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Laura R. Ingraham
San Jose State University, laura.ingraham@sjsu.edu

S. Karlinsky
San Jose State University

M. McKerchar
University of New South Wales

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TAX COMPLEXITY AND SMALL BUSINESS: A COMPARISON OF THE PERCEPTIONS OF TAX AGENTS IN THE UNITED STATES AND AUSTRALIA

By Margaret McKerchar,* Laura R Ingraham** and Stewart Karlinsky***

There is ongoing pressure in both the United States and Australia to simplify their respective tax systems, particularly in regard to small business taxpayers. In the case of both regimes, if substantial progress is to be made towards simplification, the areas of greatest need and the necessary reforms will require careful evaluation. The views of tax agents (practitioners) are highly relevant to the implementation of successful reform in that both regimes rely on self-assessment. It was considered that by undertaking a cross-jurisdictional comparison a greater understanding of complexity, from the perspective of tax agents, could be gained and that the consideration of alternate treatments could better inform tax policymakers. That is, what can we learn from each other? The article compares and contrasts the perceptions of practitioners on small business tax complexity based on a questionnaire instrument conducted in the US and an electronic survey and case study conducted in Australia. Tax practitioners in the US consistently rated the areas of partnerships, estate and gift valuations, tax deferred exchanges, frequency of law changes and retirement plans as the most complex and progressive tax rates, estimated taxes, social security/self-employment taxes, corporate capital gain provisions and cash v accrual method as the least complex. In comparison, Australian practitioners found the frequency of change, the volume of legislative material and the effect of change on other aspects of taxation (including reporting) to be the major causes of complexity. Capital gains

* Associate Professor of Taxation, Australian Taxation Studies Program, University of New South Wales and Visiting Research Scholar, San Jose State University.
** Associate Professor of Accounting and Information Systems, San Jose State University.
*** Professor of Accounting and Taxation, San Jose State University and Senior Fellow, Taxation Law and Policy Research Institute, Monash University.

tax provisions were regarded as complex as were self-managed superannuation funds and trusts, but similar to US tax practitioners, Australian tax agents did not find the use of tax rates or accounting methods to be complex. The policy implications of these findings are discussed for both regimes, including the implications of having small business-specific rules.

1. INTRODUCTION

The features of an effective and equitable tax system have been restated in various forms over time and across jurisdictions, but today in both the United States and Australia, they still reflect the four fundamental principles espoused by Adam Smith in 1776: namely equality, certainty, convenience of payment and economy in collection.[1] Equality (equity or fairness) is generally espoused as the most desirable of these features, though its achievement usually requires a sacrifice in terms of at least one of the other principles. Certainty is also highly desirable, perhaps more so now than ever as more and more tax regimes adopt self-assessment[2] and the business world becomes increasingly sophisticated. Ultimately a balance must be struck based on the goals of the decision-makers which in turn will reflect political will and the power of the constituency. Ideally (based on Smith's philosophy), this balance should recognise that taxation can be used to regulate certain activities or provide for the long-term good of society, in addition to simply raising revenue.

The principles of certainty (able to accurately interpret and apply the law) and economy in collection (minimise compliance and administration costs) are both encompassed in the notion of tax simplification, on which much has been written. In today's world, how simple can a tax system be? While undoubtedly a "sheikdom that can raise all the revenue it requires (and maybe much more) from a single tax on a single oil company has unquestionably the

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[1] R Heilbronger, *The Essential Adam Smith* (1986) 313-314.

[2] The US adopted self-assessment in 1913, Australia adopted self-assessment in 1986.

simplest tax system of all",[3] it is inappropriate in either jurisdiction. However, does this mean that tax simplification should be forsaken altogether?

Policymakers in both the US and Australia are currently grappling with demands for tax law simplification, particularly in respect of small business taxpayers who appear to be the group most adversely affected by increasing tax law complexity and escalating compliance costs. These taxpayers typically use a tax agent (or tax practitioner)[4] to manage their tax affairs and lodge the required returns. This practice serves to emphasise the importance of the agent to the maintenance of high levels of voluntary compliance (on which self-assessment systems depend). Further, research has demonstrated that high levels of complexity lead to reduced technical accuracy by both tax professionals and future tax practitioners (students).[5]

This article sets out to examine the experiences in both jurisdictions of achieving a balance between equity and simple tax law; and in particular, the effect of this balance on small business taxpayers. Clearly, there are limited resources in any tax system and those devoted to tax simplification need to be put to the most effective use possible. To this end, having an understanding of the perceptions of tax agents on these issues, and examining the experiences of tax practitioners and administrators in other regimes dealing with similar issues, may assist policymakers.

The balance of this article is presented in four sections. Section 2 provides the background on the adoption of tax simplification

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[3] K Asprey (Chair), *Taxation Review Committee – Full Report* (1975) 15 ("Asprey Committee").

[4] "Tax agent" is the term used in Australia, "tax practitioner" is the term used in the US. For the purpose of this article the terms have the same meaning – a qualified/registered accountant charging clients for attending to their tax affairs – and are used interchangeably.

[5] K Karlinsky and BS Koch, "Impact Of Tax Law Complexity On Professionals" (1987) 9 *Journal of the American Taxation Association* 24.

agendas in both jurisdictions. Section 3 briefly examines the economic importance of small business in both economies and the literature on the relationship between complexity and compliance behavior. Section 4 compares and contrasts the findings of research undertaken in both jurisdictions on tax agents and their perceptions of tax complexity. Based on this research, Section 5 discusses the policy implications of tax simplification in both the US and Australia and identifies potential strategies worthy of further exploration.

2. BACKGROUND

In the US significant lip service is paid to tax law complexity, its causes and effects, by government officials[6] but little has been done to date to simplify tax laws in spite of growing calls from many stakeholders.[7] While the need and desire for tax law simplification appears to be accepted by Congress, the Executive branch, practitioners and taxpayers alike, there is a perceived lack of constituency for simplification. Indeed, tax simplification has been described as "everyone's favorite orphan".[8] In turn, this perception of tax law complexity as being politically insignificant has a direct

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[6] See (22 July 2002) 96 *Tax Notes* 490 in which a member of House Ways and Means Committee, Rob Portman, introduced a tax simplification Bill that would potentially be implemented when budget surpluses exist. President Bush's Administration has requested Treasury's Office of Tax Policy to issue white papers on tax simplification, (11 February 2002) 94 *Tax Notes* 676.

[7] See S Dinon, New York State Bar Association Tax Section, Simplification of the Internal Revenue Code, (22 April 2002) 95 *Tax Notes* 575; American Institute for Certified Public Accountants has issued "Tax Policy Concept Statement #2"; "Guiding Principles for Tax Simplification 2002" and "Blueprints for Tax Simplification 1992"; C Eugene, Steuerle Senior Fellow at the Urban Institute and President of the National Tax Association, "The Simple Case for Tax Simplification" (10 December 2001) 93 *Tax Notes* 1497; WG Gale, Joseph A Pechman Fellow at the Brookings Institute, "Tax Simplification: Issues and Options" Testimony to the House Committee on Ways and Means, July 17, 2001; available at: http://www.brook.edu/views/testimony/gale/20010717.htm (accessed 4 April 2005).

[8] Fred Goldberg, former IRS Commissioner quoted in *Wall Street Journal*, August 5, 2004, D2.

impact on the development of tax policy. For example, at the time the Bush Administration requested Treasury to issue white papers on tax simplification, legislation was being enacted that either significantly increased tax law complexity or focused solely on rate reduction. While tax rate reduction may be popular with voters (at least in the short term), it ignores the very reasons for paying taxes at all.

