Agency Company of South Australia Ltd* (Carden's case) (1938) 63 CLR 108; *FCT v Australian Gas Light Co* 83 ATC 4800; *J Rowe & Son Pty Ltd v FCT* (1971) 124 CLR 421. See J Hoggett et al, Financial Accounting (6th ed, 2006) 130; AASB Framework for the Preparation and the Presentation of Financial Statements paras 83, 92, 93 provides that income is recognised in the period in which the anticipated inflow of economic benefits will flow to the entity and where this can be measured reliably. In recognising income, revenue should be earned.

77 The approach of the Courts in interpreting 'incurred' in s 8-1 is similar to the accounting treatment where expenses are recognised when consumption of goods and services has occurred and is capable of reliable measurement. See *W Nevill & Co v FCT* (1937) 56 CLR 290; *New Zealand Flax Investments Ltd v FCT* (1938) 61 CLR 179; *FCT v James Flood Pty Ltd* (1953) 88 CLR 492. See Hogett, above n 81, 130; AASB Framework above n 68, paras 94, 95 provides that expenses are recognised on the basis of a direct association between costs incurred and the earning of income.

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

concepts are well established and understood by small business and taxation practitioners. Overall, the impact of these non-STS income tax accounting principles on compliance and administration costs for small business appears to be manageable.

Prepayment

Taxpayers outside of the STS that carried on a business can only generally claim a deduction for prepayments over the lesser of ten years or the period to which the prepaid benefits related (eligible services period).[79] Similarly, under the accounting rules, prepaid expenses should be accrued over the period that directly relates to the earning of income.[80] Again, the tax treatment broadly reflects proper financial accounting practice.

Capital allowances

Prior to 1 July 2001 the income taxation provisions contained over 37 separate capital allowance provisions.[81] As a result, the *Review* recommended that these regimes be consolidated under a unified system with consistent rules.[82] On 1 July 2001 a new system known as the uniform capital allowance system was introduced.[83] As part of the new regime, the new depreciation rules were established in Division 40 ITAA 1997.

There are a few reasons why the compliance costs of Div 40 would not be overly onerous to small business taxpayers and tax practitioners. First, these depreciation provisions based on effective life broadly reflect proper financial accounting practice.[84] Secondly, Div 40 has operated since 1 July 2001 and thus this regime is now well established. Thirdly, given the widespread use of computers to calculate depreciation these costs appear to be manageable for small businesses. Fourthly, given the small scale of their operations many small businesses are likely to have relatively few depreciating assets and thus any compliance costs under Div 40 may not be significant.

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79 Section 82KZMD(2) ITAA 1936.

80 AASB Framework above n 76, paras 22, 93.

81 A Tax System Redesigned above n 1, 308.

82 Ibid, Recommendation 8.2

83 Div 40 ITAA 1997.

84 AASB Framework above n 76, paras 22, 96, In recognising expenses associated with the using up of assets such as plant and equipment the expenses are recognised in the accounting period in which the economic benefits associated with these items are consumed or expire.

Trading stock

Since the trading stock system is well established[85] and is broadly similar to the accounting trading stock rules[86] it appears that Div 70 is well understood by small businesses and tax practitioners. Thus the trading stock compliance costs do not appear to be onerous for small business since these calculations are required for financial accounting[87] as well as internal control[88] purposes.

Further issues

The *Review* did not provide any research to underpin its problem identification process and its finding that income tax accounting issues caused excessive compliance costs for small business. It further failed to identify what constitutes a 'small business'. To simplify taxation law for small business, a single definition of 'small business' needs to be universally applied to the small business rules across the various taxation laws, replacing all former definitions. This breached the *Review's* own recommendation for an integrated tax code.[89] The *Review* did not even contemplate the possibility of providing direct compensation so as to better target the provision of assistance to small business with their compliance costs.[90]

As discussed above, for small business taxpayers that are not part of the STS concessions, the accruals income tax accounting rules, prepayment, depreciation and trading stock provisions do not impose any serious compliance costs since these measures are required for financial accounting, managerial accounting and internal control purposes. These tax accounting provisions are long-established and appear to be well understood by small business and taxation practitioners. Since the non-STS income tax accounting regime provides no real compliance problem for small business it is apparent that the *Review* misdiagnosed the underlying causal factors in its problem identification process.

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85 Div 70 commenced on 1 July 1997.

86 AASB Framework above n 76, paras 22, 92-95, 101; AASB 102, IAS 2 Inventories.

87 Ibid.

88 Hoggett, above n 76, 255: Stock takes are required to detect accounting errors, losses and theft.

89 A Tax System Redesigned above n 1, 129.

90 Ibid 575-586.

THE REVIEW'S SOLUTION

The non-commercial loss rules

The third paper briefly outlined possible solutions to the hobby / lifestyle losses problem.