Recent tax reforms in the US have not favoured the small business sector. For example, there was little funding provided to support small businesses in the 2004 budget and of the $674 billion in tax cuts announced, only $18 million was targeted at small businesses.[9] Landmark tax cuts have been an on going feature of the Bush Administration's fiscal policy with all provisions due to expire by 2010. Bush has signalled his intention that the cuts be made permanent, but there is growing concern about how the cuts are to be funded and, more importantly, their implication for long term economic growth.[10]

However, no matter how tax cuts are shrouded, they do not address the need for tax simplification. In a poll conducted in 2004 by the American Institute of Certified Public Accountants, tax-related issues emerged as the top priority legislative and regulatory issues for small businesses. Within tax issues, the consistency, complexity, compliance and structure of tax laws caused the most concern.[11] Compliance costs are an outcome of having complex, inconsistent and poorly structured law.

The first US study on the cost of compliance with federal regulations (including taxes) was conducted in 1995 and reported

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[9] (22 March 2003) 98 *Tax Notes* 1802.
[10] For example, see WG Gale and PR Orszag, "Bush Administration Tax Policy: Effects on Long-Term Growth" (18 October 2004) 105 *Tax Notes* 415; available at: http://www.brookings.edu/views/articles/20041018orszaggale.htm (accessed 4 April 2005).
[11] Available at: http://www.aicpa.org/pubs/cpaltr/may2004/poll.htm (accessed 4 April 2005).

that the cost to comply with tax regulations for small business was 50% higher per employee than for large businesses (over 500 employees). Large businesses incurred a cost of $3,400 per employee, while small businesses were burdened with a cost of $5,500 per employee. Furthermore, small businesses bore 63% of the compliance burden but generated only 50% of employment and sales.[12]

A study in 2001 by Crain and Hopkins[13] subdivided the small business sector based on employee size: those with less than 20 employees (small firm); and those with 20 or more employees but less than 500 (mid firm). They found that for the year 2000, small firms faced a total regulatory burden of almost $7,000 per employee, which was 60% higher than the cost per employee for large businesses. The tax compliance burden for small firms was more than twice the size per employee than for large businesses. Interestingly, a mid firm's tax compliance costs were only 10% higher per employee than those of a large business. This demonstrates that compliance costs are essentially of a fixed nature and therefore regressive for smaller businesses. The Internal Revenue Service ("IRS") has responded positively to the issue and developed a micro-simulation model to estimate the compliance burden of law changes and currently enacted law.[14] However, as the effect of this development on tax policy is not yet apparent, it may simply be further evidence of the lip service being paid to the issue of tax law complexity in the US.

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[12] Report to Congress by the Office of the Chief Counsel for Advocacy, US Small Business Administration entitled "Changing Burden of Regulation, Paperwork and Tax Compliance on Small Business"; available at: http://www.sba.gov/advo/laws/archive/law_brd.html (accessed 4 April 2005).

[13] MW Crain and TD Hopkins, "The Impact of Regulatory Costs on Small Firms" Report for the Office of Advocacy, US Small Business Administration RFP no SBAHQ-00-R-0027 (2001); available at: http://www.sba.gov/advo/research/rs207tot.pdf (accessed 4 April 2005).

[14] (25 November 2002) 97 *Tax Notes* 1013.

In contrast, the calls for tax reform in Australia have been both vehement and sustained from all external stakeholders. There has been extensive research conducted[15] and recognition by government of the regressive nature of compliance costs.[16] There have been a number of comprehensive reviews[17] conducted and recommendations made for major reform, but adoption has been piecemeal and delayed at best, and generally responsive and politically acceptable rather than visionary or fully committed. While a number of measures introduced have been specifically to address compliance costs and small business[18] issues, no one would argue that the Australian tax system today is less complex than in was in 1970s.

The Asprey Committee stated in 1975 that the tax system was becoming increasingly complex based on the number of amending Acts, the number of cases transmitted to Boards of Review, the number of appeals, and the size of the publication of sales tax rulings.[19] The Asprey Committee made many recommendations, including a greater reliance on indirect taxation, though it took until 2000 for a Goods and Services Tax ("GST") to be introduced, due largely to continued public resistance. In the intervening years there were many other changes including the introduction of the Capital

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[15] See, eg, J Pope, R Fayleand and M Duncanson, *The Compliance Costs of Personal Income Taxation in Australia, 1986/87* (1990); J Pope and R Fayle, "The Compliance Costs of Public Companies' Income Taxation in Australia 1986/87: Empirical Results" (1991) 8 *Australian Tax Forum* 485; and C Evans, K Ritchie, B Tran-Nam and M Walpole, *A Report into Taxpayer Costs of Compliance* (1997).

[16] A Statement by the Prime Minister, John Howard, *More Time for Business*, 24 March 1997; available at: http://www.pc.gov.au/orr/reports/external/mtfb/ (accessed 5 April 2005).

[17] The Asprey Committee commenced in 1972; Small Business Regulation Taskforce (known as the "Bell Taskforce") commenced in 1996 and the Review of Business Taxation (known as the "Ralph Review") commenced in 1998.

[18] The term is used to include both micro and small businesses in an Australian context. For tax purposes, a micro business has a turnover <$2M, and a small to medium business has a turnover between $2M and $100M.

[19] Asprey Committee, above n 3, 7.

Gains Tax ("CGT") in 1985 and Fringe Benefits Tax ("FBT") in 1986, and the volume of legislation, explanatory material and rulings grew almost exponentially. The *Income Tax Assessment Act 1936* (Cth) was some 750 pages in length in the 1970s and over 4000 pages by 2000 at which time it was described as a monster – out of control and becoming progressively worse.[20] The Federal Government announced a rewrite of the legislation into plain English. The rewritten legislation was progressively enacted as the *Income Tax Assessment Act 1997* (Cth) but the project was subsequently disbanded (only one third complete) as voters finally supported the introduction of a reform package known as *A New Tax System* ("ANTS") of which GST was the major change. As a result, both Income Tax Assessment Acts remain in force – further compounding the problem of voluminous legislation.[21] The pace of reform since 2000 has continued, with further reforms to CGT, depreciation and small business measures. Currently there are between 200-300 tax bills in Parliament, 300 public rulings issued by the Australian Taxation Office ("ATO") and some 2,500 private rulings issued on an annual basis.[22]

In terms of business reform, the Ralph Review was charged with devising measures to increase the efficiency of all Australian businesses and, more importantly, to tackle the problems of the lack of simplicity and the burgeoning of compliance costs.[23] Two important outcomes of the Ralph Review specifically directed at small business were the introduction of a Simplified Tax System

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[20] ICF Spry, "Editorial: Developments in Taxation from 1971-1993" (1993) 1 *Australian Tax Review* 5, 6.

[21] This may be an important lesson for the US especially with a regime investigating the implementation of a consumption tax. If the definitions utilised are different in the income and consumption tax systems, substantial complexity is engendered.

[22] Michael Dirkis, Tax Director of the Tax Institute of Australia, quoted in K Marshall, "Sharp End Offers a Hollywood High – Tax Education", *Australian Financial Review*, 7 March 2005, 30.

[23] B Bondfield and M Dirkis, "The RBT ANTS Bite: Small Business the First Casualty" (2004) 19 *Australian Tax Forum* 107.

("STS") from 1 July 2001 and a range of CGT concessions available on disposal. In addition, new anti-avoidance measures targeted at small business (affecting both contractors and small business operating at a loss) were introduced. The STS allowed small business taxpayers to use cash accounting, to cease undertaking physical stocktakes (inventory counts), and to pool assets for depreciation purposes.[24] However, to date few businesses have elected to be taxed under the STS. The Ralph reforms in respect of small business have been strongly criticised for lack of consultation, and the poor quality of policy, legislative design and implementation. More importantly, in terms of small business, it has been argued that compliance costs post-Ralph are greater than ever.[25]

While the Australian approach to tax simplification has been more than lip service, it has been far from effective. Policymakers have not been able to come to terms and commit to what is required. For example, legislation has recently been passed whereby small business taxpayers who elect to be taxed under the STS will receive up to a 25% "entrepreneur's tax discount".[26] That is, they will be compensated for their compliance costs. However, this still does not address the underlying issue of the impact of unnecessary tax law complexity on business productivity and economic growth in the long-term.

3. SIGNIFICANCE OF THE SMALL BUSINESS SECTOR AND OF COMPLIANCE

Small businesses in the US employ 58% of the non-farm workforce and 39% of the high tech workforce. Small businesses

[24] Note that more recent changes to STS have been made effective from 1 July 2005.
[25] Bondfield and Dirkis, above n 23.
[26] Press Release, Treasurer, Peter Costello, 17 March 2005; available at: http://www.treasurer.gov.au/tsr/content/pressreleases/2005/019.asp?pf=1 (accessed 23 March 2005).

generate 43% of sales and 51% of private GDP. Of the 22.4 million US non-farm companies in 2001, 99% were small businesses.[27]

Small businesses in Australia represent more than 96% of all non-agricultural businesses in the private sector. Small businesses account for 47% of employment in the private sector and generate around 30% of Australia's economic activity. Australia had an estimated 1.1 million small businesses employing less than 20 people,[28] representing almost 45% of the workforce.[29]

Clearly small businesses are an economically and socially critical aspect of both countries. Thus it would appear prudent to heed their concerns about tax law complexity and how it impacts on them. Taxpayers in both the US and Australia are required to self-assess their tax obligations and are heavily reliant on tax agents in doing so. Thus tax agents play an important role ensuring taxpayers voluntarily comply. The use of tax practitioners has grown in the US from 41% of total returns filed in 1981 to more than 55% in 2002.[30] For those taxpayers lodging their own return, based on IRS estimations, it would take them over two hours longer in 1998 than it did ten years earlier.[31]

Australia has arguably the highest usage of tax agents in the world, with over 75% of personal taxpayers using a tax agent (compared to 40% in 1978 and 60% in 1984) and over 92% of

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[27] S Karlinsky and G Payne, "A Comprehensive Analysis of How US and Australian Income Tax Law Define and Encourage Small Business" (2005; unpublished manuscript).

[28] Ibid.

[29] Media release, N Earle, Taxation Institute of Australia, "Reflections on the ALP's Tax Package", 8 September 2004; available at: http://www.taxinstitute.com.au/index.cfm?objectid=6643CEAE-D0B7-4CCD-1AB218F87798809B (accessed 5 April 2005).

[30] WG Gale, "Tax Preparer Usage Rises Significantly Since 1981" (20 September 2004) 104 *Tax Notes* 1439.

[31] T Davies, J Carpenter and G Iverson, "Issues in Federal Income Tax Complexity" (2001) 59 *South Dakota Business Review* 1.

business.[32] Gale[33] argues that the use of tax preparers provides a simple (but by no means perfect) metric of tax complexity in that it provides evidence on the extent to which people are willing or able to prepare their own returns. Research has shown that in the case of Australian personal taxpayers, the high use of tax agents is attributable to taxpayers' high commitment to compliance.[34] Similarly, research based on US households found that approximately 70% of taxpayers surveyed approached the taxpaying process with the primary objective of filing the most correct return.[35]

However, the extent to which small business taxpayers in either the US or Australia are committed to compliance is unclear. Similarly, research into the impact of complexity on compliance behaviour has tended to focus on the broader population of taxpayers. For example, research in the US (using data from the 1990 Taxpayer Opinion Survey) found that increased perceptions of fairness led to improved compliance, but that complexity did not necessarily influence perceptions of fairness.[36] Research based on Australian personal taxpayers found that increasing complexity caused compliance costs (both monetary and non-monetary) to increase and have a negative impact on taxpayers' perception of fairness, which in turn had a negative impact on their commitment to compliance.[37]

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[32] J Baldry and McKinstry, "Explaining the Growth in Usage of Tax Agents by Australian Personal Income Taxpayers" (paper presented at the ATO Compliance Research Conference; Canberra; 7-8 December 1995) (quoted with permission). These figures have remained relatively constant since the introduction of self-assessment in 1986.

[33] Gale, above n 30.

[34] M McKerchar, "Complexity, Fairness and Compliance: A Study of Personal Income Taxpayers in Australia" (2003; Australian Tax Research Foundation).

[35] J Collins, V Milliron and D Toy, "Factors Associated with Household Demand for Tax Preparers" (1990) 12 *Journal of the American Taxation Association* 9.

[36] A Forest and S Sheffrin, "Complexity and Compliance: An Empirical Investigation" (2002) LV *National Tax Journal* 75.

[37] McKerchar, above n 34.

Clearly, complexity arises as the tax authority endeavours to improve the equity of the tax system and, at the same time, reduce its ambiguity. However, there are many measures that could be explored (for example, presentation style) by which simplification could be improved without reducing equity.[38] While there is a need to reach a political equilibrium in terms of how much complexity is acceptable, the inefficiencies it creates (in terms of both compliance costs for taxpayers and administrative costs for the tax authority) and the inherent unfairness it causes should not be ignored. For committed taxpayers, when faced with uncertainty, the tendency is to overcomply.[39] For uncommitted taxpayers, complexity may provide opportunities to evade their taxes. If tax simplification is on the reform agenda, then the perceptions of tax agents are important to the process of finding an appropriate political equilibrium.

4. RESEARCH DESIGN AND COMPARATIVE ANALYSIS

Two independent research studies were conducted on the perceptions of tax agents on tax law complexity. The US study was based on a survey of 89 small business tax practitioners conducted in the summer of 2003. The survey listed 37 areas of tax law (encompassing individual and corporate federal and state income, estates, employment taxes, sales tax, and franchise tax issues)[40] and practitioners were required to identify the relative complexity of the tax area or provision that affected small business.[41]

The 37 areas of tax law chosen were based on previous research, consultation with experienced practitioners and analysis of various

[38] Karlinsky and Koch, above n 5.
[39] Ibid; and J Andreoni, B Erard and J Feinstein, "Tax Compliance" (1998) 2 *Journal of Economic Literature* 818.
[40] A brief description of each of the 37 areas is included at Appendix 1.
[41] In the US, small business would include Schedules C, E & F, as well as partnerships, limited liability corporations ("LLCs"), limited liability partnerships ("LLPs"), small business corporations ("S Corporations") and C Corporations, with an average gross receipts of less than $10MM over the past three years.

congressional hearings, panels on small business and papers from professional bodies.[42] The test instrument was designed to be completed in less than ten minutes. It included a demographic section followed by randomised questions on the 37 areas of tax law with responses based on a five point Likert scale. In terms of demographics, 44 of the 89 participants had less than 5 years experience, while 19 had more than 15 years experience. Over 80% were CPAs and more than 30% had advanced degrees. Over 60% of the participants spent more than half their time working on small business clients' tax issues.