> …options might include measures to ensure losses are quarantined and allowed only against future assessable business income in the same or similar activity (perhaps based on an approach used in the US). …
>
> All such options would need to be developed with community consultation and structured in such a way as to ensure that legitimate arrangements were not unintentionally denied business deductions. [91]

Whilst this paper sought to obtain feedback from the community on its tax reform plans, the *Review's* proposed NCL solution was not detailed. Further, there was no socio-economic modelling so as to quantify the fiscal adequacy, economic, equity and simplicity impacts of possible reforms (in line with the *Review's* stated national policy objectives). The winners and losers from its proposed NCL reforms were also not identified. Consequently, this lack of detail stymied an important opportunity for community feedback. Again the *Review* relied on such feedback in preparing its final report.

Further, the third paper was misleading, as it asserted that hobby / lifestyle activities would be targeted by the reform proposals and that losses from 'legitimate' businesses would not be affected.[92] However, in its report, the *Review* subsequently recommended rules that exclude certain hobby / lifestyle activities from the loss limitation rules that satisfy the small business minimum criteria (as discussed below). Additionally, genuine small businesses that fail to meet the small business minimum criteria (as discussed below) would have their losses quarantined.

Given the absence of detail in the third paper, the *Review* appears to have quickly designed its NCL rules some time after the third paper, (February 1999) and before its report, *A Tax System Redesigned* (July 1999), a period of 5-6 months. As noted above, the *Review* recommended quarantining of certain small business losses. [93] Under this proposal, a loss from an activity carried out by an individual could not be offset against other income of that individual unless the particular activity satisfied at least one of the following tests:

(i) the loss arose in relation to the rental of real property;

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[91] Platform for Consultation above n 27, 57-58.

[92] Ibid 57-58.

[93] A Tax System Redesigned above n 1, 294-300, Recommendation 7.5.

(ii) the particular activity from which the loss arose had an annual turnover of greater than $20,000;

(iii) assets, not being assets that are primarily used for private purposes, have a value:

(iv) that, in respect of real property, exceeds $500,000; or

(v) that, in respect of all other assets, excluding passenger motor vehicles, exceeds $100,000;

(vi) and were used on an ongoing basis in the particular activity;

(vii) the particular activity resulted in taxable income in three out of the last seven years; or

(viii) it would be unreasonable for the loss from the activity not to be offset against other income for that year because:

(ix) the activity was affected by circumstances outside the control of the taxpayer, including drought, flood, bushfires or other natural disasters; or

(x) an activity with a significant commercial purpose or character has been commenced. [94]

If none of these tests were satisfied, the losses from the particular activity would be deferred until a future year where income from the same or a like activity is available or at least one of the above tests is satisfied.[95] Then the deferred losses could be offset against other income.

Not surprisingly given the brief time frame, the *Review* again failed to provide any socio-economic modeling so as to quantify the economic, equity and simplicity impacts of its NCL proposal.[96] The *Review* only estimated the impact on fiscal adequacy.[97] The winners and losers in the various sectors of the economy from the proposed reforms were also not identified and there was no consultation. The *Review's* processes appear to have lacked transparency. [98]

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94 Ibid.

95 Ibid.

96 Ibid.

97 Ibid 722.

98 Ibid 294-300, 739-754. Whilst Chapter 25 provided modelling of the impact on industry production of the entirety of the Review's business tax reforms, no modelling was undertaken in respect of the specific impact of Div 35. Overall, after noting the significant degree of uncertainty involved in estimating effects on individual industries, the Review

Nevertheless, the *Review* went onto assert that the reforms would ensure a more equitable and certain taxation treatment. [99] However, the practical operation of the enacted NCL rules (that were closely aligned to the *Review's* recommendations) has illustrated a number of structural flaws in the *Review's* proposals.

Failure to prevent hobby / lifestyle activity losses

First, as noted above, the NCL recommendations do not always limit loss deductions for hobby / lifestyle activities since such activities that satisfy any of the tests would not be subject to loss quarantining. [100] For example, hobby / lifestyle activities that satisfy any of the four proposed tests above (the $20,000 annual turnover test, the $500,000 real property test, the $100,000 other assets test or the profits in 3 out of the last 7 years test) would be exempted from the loss limitations.

The enacted NCL rules similarly contain four tests (the $20,000 annual turnover test, the $500,000 real property test, the $100,000 other assets test or the profits in 3 out of the last 5 years test).[101] As commentators noted, these exemptions in Div 35 enable many hobby / lifestyle activities to sidestep the loss limitation rules.[102] This is considered to be a structural flaw in the Review's NCL recommendations since the purpose of the rules was to deny such loss deductions.[103] Such exemptions for hobby / lifestyle activities are economically inefficient as this encourages inefficient use of scarce resources. This also damages equity since high income and wealthier taxpayers holding more expensive or larger scale hobby / lifestyle activities are generally unaffected by the loss limitations given the quantum of these exemptions.[104]

Prevents loss deductions for genuine small business

Secondly, the *Review's* NCL recommendations actually prevent deductions for genuine business losses for businesses that do not satisfy any of the tests.[105] As noted above, the enacted NCL rules contain similar tests[106] and these tests have a harsh

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concluded that its total reforms would not significantly advantage or disadvantage any industry sector (pp 747-748).

99 A Tax System Redesigned above n 1, 294-300, Recommendation 7.5.

100 Ibid, Recommendation 7.5(a)(ii)-(v).

101 Sections 35-30, 35-45.

102 Cooper, above n 7, 163; Douglas, above n 7, 390-392; Kenny, above n 7, 595-598; Treefarm Investment Managers, above n 7, Greenleaf, above n 7, 681.

103 A Tax System Redesigned above n 1, 295-296.

104 Douglas, above n 7, 387; Greenleaf, above n 7, 705-706; Kenny, above n 7, 595-597.

105 A Tax System Redesigned above n 1, 295-296: Recommendation 7.5(a)(ii)-(v).

106 Sections 35-30 – 35-55.

impact in denying losses for genuine business given that over 100,000 individuals are subject to the NCL limitations.[107]

Taxpayers Australia asserted that 'The legislation provides certainty – certainty that it will kill off many genuine small businesses.'[108] The Taxation Institute of Australia similarly argued that '…the NCL provisions have the potential to deter people from investing in and carrying on a business…'[109] The *RIRDC Report* concluded on Div 35, 'From an efficiency point of view, it appears likely that this provision will have a negative impact on innovation in new and emerging industries and in farm diversification'. [110] Other commentators have also noted the harsh impact on small business.[111]

This is considered to be a structural flaw in the *Review's* NCL recommendations since the *Review* stated that the loss rules would not apply to legitimate arrangements.[112] Further, this is economically inefficient as genuine micro businesses can not offset their losses yet the other loss making businesses and investors do face these limitations.[113] It is also inequitable that certain genuine micro businesses face such restrictions whilst other loss making businesses and loss making investors are unaffected by Div 35.[114]

Adds another layer of complexity

A complex piece of legislation that replaces a myriad of judicial principles can improve simplicity but the *Review's* NCL recommendations failed to achieve this. [115] Rather, under the proposals the issue of whether a business is being carried, a major area of uncertainty, still needs to be resolved in applying loss limitations.[116] In this way, these recommendations work to add another layer of complexity which is evident in Div 35. This is considered to be another structural problem.

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107 Board of Taxation Post-implementation Review above n 7, paras 1.13-1.14.

108 Taxpayers Australia above n 7, 6.

109 Taxation Institute of Australia above n 7, 2.

110 Rural Industries Research and Development Corporation, Economic Effects of Income Tax Law on Investments in Australian Agriculture, With Particular Reference to New and Emerging Industries, January 2006, <http://www.rirdc.gov.au/fullreports>, vi.

111 Douglas above n 7, 389; Cooper above n 7, 162; Kenny above n 7, 593

112 Platform for Consultation above n 27, 57.

113 Kenny, above n 7, 592.

114 Douglas, above n 7, 387; Greenleaf, above n 7, 705-706; Kenny, above n 7, 595-597; Taxation Institute of Australia above n 7, 2, 6; Taxpayers Australia above n 7, 1-6.

115 Tran Nam B, 'Tax Reform and Tax Simplicity: A New and 'Simpler' Tax System' (2000) 23 *University of New South Wales Law Journal* 241, 244.'

116 A Tax System Redesigned above n 1, 294-300.

The loss limitation rule

For example, under the *Review's* loss limitation rule small businesses need to apply the loss rules to each particular activity.[117] Thus, only similar activities can be grouped for the purposes of working whether the limitations apply. As commentators have noted in respect of Div 35, working out what constitutes a similar activity involves a great deal of uncertainty.[118]

Further, the *Review* proposed that, where the business activity ceases for a period of time, the loss is carried forward until the income year when the activity recommences.[119] As a result, a permanent cessation of a business activity would mean that deferred losses are lost. Deferred NCL losses will also be lost on death. Additionally, this will be a major disadvantage for individuals who carry on a business that is subject to the NCL restrictions and who in later years restructure the business into a company or a trust. In this situation the quarantined losses are lost when the restructure occurs. Commentators have pointed to these difficulties in Div 35.[120]

The four tests

Small businesses also need to deal with the complexities of the *Review's* tests. This is evident in Div 35, where under the assessable income test, taxpayers have scope to manipulate assessable income.[121] The profits test in Div 35 may also lead to some manipulation by taxpayers as they seek to bring assessable income forward and to defer deductions so as to obtain a profit.