Table 1 ranks the 37 tax items in order of decreasing complexity and shows their relativity based on a scale of 1.0 ("not complex") to 5.0 ("extremely complex"). Although individual participants rated certain issues "very complex" (4) or "extremely complex" (5), the average listed in Table 2 below showed no average score at or above "very complex" (4.0). Of the listed tax items, partnerships (3.4167) were perceived by tax practitioners as the most complex small business provision. In comparison, small business corporations ("S Corporations") were perceived as almost one whole point less complex at 2.5281. This is an interesting outcome and calls into question recent legislative proposals[43] to make S Corporation tax rules more like partnerships, if simplification is indeed the goal.

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[42] For a more detailed coverage of the design and conduct of this survey see L Ingraham and S Karlinsky, "Tax Professionals' Perception of Small Business Tax Law Complexity" (4 April 2005) 107 *Tax Notes* 79.

[43] See Representative Amo Houghton's HR 4137 *Small Business Tax Modernization Act of 2004* which seeks to "simplify" by essentially eliminating the S status and tax those entities under the Partnership Subchapter K rules.

Table 1: US Small Business Tax Items in Descending Order of Complexity

Complexity ranking	Small business tax item	Average complexity score
1	Partnerships	3.4167
2	Estate & Gift Tax Valuation	3.1910
3	Tax Deferred Exchanges	3.1058
4	Frequency of Tax Law Changes	3.1023
5	Retirement Plans	2.9772
6	AMT-Individuals	2.9333
7	Accumulated Earnings Tax	2.8539
8	AMT-Corporate	2.7159
9	Inventory	2.7079
10	Passive Activity Losses	2.6897
11	Constructive Ownership	2.5814
12	S Corporation Tax Rules	2.5281
13	Revenue Recognition	2.5114
14	Carryover Utilisation	2.3932
15	Personal Holding Company Tax	2.3810
16	State Franchise Taxes	2.3563
17	Carryovers	2.3483
18	Phase-Outs/Phase-Ins of Tax Provisions	2.3034
19	Debt v Equity Classification	2.2976
20	Taxable Fringe Benefits	2.2809
21	Section 1244 Loss	2.2024
22	Depreciation	2.1685
23	Instalment Sales	2.1685
24	Revenue v Capital Expenditure	2.1591

25	Sales Tax	2.1573
26	Sale of Assets Used in a Trade or Business	2.0778
27	Character of Interest Expense	2.0455
28	Independent Contractor v Employee Status	2.0337
29	Reasonable Compensation Deduction	2.0114
30	State Income Taxes- Individuals	1.9667
31	Capital Gain & Losses-Individuals	1.9333
32	Home Office Deduction	1.8764
33	Cash v Accrual Method of Accounting	1.8539
34	Capital Gains & Losses- Corporations	1.6279
35	Self Employment & Social Security	1.5778
36	Estimated Taxes	1.4545
37	Progressive Tax Rates	1.3750

The top ten most complicated small business tax provisions identified by the survey lead to some interesting reflections. As mentioned above, partnerships was rated by far the most complex small business tax provision. Estate and gift tax valuation was the second most complex area which makes sense given the complexity of valuing such assets as stock options, family limited partnership interests, closely held companies and real estate. Interestingly, frequency of tax law changes was perceived as being more complex than Alternative Minimum Tax ("AMT"), retirement plan tax rules or even passive activity losses. It may be optimistic to expect Congress and the Administration to heed the call and allow small business practitioners time to assimilate the rush of tax law changes that have been enacted over the last four years.

The least complex small business tax provisions identified by the participants in the study was progressive tax rates (1.375), which is interesting given that some politicians and tax policy makers have been pushing for a flat tax in the name of simplification. What this probably shows is that multiple rates do not contribute heavily to

complexity, but complex rules to compute small business taxable income do.

Another interesting finding, and what might be viewed as a good validity or consistency check, was the relatively low ranking of the cash v accrual method of accounting. Given Treasury's recent rulings and procedures in 2001 and 2002 allowing more small businesses (under $1MM blanket rule or $10MM prior three years gross revenue factor, depending on the line of business) to utilise the cash method of accounting, it would seem to be paying off in reducing tax complexity for small business. Further, allowing small business a first year expensing allowance of $100,000[44] (previously $25,000) has fundamentally eliminated depreciation and much of the related recordkeeping requirements, no doubt contributing to its relatively low complexity ranking.

Capital gain or loss – corporations was perceived by the participants as relatively simple (1.6279), which makes sense since there is no special tax rate for long term capital gains. On the other hand, capital gains and losses – individuals was rated as slightly more complex at 1.9333. The closeness of these two applications of the capital gain rules is a little surprising given the relatively recent 15%, 20%, 25% and 28% CGT rates that apply to individuals but not corporations. Nonetheless, the individual rules are significantly more complex than the corporate rules at a .05 confidence level.

One rationale that fits many of the items that rank as least complex is that they are issues that the experienced tax practitioner deals with on a regular basis or have been relatively stable. For example, estimated taxes are common to individual and closely held business entities and are encountered by the tax practitioner two, three or four times per year per client. Similarly, capital gains and losses (both individual and corporate) as well as sale of assets used in

[44] This may be a lesson for Australian policymakers in that this provision has significantly simplified the lives of small business and reduced their compliance costs.

a trade or business are dealt with many times during the year by small business tax practitioners.

The Australian research was conducted in 2004 by means of an electronic survey of registered tax agents followed by a case study.[45] There were 221 survey respondents[46] and six replications of the case study were undertaken. The survey participants were experienced (51% had more than fifteen years experience) and well qualified (56% had post graduate qualifications and 67% had completed a professional year program). The majority of respondents (83%) were sole practitioners or partners in small firms and 92% belonged to at least one professional body. Most of their work (95%) related to income tax matters and 75% of their clients were small business taxpayers (25% of which were corporate).

Only 11% of the survey respondents rated their income tax knowledge as “excellent” and 32% indicated that they were “dissatisfied” with their employment. The aspects they liked best about their work were “helping clients”, “client interaction” and “problem solving”. The aspects they liked least were “the increasing complexity of the law”, “dealing with the explosion of unproductive paperwork” and “frequent law changes”. Agents were asked to identify the most complex aspect of taxation from their perspective, with their responses to this open-ended question presented in Table 2.

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[45] The research was funded by CPA Australia (Frank Burke Research Scholarship) and facilitated by both CPA Australia and the Australian Taxation Office (“ATO”). For a detailed discussion of the research see M McKerchar, “The Impact of Income Tax Complexity on Practitioners in Australia” (2005) 20 *Australian Tax Forum* 529.

[46] Most tax agents (83%) interact electronically with the ATO hence the choice of this medium. The survey was made available to some 20,000 agents via the ATO’s electronic newsletter but the response rate was very low.

Table 2: Complex Aspects of Australian Income Tax System in Descending Order

Complexity ranking	Area of complexity[47]	Percentage of respondents
1	Legislation	25
2	Everything	21
3	CGT	18
4	GST	7
5	Basic Aspects Including Income and Deductions	5
6	Consolidations	5
7	STS	3
8	Compliance	3
9	Superannuation	2
10	International Issues	2
11	Business Trading Structures	2
12	Taxation of Trusts	2
13	Uniform Capital Allowances	2
14	FBT	1
15	Companies	1
16	Clients	1
	Total	100

[47] Technical explanations are included at Appendix 2. Note that these taxes are raised at the Federal level. The states relinquished their power to raise income tax in 1942 with the introduction of the Uniform Tax Scheme. They rely on grants from the Federal Government in addition to a range of taxes levied at State level (including payroll tax and land tax) but are beyond the scope of this research.

It appeared that apart from CGT, complexity was felt to be "across the board" rather than associated with specific areas. Further questions were asked to determine and rank the causes of complexity, based on the six dimensions of complexity identified by Long and Swingen in an earlier study with US tax practitioners.[48] These dimensions were ambiguity, computations, change, detail (numerous rules and exceptions to rules), record keeping; and forms (in terms of the format or instructions). Their responses are presented at Table 3.