Complexity in the *Review's* real property and other assets tests is evident in Div 35 in determining which assets are to be included, determining their use and in making valuations.[122] The valuation process may also give rise to taxpayer manipulation and as a result lead to increased levels of tax disputation. These tests further provide incentives for business to over-capitalise on their holdings of real property and other assets.

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117 Ibid 294-295.

118 Cooper, above n 7, 162, Greenleaf, above n 7, 694; Taxpayers Australia, above n 7, 5; Kenny, above n 7, 590; Douglas, above n 7, 389

119 A Tax System Redesigned above n 1, 294-295.

120 Institute of Chartered Accountants 'Submission' above n 7, 3; Taxpayers Australia above n 7, 5 considered that the impact on such corporate restructuring was '…punitive and drastic to some owners of genuine small businesses caught by this legislation'.

121 Section 35-30; see Cooper above n 7, 163.

122 Sections 35-40, 35-45.

Additionally, in order to cater for individuals that are in partnerships, special rules need to be devised. Whilst the *Review* ignored this issue, Div 35 provided such rules for partnerships.[123] These rules, though, add considerably to the difficulty in applying the four tests in respect of partnerships.[124]

The 'unreasonable' exceptions

The *Review* recommended that the loss limitations should not apply where that would be unreasonable given the activity's special circumstances, or given the activity's significant commercial character.[125] However, little guidance was provided as to what special circumstances would amount to being 'unreasonable' or for determining whether an activity had significant commercial character. These proposals appear to introduce significant levels of uncertainty for small business.

Whilst the enacted legislation provided more detail in respect of the application of the special circumstances exception[126] and the significant commercial character (known as the lead time)[127] exception, new problems emerged. For example, the vagueness of the definition of 'special circumstances' in Div 35 and the many unusual conditions that are likely to affect many businesses from time to time, means that this issue is likely to result in increased levels of tax disputation.[128]

Additionally, the lead time exception in Div 35 introduced significant levels of uncertainty. Under this exception the business activity must because of its nature fail to satisfy one of the four tests set in ss 35-30, 35-35, 35-40 or 35-45.[129] Taxation Ruling TR 2007/6 explains that this requirement refers to some 'inherent characteristic that

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123 Section 35-25.

124 For example, individuals in partnerships need to take into account their partnership interests from a particular activity plus their own interests for that activity in determining whether the tests in Div 35 are met, ss 35-30 – 35-45. The difficulty this provides is illustrated in TR 2001/14 paras 145-146, which provides worked examples for partnerships and Div 35. In particular there is a rather demanding need to obtain valuations for partnership assets for the real property and other assets tests, ss 35-40 – 35-45.

125 A Tax System Redesigned above n 1, 294-295, Recommendation 7.5(v).

126 Section 35-55(1)(a).

127 Section 35-55(1)(b).

128 See *Farnan v FCT* 2005 ATC 2093, 2098. The taxpayer unsuccessfully argued that as a result of special circumstances the Commissioner should have exercised his discretion not to defer losses from his driving instruction business. The special circumstances were the closure of a high school where the applicant made business presentations and this impacted negatively on his business. The AAT rejected this argument finding 'no evidence that, but for the closure of the high school, the taxpayer would have met any of the tests.'

129 Section 35-55(1)(b)(i).

the taxpayer's business activity has in common with other business activities of that type.'[130] The taxpayer's business must fail to satisfy one of the four tests during the 'initial period' (the period from commencement of business until the last income year when the characteristic affects the taxpayer's business) because of this inherent characteristic for this discretion to apply.[131] For example, this occurs where there is a lead time between when a business commences and the production of assessable income or profit.[132] Uncertainty in the lead time test is evident in a number of disputes before the courts.[133]

Further, since both of these exceptions in s 35-55 were made subject to the Commissioner's discretion, this created real difficulty for small business.[134] This meant that a taxpayer must apply to the Commissioner for a private ruling under s 359-10 of Sched 1 of the *Taxation Administration Act 1953* (TAA), requesting him to exercise his discretion under s 35-55 ITAA 1997 not to apply the loss deferral rule. This involves the completion of an extensive 20-page Australian Taxation Office application private ruling form.[135] It requires comprehensive information about the business activity and associated documentation. In respect of the business lead time discretion, the taxpayer will need to furnish independent evidence and business plans in respect of the lead time required for the business activity to pass a test or make a profit.[136]

From a practical point of view, partially offsetting these complexities, where the Div 35 limitations clearly apply, this provides some certainty by definitively eliminating deductions for a significant number of loss making small businesses who would otherwise need to consider whether they are carrying on a business. This will simplify the process of working out the deductibility of NCL business losses for taxpayers, taxation practitioners and administrators.