Table 3: Relative Importance of the Dimensions of Complexity

Dimensions of complexity	Weighted importance (as a percentage of total)
Ambiguity	27
Computations	7
Change	25
Detail	35
Record Keeping	4
Forms	2
Total	100

These dimensions were further explored in both the survey and in the case study.[49] Agents reported that they were struggling to cope

[48] S Long and J Swingen, "An Approach to the Measurement of Tax Law Complexity" (1987) 8 *Journal of the American Taxation Association* 22.
[49] Participants in the case study were members of CPA Australia. All were experienced registered tax agents working with small business clients.

with the increasing breadth of tax law and rulings. They were becoming increasingly reliant on specialised experts (in spite of being well qualified themselves) and were tending not to fully pass on the compliance costs to their clients (either because they felt guilty that they were not able to solve the problem more quickly, or else they felt the client could not afford the cost).

The pattern that emerged was that having two Income Tax Assessment Acts, while not desirable, was not unduly problematic, nor was the language used in the Acts or the rulings. The cause of complexity was the sheer volume of rules, that there were too many across the board and that they did not necessarily increase certainty. Further, the rules changed too often. The rules often appeared to have been designed to close a particular loophole, but their consequences may be far reaching in that non-players were also caught and onerous reporting and compliance obligations were imposed on everyone. At times new rules were introduced as part of tax reform, but the value of their contribution was questionable (the STS and the Uniform Capital Allowance ("UCA") regime both drew considerable negative comment). The difficulties were further complicated by the unwieldy manner in which the various tax systems interacted.

In spite of their needs, participants in both the survey and case study had little faith in a more simplified tax system being delivered given the realities of the Australian political environment (such as using the tax system to win votes; the vested interest groups; and the perceived failure by the ATO and the Commonwealth Government to understand the practicalities of small to medium businesses).

By comparing the perceptions of tax practitioners in the US and Australia on small business tax complexity, a number of key lessons emerge. Clearly, the rate of change is a common contributing feature to complexity in both jurisdictions. Areas where change has been recent (such as retirement plans in the US) or ongoing (such as CGT in Australia) were more complex than areas where there had been some stability (such as estimated taxes or self-employment and social security taxes in the US). Computations were regarded as the

least aspect of small business tax matters in both jurisdictions. This brings into question the rationale often used in both jurisdictions to promote a flat tax system as a means of allegedly achieving tax simplification. Requiring or offering alternate taxing methods (such as AMTs in the US and the STS in Australia) did cause complexity, to the extent that additional concepts must be complied with and choices needed to be made, and this increased compliance costs. It was unclear whether these alternate methods offered any real gains for either taxpayers or the tax authority.

The lesson here for the US is that, based on the Australian experience, simply rewriting the legislation in "plain English" may make it more readable, but is unlikely to make it any easier to understand or apply.[50] The underlying policy issues that caused complexity must be addressed.

The US depreciation rules were regarded as relatively simple, unlike the UCA in Australia. This most likely reflects the recent changes to these rules in Australia and the higher first year write offs in the US system. This notion of accelerated write off appears to offer real savings in record keeping (and a reduction in compliance costs) and may not necessarily have a negative impact on revenue collected over time. While the STS does offer accelerated write-offs, they are limited in comparison to the US system. Further, electing to be taxed under the STS means adopting all its provisions and this has been unattractive to Australian small business taxpayers. Perhaps the lesson here for Australian tax policy makers is to be prepared to strike a more reasonable balance between revenue raised and the compliance costs imposed. However, there appears to be a real reluctance to do so, for example, the recently announced tax cuts for entrepreneurs have been limited to those who elect to be taxed under STS.

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[50] There is some complexity research that found that at both ends of the complexity spectrum – simple and complex – reading complexity does not make a significant difference, but in the middle, it may help reduce complexity. See Karlinsky and Koch, above n 5.

Finally, the rate of change appears to have been faster in Australia and clearly tax agents are struggling to cope. They feel that tax policymakers have little understanding of how small and medium businesses are affected by changes to the law. In particular, the low levels of job satisfaction are a concern for both the industry and for taxpayer compliance overall. This in itself may be the single most important lesson for the US should tax simplification be fully embraced.

5. CONCLUSION

This article has compared and contrasted the adoption of tax simplification, and tax agents' perceptions of the complexity of small business tax laws in the US and Australia. The shortcomings of the analysis are acknowledged. They include that the studies conducted used different research methods and that each study in itself has its own weaknesses (principally in terms of representativeness). Further, that the two systems of tax law themselves are different making meaningful comparisons more difficult. Nevertheless, there are strengths in this approach. The fundamental goal of tax simplification is present in both jurisdictions and that by using different research methods and undertaking a comparative analysis, a deeper understanding of the problems can emerge. This understanding is even further enhanced by the fact that participants in all aspects of the research were tax practitioners (as opposed to students who are commonly used in this type of research) and able to provide invaluable insights based on their practical experience in working with small business taxpayers. The participants may not be representative of all tax practitioners or agents, but their insights are informative nonetheless.

Clearly there are lessons to be learnt by both jurisdictions in terms of achieving tax simplification. It does require considerable commitment by policymakers and needs to be well considered prior to implementation (particularly in terms of practical application) and as seamless as possible. Policymakers need to show restraint in using simplification as an excuse for other agenda items. For example, it is

clear in both countries that a progressive tax rate is not a significant complicating factor, yet simplification is a commonly asserted political rationale for a flat tax system in the US. Further, policy makers need to give more consideration to the rate of change and its effect on taxpayers as a whole as well as providing uniform definitions both within a tax system and between different tax systems. The latter is clearly a complexity issue for Australia, and it is one that US policymakers need to be sensitive to if the US moves to a dual tax world (both income and consumption tax systems).

Simplification can take place on a number of levels, but it is unlikely to be achieved by cutting tax rates or simply rewriting existing legislation. In respect of small businesses specifically, the research by Crain and Hopkins[51] theorised that tiering (providing special rules for a targeted group) may reduce the compliance burden. Both the US and Australia have adopted a tiered (or carve out) approach to some extent. In the case of the US, the cash method, depreciation, estimated taxes, corporate AMT, and instalment sales have different rules that apply to small businesses than to large businesses and these provisions have been found in this study to be relatively simple, thus supporting the Crain and Hopkins theory. In the case of Australia, the carve out rules for small business, specifically in respect of CGT and STS are not perceived by tax agents as being simple, in fact quite the opposite. It may not be that the correct group was targeted effectively, or a more likely explanation based on this study may be that there are too many exceptions to the rules and/or that change is taking place at too great a pace for it to be comprehensible.

Whether a tiered approach is effective or not (in terms of take up) will depend to some extent on practitioners' perceptions of the relative complexity and value of recommending one course of action over another to their clients. Perceptions may not be the reality, but unless they are understood and appropriate strategies developed, it is

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[51] Crain and Hopkins, above n 13.

unlikely that the desired change (simplification) will be achieved. In the US context, given the level of complexity US tax practitioners felt in respect of partnership tax rules, the current proposal to shift S Corporations to partnership rules would not achieve tax simplification. Similarly, in the Australian context, given the level of complexity perceived in respect of the STS, reducing the tax rate will not address the perception that it is complex.

As difficult as grappling with the issue of tax simplification is, tax policymakers should not cease to strive for a fairer, simpler and more efficient tax system and one which values voluntary compliance. Small business taxpayers are only one group of taxpayers, but they do make an important contribution to society. At present given the increasingly regressive nature of compliance costs, they are undoubtedly bearing more than their fair share of the burden. By examining practices in other jurisdictions there are undoubtedly lessons to be learnt by all stakeholders. One potential area of fruitful research may be the trade-off between complexity and higher taxes. That is, to what extent would a taxpayer be willing to have a simpler system and reduce compliance costs for a slightly higher tax cost? Further, there is potential to explore in more detail the frustration at "everything" felt by Australian tax agents in Table 2. Finally, there is scope to extend this research to other jurisdictions and other sectors of the taxpaying community – tax complexity is not unique to either small business taxpayers or to income tax in the US or Australia.

Appendix 1:

Accumulated Earnings Tax ("AET"): One of three weapons that the government has to force the imposition of double taxation between a C Corporation and its shareholders is the taxation of earnings accumulated at the entity level beyond the business needs of the entity, in addition to taxing taxable income. This provision, while technically applicable to large and small businesses, is primarily applied to small businesses.

AMT – Corporations: AMT is a parallel system imposed on taxpayers that requires a separate computation of depreciation, adjusted basis in assets, different net operating losses, foreign tax credits, computing a special earnings and profits (called ACE), etc. For large companies this is a complicated issue, but in the context of small business C Corporations, but not limited liability corporations ("LLCs"), partnerships, S Corporations and sole proprietorships, a 1997 tax provision exempts most new companies and many established small businesses from the need to compute the corporate AMT. However, if their clients have average gross receipts greater than $5MM, then the full complexity of AMT would be felt.

AMT – Individuals: AMT is a parallel system imposed on individual taxpayers on their small business and personal activity as well as from flow-through entities like partnerships, LLCs and S Corporations. Depreciation adjustments, exercise of incentive stock options, taxes as an itemised deduction, miscellaneous deductions and hobby losses, all impact on AMT for individuals.

Capital Gain or Loss – Corporations: Capital losses are only allowed against capital gains generated by that entity. Capital gains are taxed at the same rate as ordinary income but all businesses still need to distinguish a capital transaction from an ordinary one.

Capital Gain or Loss – Individual: Capital losses are netted against capital gains and $3,000 of net capital loss is allowed against ordinary income. Capital gains are divided into various categories and taxed accordingly (28% on collectables and s 1202 gains, 25%

on real estate depreciation gains, 15% on other gains from May 2003). Section 1202 gains refer to the exclusion of 50% of any gain from the sale of exchange of qualified small business stock held for more than 5 years by a taxpayer other than a corporation. Also, if a taxpayer is in a low tax bracket (ie children of the entrepreneur) even lower tax rates may apply.

Carryovers: Due to the accounting year convention, various items may not be utilised in the tax year, so carryback and carryforward rules apply. For individual and corporations, net operating losses are usually carried 2 years back and 20 years forward (2001 and 2002 were a recent exception, allowing a 5 year carryback) or foregoing the carryback and allowing a 20 year carryforward; capital losses are 3 back and 5 forward for corporations and no back and unlimited time (until you die) forward for individuals; foreign tax credits are 2 back and 5 forward; and General Business Credits ("GBC") are carried back one year and forward 20 years. For GBCs, there is an annual limitation of $25,000 of tax plus 75% of the excess tax liability. GBCs include the research and development credit, rehabilitation credit, and the work incentive credit, but do not include personal credits.

Carryover Utilisation: When a corporation has a major change in ownership, net operating loss carryover as well as capital losses, credits, built in losses, etc. are limited in their utilisation to the value of the company times a tax exempt bond rate at the date of ownership change. Since most small businesses are owned by a few shareholders, it is relatively easy to know if an ownership change occurs. Further, most small businesses, if acquired, are purchased by large companies who have the onus of computing this limitation.

Cash Versus Accrual Method of Accounting: Most individuals are on the cash method of accounting for tax purposes. When they receive or are deemed to receive cash or property, they are taxed in that year. Small businesses may be on either the cash or accrual method. The accrual method reflects in income when it is earned rather than received. Small business generally prefers the cash method. The last few years has seen the Treasury allowing more

small businesses to utilise the cash method of accounting, which is a simpler system.

Character of Interest Expense (business, investment, tax exempt, passive or personal): Corporations do not need to distinguish the type of interest expense they incur, except for borrowing money to acquire or carry tax exempt bonds. On the other hand, individuals and flow-through entities must differentiate the type of interest expense they incur. Depending on whether it is related to buying a home (and depending on the amount of the mortgage), buying investments (stocks and bonds) versus buying a business versus investing in a passive activity versus buying personal items like a washing machine or a personal car, the deductibility of the expenditure will be determined.

Constructive Ownership: For a variety of reasons, small business accountants need to examine their clients' ownership including various family and related party relationships to see if special rules may apply. For example, losses between related parties are disallowed. If a brother owns 30% of a company and his sister owns 25%, the two are treated as one owner and the brother is considered to constructively own 55% of the business with the consequence that the loss between the parties will be disallowed. When you sell at a profit, s 1239 or s 707 may cause the character of the gain to be ordinary. Similarly, when a shareholder sells corporate stock back to the company (treasury stock transaction or a redemption), the extent of the change in ownership is important in characterising the nature of the gain. The taxpayer must look at his direct and indirect ownership. There are a variety of other situations where a small business must measure the ownership by taking into account direct and indirect ownership.

Debt versus Equity: For a variety of reasons (eg interest is deductible while dividends are not; repayment of a loan is treated as a return of capital, while re-purchase of stock may result in dividend treatment), debt is favored over equity for both small and large companies. For 35 years, we have not had any certainty as to whether

an instrument is debt or equity and the issue has generally been settled in the courts.

Depreciation: When new or used capital equipment or buildings are acquired in a trade or business or for an investment, the taxpayer is required to take a deduction ratably over the hypothetical life of the asset using an accelerated method (generally 200% declining balance) for non-real estate and straight line for buildings. There may be a different life for AMT purposes, depending on the year placed in service. A mid-year convention (mid-month for real estate and mid-quarter in some situations for non-real estate) is also applied in the year of purchase or sale. To encourage small businesses to acquire equipment and to simplify their accounting, a large expensing deduction is allowed (historically around $20,000, currently $100,000). On the other hand, certain listed property (eg cars, computers) may be treated less generously, deduction-wise.

Estate and Gift Tax Valuations: When someone makes or bequeaths a gift of property (non-cash) to a relative, friend or charity, the value of the property needs to be ascertained. Based on this valuation, an estate or gift tax will be imposed on the donor/decedent. In the case of a death, the beneficiary will generally take the full market value of the property at date of death as their basis in the property. If the property is publicly traded stocks or bonds, the valuation issues are relatively simple. However, if the investment is non-publicly traded or restricted, or is artwork, partnership interests, etc valuation is more difficult.

Estimated Taxes: The US tax system requires individual and corporate taxpayers to pay as they go on income that is not covered by withholding at source. Small businesses may generally pay equal to last year's taxes and satisfy the estimated tax rules (often called "safe basis"). Small business individuals may have to pay slightly more than last year's tax to avoid interest and penalty charges.

Frequency of Tax Law Changes: The tax law has changed in some large measure in almost every year since the reform of 1986 and there have been a multitude of small changes enacted. This

constant change makes the law more complicated because the small businesses and their accountants must comply with these rules as well as try to plan when the future is uncertain not only as to economic events, but also as to what tax rules will apply.

Home Office Deduction: If a small business person uses their home to run a business, there are specific rules that must be met before a business deduction may be taken. This area has not changed in the last ten years or more.