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130 Taxation Ruling TR 2007/6 'Income tax: non-commercial business losses: Commissioner's discretion' para 17.

131 Ibid.

132 Section 35-55(1)(b)(ii) Note.

133 *FCT v Eskandari* (2004) 54 ATR 695; *Kennedy v FCT* (2005) 59 ATR 1030.

134 Kenny above n 7, 590. Also, see Taxation Ruling TR 2007/6 which provides a 184 paragraph commentary on s 35-55.

135 Australian Taxation Office, 'Application for private ruling on the exercise of the Commissioner's discretion for the Non-commercial business losses' <www.ato.gov.au/downloads/n5806-12-2005.pdf>.

136 Taxation Ruling TR 2007/6 paras 103-104.

The simplified tax system

Given that the *Review* misdiagnosed the causes of the compliance problem for small business, its solution, the STS, was doomed from the outset. The STS was primarily designed to simplify the income tax system for small business,[137] so it would have been appropriate for the *Review* to refer firstly to the relevant tax research on how this may have been achieved, then consider the alternatives and go on to consult widely with the community. As commentators noted, there was a lack of research and debate involved in formulating the STS.[138]

There was no apparent thought given to the development of a universal definition of what constitutes a small business.[139] The *Review* failed in its publications to refer to the leading reports on compliance costs, apart from some extrinsic compliance cost material referred to as ATAX empirical research.[140] ATAX research was only used to confirm the regressive impact that compliance costs have on small business.[141]

The *Review* made no references to any tax research to underpin its cash accounting system, the prepayment regime, the accelerated depreciation regime or the trading stock rules.[142] In its third paper the *Review* should have detailed its STS proposal so that community input could have been obtained.

This all hindered the preparation of the *Review's* report and the *Review* hastily designed its STS over a period of 5-6 months.[143] The *Review* then recommended that a STS be introduced for small business to reduce their compliance costs.[144] Under this proposal, a small business with an annual turnover or annual receipts of less than $1 million, exclusive of Goods and Service Tax, and which derives less than 5 per cent of its income from a leasing activity would be able to elect to be taxed under the STS.[145] The proposed STS comprised a package of four elements involving:

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137 Ibid 575.

138 Bondfield, 'If there is an Art to Taxation' above n 8, 348; McKerchar, above n 8, 145; Burton, above n 8, 88-89.

139 Ibid.

140 Bondfield, 'If there is an Art to Taxation' above n 8, 348.

141 A Tax System Redesigned above n 1, 757-586.

142 Ibid 757-586; Burton, above n 8, 88-89.

143 Some time after the third paper, (February 1999) and before its report, A Tax System Redesigned (July 1999).

144 A Tax System Redesigned above n 1, 575.

145 Ibid.

accounting methods, prepaid expenses, capital allowances and trading stock.[146] All of the elements of the *Review's* STS were mandatory.[147]

The *Review's* cash accounting concession meant that small business would account for their income and expenses on a cash basis (rather than accruals).[148] This was designed to minimise compliance costs by providing a more straightforward and less costly accounting method. This would also enable some alignment with GST cash accounting. However, as noted previously, small business need to use the accruals basis for financial and managerial purposes and given the complexity of the STS, this provides no real simplification benefit. Also, the STS was poorly aligned with the GST legislation given the different eligibility criteria. For example, the method of calculating the $1 million turnover threshold varied between the two regimes.[149]

The *Review's* prepayments concession provided a write off where the prepayment relates to the provision of services or products over a period of more than 12 months.[150] This was also thought to provide simplification benefits by removing the obligation for small business of having to account for such assets. Again, as noted earlier, this would provide little simplification benefit since small business need to use the accruals basis for financial and managerial purposes.

The *Review's* depreciation concession provided immediate write offs for low cost assets and the pooling of depreciating assets in pools using accelerated depreciation rates.[151] This was also designed to reduce compliance costs since the pooling of depreciating assets would reduce record keeping requirements and deprecation calculations. Similarly, as noted above, this would provide little simplification benefit since small businesses need to use effective life depreciation for financial and managerial purposes.

Under *Review's* the trading stock concession small business would not have to account for trading stock where the difference between opening and closing stock was less than $5,000.[152] This was expected to aid the vast majority of small businesses by removing the need to account for trading stock and to undertake stock. Again, as

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146 Ibid 575-586.