Independent Contractor Versus Employee Status: The income tax law and the social security/self-employment rules differentiate the treatment of expenses between being an employee (below the line deduction and gross wages subject to social security) and a self-employed independent contractor (above the line deductions and self employment tax based on net income). The tax law is ambiguous as to which category the various items fall within and there are many court cases trying to differentiate the status based on facts and circumstances.

Instalment Sales: Whether a taxpayer is on the cash or accrual method, if payment for the sale of non-ordinary income property is to be received in a future year, the corporate or individual taxpayer may postpone gain recognition until the proceeds are collected. The current and future year collections are treated as part interest income, part return of capital and part capital gain or s 1231 gain. A s 1231 gain refers to any recognised gain on the sale or exchange of property used in trade or business. If the note is collateralised or discounted, the postponed gain may be triggered early.

Inventory: When a taxpayer sells goods, gross profit must take into account the cost of goods sold (“COGS”). First-in, First-out (“FIFO”) is one permissible method as is Last-in, First-out (“LIFO”). In the case of high priced items or unique or customised inventory, the taxpayer might specifically identify each asset and include the cost of items sold in the COGS. Another issue that arises is s 263A (called Uniform Capitalisation or Unicap for short) that requires some small businesses (usually manufacturers) to allocate some of

their indirect costs to the cost of inventory. In general, a small business exception of $10MM gross receipts exempts wholesalers and retailers, but not manufacturers.

Partnership Tax Rules: This flow-through entity has the most flexibility and elections available to the entity and the individual partners of all the taxable business entities.

Flexibility often engenders complexity in deciding what choice to make an in the planning alternatives available. "Substantial Economic Effect" (s 704(b)), treatment of different types of liabilities, adjusting outside and inside basis elections, deciding whether the aggregate theory or the entity theory applies to a transaction, and separate accounting requirements are a few of the complex aspects of partnerships.

Passive Activity Losses: Prior to 1986, "tax shelters" were rampant and allowed individual taxpayers to use losses and credits from these shelters against their true investment income (interest and dividends) and their earned income. Legislative change in 1986 significantly reduced this ability to offset by building a Chinese tax wall between passive losses, and active income or portfolio income. The distinction between passive and materially participating as well as what is an activity is complex.

Personal Holding Company Tax: The IRS primarily has three weapons to force closely held businesses to pay out dividends to their shareholders. The first one was discussed above (AET). Personal Holding Company Tax ("PHC") tax is potentially imposed on a small business C corporation that more than 50% of the stock is owned by 5 or fewer shareholders including a broad attribution section (s 544) that counts brothers and sisters, a parent and his lineal descendants and ancestors, partners of a partnership, etc. If this criterion is met, then the company must look at see if its portfolio type income (interest, dividends, rents and certain royalties) equals or exceeds 60% of a special gross income concept. If both requirements are met, then an additional 15% tax may be due.

Phase-Outs & Phase-Ins of Tax Provisions: When Congress enacts tax laws, they often want to target the provisions to a certain group, so they impose rules that exclude certain classes of taxpayers, usually based on Adjusted Gross Income ("AGI") or taxable income level. For example, s 469(i) permits the passive activity loss limitation rules to be suspended for investments in a rental property that you own personally and if your modified AGI is less than $100,000. If your AGI exceeds $150,000, the potential $25,000 deduction is disallowed. Between $100,000 and $150,000, you lose $0.50 for every $1 above $100,000. Similar rules apply to the personal exemption, itemised deductions, alternative minimum tax exemption, etc.

Progressive Tax Rates: The corporate tax rate is progressive on the first $100,000 of taxable income and then moves essentially to a flat tax rate of 34%. The individual income tax rate schedule is also predicated on a progressive tax rate system.

Reasonable Compensation Deductions: The third weapon that the government uses to force closely held companies to pay dividends is the issue of reasonable compensation. An owner-employee may be tempted to withdraw profits from a C corporation as salary rather than as a return on their capital investment (dividends). The government and especially the courts look to see if a hypothetical investor would be satisfied with their return in deciding if the salary to the owner-employee is reasonable. Interestingly, in the context of an S corporation, a relatively recent issue is the underpayment or non-payment of salary to an owner-employee to avoid social security taxes.

Retirement Plans: Since Congress enacted the *Employment Retirement Income Security Act* ("ERISA") rules, the area of retirement plans, discrimination rules, limits, s 401(k) plans and the different types of Individual Retirement Accounts ("IRAs") has become fairly complex for small and large businesses. A s 401(k) plan is a company-offered retirement plan featuring tax-deferred contributions that may or may not also include matching contributions by the company.

Revenue Recognition: Besides cash versus accrual, instalment sales and inventory methods, there are a group of rules that deal with the year in which the business should recognize revenue and deduct expenses. For example, if a small business is a builder, they might be able to use completed contract method or percentage completion. If one is a dance studio or a gym and receives advanced payment on services to be rendered in the future, there are special revenue recognition rules that apply to these enterprises.

Revenue Versus Capital Expenditure: In the financial accounting world, the issue of whether an outgoing is revenue expenditure (required to be expensed immediately) or capital expenditure (allowed to be capitalized and not reduce net income) is pervasive. Generally, companies want to capitalize their costs. In the tax world, the same issues frequently arise, but the opposite goal is desired.

S Corporation Tax Rules: Since 1958, the US tax system has had a hybrid entity that borrows elements from the regular corporation rules and from the partnership flow-through rules. This small business entity (one class of stock and less than 76 shareholders) is the most popular business entity return, exceeding the number of C Corporation 1120s (the US corporate income tax return) and partnership/LLC 1065s (the US partnership income return) filed. Similar to a partnership, the issue of aggregate versus entity is still a complicating issue and one level of tax is an attractive feature, but the partnership flexibility of elections and special allocations is not available to an S Corporation which may make it simpler in the eyes of a practitioner. The limited liability, formation, distribution and liquidation rules of a C Corporation apply to an S Corporation. If an S Corporation was formerly a C Corporation and converted, then the rules may be more complicated since ss 1374 and 1375 etc would apply also.

Sale of Assets Used in a Trade or Business (1231, Recapture): When a taxpayer sells or exchanges an asset used in a trade or business such as land, building, machinery/equipment, trucks, automobiles, computer equipment, goodwill, other intangibles, etc, the character of the gain may be ordinary or capital gain in nature.

The nature of the gain is dependent on depreciation recapture rules as well as the netting process.

Sales Tax: Many States impose a retail sales tax upon the sale of goods and sometimes services to the ultimate consumer. Rates vary and on some goods and services it is zero.

Section 1244 Loss: The tax law distinguishes capital losses from ordinary losses. If an individual or partnership (but not a C or S Corporation) invests in an active corporate entity, the first $1,000,000 of equity raised is covered by the s 1244 loss rules, essentially allowing $100,000 of ordinary loss treatment for a married couple ($50,000 for a single taxpayer) in a given year.

Self-Employment and Social Security Taxes: Besides federal income taxes, the tax system is also used to collect social security and self-employment taxes. As described in the independent contractor-employee category above, self-employment is a tax imposed on net business income, while social security is based on gross salary or wages. Above certain income limits (around $90,000) a Medicare tax is imposed at 1.45% for the employer and the same rate for the employee (or 2.9% for the self-employed). This area has been relatively stable.

State Franchise Taxes (including multi-State returns): Most States impose a corporate income or franchise tax. Often the income of the entity must be allocated and apportioned between various states where it may be doing business, often based on the type of income and by where its sales, payroll and property are located. For many small businesses, they are only located in one state and therefore, their state tax issues may be less complicated than for large businesses.

State Income Taxes-Individuals: Many States impose an income tax on individuals and their income from flow-through entities. Often the State will conform many aspects of this tax to the Federal taxable income rules. When this occurs, the complexity at the State level is decreased. Some States only partially conform and the tax practitioner needs to know which aspects of an activity conform or

not. For example, some States use the Federal depreciation rules, while others do not. If they do not, then the depreciation computation, basis and gain or loss needs to be computed separately.

Taxable Fringe Benefits: The tax law allows employers to provide employees with taxable and tax-free fringe benefits. These benefits are often subject to non-discrimination rules (not supposed to skew the benefits to highly-paid executives). Taxable fringe benefits include use of the company car or plane, life insurance coverage, education expense over certain limits, and country club dues.

Tax Deferred Exchanges: This category encompasses a wide range of transactions in which the taxpayer does not cash out an investment, but instead substitutes one form of investment for another. By continuing to do tax free swaps, a taxpayer can permanently defer the built-in gain at death, since there will be a step-up in basis at that time. If one company acquires another through a straight stock swap, no gain or loss will be recognized. Similarly, if you form a new company from an existing sole proprietorship, no gain or loss will be recognized as long as 80% ownership is maintained in the business. Instead, the basis of the new/replacement asset will reflect the deferred gain.

Appendix 2:

Basic Aspects Including Income and Deductions

The legislation is broad in these respects. This in itself is not problematic in that case law has identified guiding principles. The complexity appears to lie with the ATO rulings and other interpretative materials. Given the volume and rate of change, agents were never sure if they have the definitive document or have missed a ruling or statement that may be relevant. Regimes to address tax evasion have been introduced recently including personal services income (aimed at self-employed contractors) and non-commercial losses (aimed at "hobby" activities).

Business Trading Structures

Small businesses are operated under a variety of trading structures including sole trader, partnership, trust and company. Companies are taxed at a flat rate of 30%. The rates for individuals (including sole traders, partners, and beneficiaries in a trust) are progressive with the highest marginal tax rate being 47% at $70,000. Giving advice on suitable business structures is complex because of the many considerations and the likelihood of change (for example, the Ralph Review recommended changes in respect of trusts). In particular, changing business structures is complex, principally because of the CGT issues involved.

CGT

First introduced in 1985 to tax gains made on the disposal of almost all assets (family home normally exempted) CGT has undergone almost continual change. Recent changes include concessions on the CGT payable on disposal of small businesses where certain conditions regarding assets and control are met. There are many exceptions to the rules and they may have consequences for superannuation benefits. The small business CGT tax concessions are more complex than for other assets, though depending upon the date of acquisition, there are alternative methods (including indexing

for inflation) for calculating the capital gain and this does add to compliance costs.

Clients

Australian taxpayers are heavily reliant on tax agents to manage their affairs. Agents at times had difficulty explaining how the tax law applied to clients given its complexity. Clients felt they had read or heard about an entitlement, but often were unaware of the various exceptions to such entitlements and were unhappy with the agent's advice. It took additional time to deal with these matters for which agents tended not to charge.

Companies

Australia has had a dividend imputation system since 1987 thought the rules were rewritten and simplified from 1 July 2002. The more complex area appears to be Div 7A (effective from 4 December 1997) which applies to private companies that make tax-free distributions to shareholders (or their associates) in the form of payments, loans or debt forgiven. These distributions may also have implications for franking and for FBT. Further changes were introduced to Div 7A from 27 March 1998 to include payments and loans by interposed entities relying on guarantees and certain amounts received from trusts.

Compliance

Detailed record keeping and reporting are features of all aspects of federal tax. Businesses report at least quarterly to the ATO on sales, export sales, GST-free sales, capital and non-capital purchases, wages paid and tax withheld, and tax instalments paid or payable.

Consolidations

Introduced from 1 July 2002, the consolidation regime allows wholly-owned corporate groups to operate as a single entity for tax purposes. A number of implementation issues have arisen on the interpretation of the single entity principle, group membership rules and the same business test, the tainting of share capital, the

distribution of retained profits and the triggering of CGT events. It is a relatively new area with many rules and exceptions to rules.

Everything

Many agents expressed overwhelming frustration at all aspects of taxation and the difficulties they had in keeping abreast of change and the volume of rules. There was frustration at how poorly the various systems integrated, particularly GST with income tax and with FBT in terms of both accounting and reporting.

FBT

FBT was first introduced in 1986. It is a tax imposed on the employer for non-cash benefits provided to an employee. The rules (and exceptions) relating to food and entertainment are complex in that there are many exceptions. With the introduction of GST, separate calculations are required for benefits on which GST has been paid and this has increased compliance costs. The reporting year for FBT is 1 April-31 March (as opposed to 1 July-30 June for all other Federal taxes).

GST

There are three categories of supplies each with its own tax rate or treatment, as opposed to two as was originally proposed. The calculations themselves are not all that difficult and most small businesses would prepare their own GST reports for the ATO (Business Activity Statement ("BAS")) to reduce monetary compliance costs. However, agents then have difficulty reconciling the client's BAS to the income tax return for various reasons. Reconciling GST and FBT can be tedious.

International Issues

Even for small business, international tax issues arise (such as the thin capitalization rules) and are considered complex. A separate schedule is required to be lodged where a businesses has international dealings >$1M with a related party; or has a direct or indirect interest in a controlled foreign company, investment fund or

a transferor trust. In addition, Trans-Tasman imputation measures were introduced in 2003.

Legislation

Apart from the two Income Tax Assessment Acts and case law, there is legislation covering other areas such as rating and administration, GST, FBT, superannuation contributions tax, and customs and excise. There are also extensive interpretative material issued by the ATO including legally binding public rulings, private rulings and product rulings. Further, there are public determinations, ATO interpretative decisions, ATO practice statements and taxpayer alerts.

STS

Qualifying small business can elect to be taxed under the STS, which was first introduced in 2001 to help small business reduce compliance costs. The election is made each year. Features of the STS include cash accounting, a simplified deprecation system and a simplified treatment of trading stock. Taxpayers cannot choose to have only parts of STS apply – it is all or nothing. The simplified depreciation system involves the pooling of assets into one of two groups depending on expected life. Assets costing <$1,000 can be written off in the year of acquisition.

Superannuation

The Government gave responsibility for the regulation of self-managed superannuation funds ("SMSF") to the ATO in 1999. There has been enormous growth in SMSFs and they are widely used by small business taxpayers.[52] Apart from having more control over the accumulation of funds for retirement, small business taxpayers are attracted by the low flat tax rate (15%) that applies. There are

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[52] In 2003 the ATO reported that some 2,000 SMSF were being established monthly; available at: http://www.ato.gov.au/content.asp?doc=/content/39631.htm&page=2#H2 (accessed 8 April 2005).

specific rules about member relationships, remuneration of trustees and decisions that may result in a change of the fund structure (and a loss of SMSF status).

Taxation of Trusts

Trusts are widely regarded as a vehicle for tax avoidance but commonly used in Australia as a trading structure (particularly by farmers for succession planning purposes). They have been under considerable scrutiny since the Ralph Review and new measures introduced from the 1998 year include the franking of distributions and the availability of elections to be lodged for family trusts or interposed entity (for the purposes of the franking credit trading measures) and various transitional arrangements.

UCA

The UCA system was introduced from a July 2001 and covers deductions allowable for depreciating assets. It includes considerable (and perceived by agents as unnecessary) change in terminology from earlier provisions. There are variations on calculations and treatments depending on the date of acquisition of the asset (pre 21 September 1999, 21 September 1999 to 30 June 2000, 1 July 2000 to 30 June 2001, and post 1 July 2001).