147 A Tax System Redesigned above n 1, 575-586. Note, that under the enacted STS the trading stock regime was optional, former subdiv 328-E.

148 Ibid 578-581.

149 Sections 328-365 - 328-380 ITAA 1997; ss 188-10 – 188-20 A New Tax System (Goods and Services Tax Act) 1999 (GST Act).

150 A Tax System Redesigned above n 1, 580.

151 Ibid 581-584.

152 Ibid 584-586.

discussed above, this would provide little simplification benefit since small businesses need to undertake stock takes for financial and managerial purposes.

Unfortunately the *Review* failed to refer to any socio-economic modelling so as to quantify the economic, equity and simplicity impact of the STS. Also, the winners and losers from the proposed STS were not identified and there does not appear to any community consultation prior to its report. The *Review* only estimated its impact on fiscal adequacy.[153]

Notwithstanding all of this, the *Review* went on to make its STS the show case[154] of its reforms for small business, being one of its largest tax expenditures[155] that would help a vast number of taxpayers.[156] Further, the *Review* claimed that the STS would reduce compliance costs of small business.[157]

However, as discussed previously, the enacted STS (that closely followed the *Review's* recommendations) proved to be very unpopular. Only 14 per cent of eligible small businesses joined in the year ended 30 June 2002.[158] In later years, the take up rate increased to only 27 per cent of small business.[159] The cash accounting concession was scrapped on 30 June 2005[160] and the STS abandoned on 30 June 2007.[161] As the following analysis shows, the *Review's* recommendations contained serious structural flaws.

Failure to adequately define what constitutes a small business

First, as noted previously, the *Review's* recommendation failed its simplification goal because it did not provide a universal definition of a 'small business' to be used across the various taxation codes.[162] Rather, the *Review* recommended a unique

153 Ibid 721.

154 Bondfield 'If there is an Art to Taxation' above n 8, 314.

155 A Tax System Redesigned above n 1, 698, 721.

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

157 A Tax System Redesigned above n 1, 575.

158 ATO Tax Practitioners Forum above n 9.

159 Senate Estimates Committee Hearing, <http://www.aph.gov.au/hansard/senate/commttee/S9099.pdf> 72: Advice from Australian Taxation Office Deputy Commissioner Mark Konza.

160 Tax Laws Amendment (2004 Measures No. 7) Act 2005.

161 Tax Laws Amendment (Small Business) Act 2007.

162 A Tax System Redesigned above n 1, 575-577.

definition of small business ($1 million annual turnover).[163] Consequently, the enacted STS definition of a small business[164] was different from that utilised by the GST, capital gains tax and fringe benefits tax concessions for small business.[165] Such an arbitrary definition is considered to be a structural flaw since all small businesses and only small businesses should have access to the STS. For example, larger businesses with low turnover in their start up periods may qualify for the STS under the $1 million turnover requirement.[166]

Inflexibility and Complexity

Second, the inflexibility and complexity of the *Review's* STS recommendations worked to discourage small business. This is a serious structural issue given that the *Review*'s aim for the STS was to reduce compliance costs for small business.[167] This problem is also evident from the unpopularity of the enacted STS, its abandonment and from the views of numerous commentators.[168]

For example, the inflexibility of the proposed STS is seen by the mandatory application of the cash accounting, prepayment, capital allowance and trading stock concessions.[169] This would mean that taxpayers would have to make an annual overall calculation of the net benefit from these concessions to work out whether they should join or remain in the STS. The enacted STS also provided similar mandatory concessions (all concessions except the trading stock concession were compulsory). This resulted in difficult annual calculations for small business to work out the net benefit (if any) of joining or remaining in the STS.[170]

Further, the *Review* recommended that taxpayers be required to make an election to join or to leave the STS.[171] The enacted STS also provided elections and this further added to its complexity for small business.[172] Joining or leaving the STS involved significant compliance costs associated with ascertaining eligibility, estimating the

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163 Ibid.

164 Former s 328-365 ITAA 1997.

165 Div 48 GST Act; Div 152 ITAA 1997; s 58GA Fringe Benefits Tax Assessment Act 1986.

166 Div 35 ITAA 1997, though, included a $3 million depreciating assets limit to prevent larger businesses from accessing the STS, s 328-365(1)(c).

167 A Tax System Redesigned above n 1, 575.

168 Hine, above n 8; Snook, above n 8; Wolfers, Miller above n 8; Martin, above n 8; Douglas, above n 8; Tretola, above n 8; Bondfield, 'If there is an Art to Taxation' above n 8; McKerchar, above n 8; Kenny, above n 8.

169 A Tax System Redesigned above n 1, 575-577.

170 Former subdiv 328-F.

171 A Tax System Redesigned above n 1, 577.

172 Former subdiv 328-G.

benefits of joining or leaving the STS and notifying the Australian Taxation Office.[173] STS taxpayers needed to adjust their accounting systems for the uptake or cessation of cash accounting, prepayment deductions, pooled depreciation and for the estimation of trading stock on hand if they chose the simplified trading stock rules. Adjustments to assessable income or deductions in the year of making the change may have significantly increased or decreased taxable income and hence income tax payable. Once in the STS, a taxpayer may not be able to afford to leave given the income tax consequences. Further, where a taxpayer chose to leave, the taxpayer then needed to wait five years before re-entering.[174]

As discussed above, some of the complexity with the STS arises from the *Review's* failure to provide a universal definition of a small business and from the way that the four STS income tax accounting concessions ignore the commercial reality that most small businesses use accruals accounting.[175] This meant that small business in the STS would have had to run and adjust for two sets of accounts, one for tax purposes and another for financial reporting purposes.

Then there was the high level of detail in the proposed STS. This is evident in the first eligibility requirement that involves ascertaining whether a taxpayer was in business.[176] Further, the rules in the second eligibility requirement, the $1 million annual average turnover limit and the accompanying grouping rules appeared to be particularly complicated.[177] This is evident in the enacted STS which contained intricate rules for defining STS group turnover, defining the value of the business supplies, calculating grouping of an entity's turnover, working out who is an STS affiliate, defining control and indirect control of an entity and working out STS group turnover.[178] Unfortunately, the enacted STS grouping rules differed from the grouping rules for GST and this greatly added to its complexity for small business groups.[179]

Additionally, the recommendations provided highly detailed rules for the STS cash accounting, capital allowance and trading stock concessions.[180] Again, this detail is

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173 Former subdivs 328-F, 328-G.

174 Former s 328-440(3).

175 ICAA Media Release, above n 8.

176 A Tax System Redesigned above n 1, 575, Recommendation 17.1.

177 Ibid 575-577.

178 Sections 328-365, 328-380.

179 Sections 328-365, 328-380 ITAA 1997; Div 48 GST Act.

180 A Tax System Redesigned above n 1, 578-586.

evident in the enacted STS.[181] This detail and the lack of benefit in the cash accounting concession resulted in its abandonment from 1 July 2005.[182]

A high level of technical detail is also evident in the enacted STS depreciation rules. This created difficulties in working out which depreciating assets were to be excluded from the STS.[183] This was compounded by the choices given to STS taxpayers to choose between the STS or the general capital allowance[184] regimes. In making these choices, a taxpayer would have needed to compare the depreciation deductions to those available under STS so as to ascertain the optimal taxation position. The treatment of low cost assets provided for some simplification but this was offset by complications that arise with calculating cost.[185]

The pooling rules were particularly complex with their special rules for allocating assets, working out opening and closing pool balances, dealing with changes in business use and accounting for disposals.[186] Many depreciating assets still needed to be tracked on an individual basis when there was a change of private use by more then ten per cent, upon acquisition and on disposal.[187] In particular, a number of complexities arose for both pre-STS and post-STS depreciating assets for taxpayers joining, leaving or re-entering the STS.[188]

The enacted STS trading stocks rules provided that small business opting for this concession must make a reasonable estimate must be made of trading stock on hand.[189] The costs of making this estimate, however, may have been on par with the costs of performing a stock-take for such small levels of trading stock. As commentators noted, this concession provides no real benefit for small business.[190]

Favours a minority of small businesses

Finally, the *Review's* STS concessions favour a minority of small businesses. First, the STS discriminates against low income, small business taxpayers such as 'start up'

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

182 Tax Laws Amendment (2004 Measures No. 7) Act 2005, Sch 2. Although, cash accounting remains grand fathered for pre-exiting STS taxpayers.

183 Section 328-175.

184 Div 40.

185 Section 328-180.

186 Section 328-185.

187 Sections 328-205, 328-225.

188 Sections 328-175, 328-185, 328-220.

189 Section 328-285.

190 Hine, above n 8, 3-38; Bondfield, 'If there is an Art to Taxation' above n 8'If there is an Art to Taxation' above n 8, 334; Kenny, n 8, 41-42; McKerchar, above n 8, 144.

businesses since they face a zero or low marginal income tax rate. For such businesses, the value of a tax benefit under the STS concessions is negligible or nil.

Further, whether a small business was better off under the STS cash accounting, prepayment, depreciation and trading stock concessions involved a calculation of the overall net benefit from the STS (given the mandatory application of the first three of these concessions). As noted above, given that there appear to be few compliance savings from the STS, the primary benefit emanates from the tax deferral provided by the concessions. It is apparent from the *Review's* tax revenue modeling that the STS depreciation concessions provides the primary benefit to small business.[191] Thus small businesses involved in capital intensive sectors of the economy such as the agriculture, forestry, fishing, mining, manufacturing, construction and transport sectors benefit. Other sectors such as retail and professional service providers obtained little benefit.[192]

Overall, the *Review's* STS would not offset the compliance costs for the majority of small business by reducing the effective tax burden for small business. This is a structural flaw given that the STS was introduced to benefit and be widely accepted by small business.[193] As noted above, the unpopularity of the enacted STS exposes this flaw.

CONCLUSION

It is apparent that the structural defects in the NCL and STS legislation emanate from flaws in the *Review's* design processes. First, in the problem identification phase, whilst the *Review* correctly identified the NCL problem it failed to adequately research and analyse the sectors of the small business community that created this risk to tax revenue. As a consequence in its design phase the *Review* developed a very blunt instrument with its NCL proposals. As seen by the enacted Div 35, these loss limitation rules inappropriately caught genuine small business whilst many hobby / lifestyle activities were unaffected.

In its problem identification phase for the STS, the *Review* erroneously identified the cause of small business compliance costs as being the small business income tax accounting rules (regarding accruals accounting, prepayments, depreciation and trading stock). Consequently, in its design phase the *Review* developed a STS that poorly targeted small business and that did little to offset their compliance costs.

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191 A Tax System Redesigned above n 1, 721.

192 Snook, above n 8, 89-90.

193 A Tax System Redesigned above n 1, 575-576. The Review had in mind STS concessions that would appeal to most small businesses, given that 95 per cent of all businesses would be eligible.

These defects appear to have arisen from a number of weaknesses in the *Review's* processes. The *Review* carried out all of its processes within a period of eleven and one half months.[194] Such a tight timeline for the *Review's* research and consultation processes and the completion of the three papers and the report appears to have been its Achilles heel given the complexity and scale of its proposals.

Further, the *Review's* rationale for its NCL and STS proposals were not reconciled with the *Review's* objectives of ensuring fiscal adequacy and promoting economic efficiency, equity and simplicity. Apart from tax revenue impacts there was no quantification or analysis of the economic efficiency, equity and simplicity impacts of their reforms. The *Review* developed its rationale without forecasting the likely affect on small business and the community and the acknowledging the policy trade offs. Thus flaws emerged in the Review's policy objectives in both the NCL and STS proposals.

The NCL rules were designed to provide a more equitable and certain taxation treatment. Yet the arbitrariness of these rules creates considerable inequity. The complexity of the exceptions and the Commissioner's discretions all work to offset the gains to certainty. The NCL policy trade offs to economic efficiency, equity and simplicity were ignored in the *Review's* publications. The STS was introduced by the *Review* to reduce compliance costs of small business. However, as evident by its unpopularity, this goal was not achieved. Again, the STS policy trade offs to economic efficiency, equity and simplicity were overlooked. There was little or no consultation. Overall, the *Review's* processes lacked transparency.

Additionally, the NCL and STS provisions were directed at small business, yet the *Review's* three members (the head committee) solely consisted of large corporate business people (John Ralph (Chairman), Rick Allert and Bob Joss).[195] The absence of small business taxation law and policy experts on the head committee seems to have greatly restricted the ability of the committee to effectively carry out its NCL and STS reforms.[196] This would also appear to have made the committee overly reliant on assistance from the *Treasury Tax Reform Taskforce*. Perhaps reflecting Treasury's influence on the *Review* head committee, the *Review* was preoccupied with maximising tax revenue as evident in the excessive NCL restrictions on genuine business and the poor accessibility of the STS concessions, the draconian STS integrity rules and the minute STS trading stock exemption.

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[194] Ibid vii.

[195] Ibid v.

[196] Notwithstanding the presence of such experts on sub-committees.

The *Review's* extremely broad terms of reference appeared to cover the entirety of a highly complex business income taxation system.[197] Narrower terms of reference that sought to focus on parts of the business income tax system such as small business taxation would have been more manageable and this may have avoided many of the NCL and STS problems identified in this paper.

This partial analysis of the *Review's* policy design processes illustrates the difficulty in fast tracking comprehensive income tax reform. Future tax enquiries should adopt a more gradual, transparent and consultative approach in identifying and researching problems and in drafting taxation reform proposals. Further, wider community representation and expertise needs to be employed. It is vital that the rationale for specific tax reforms be carefully developed and supported by socio-economic modelling of the impacts on fiscal adequacy, economic efficiency, equity and simplicity.

[197] A Tax System Redesigned above n 1, v-vii.