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The tax and accounting interface: How to build a transformational tax system for small businesses using technology as a pathway to reform

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Keywords: Small business taxation; accounting profits; PAYGI; tax and accounting; tax reform; income tax

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THE TAX AND ACCOUNTING INTERFACE: HOW TO BUILD A TRANSFORMATIONAL TAX SYSTEM FOR SMALL BUSINESSES USING TECHNOLOGY AS A PATHWAY TO REFORM

Haydn Daw¹

Abstract

From time to time there are calls for the alignment of taxable income with accounting income in order to reduce some of the complexity and compliance costs associated with the Australian tax system. Such calls are usually rejected. This paper examines whether, in light of the advances in technology and digital take up rates, the benefits and compliance cost savings of applying accounting income to determine tax liabilities for small business now outweigh previous arguments that rejected such proposals. This change would see income tax based upon information taken directly from the digital accounting packages rather than the current practice of requiring small businesses to make complex income tax calculations.

1 Introduction

Perhaps James Maddison had in mind the future state of complexity of Australia's taxation system when in 1788 he remarked that:

"The internal effects of a mutable policy are still more calamitous. It poisons the blessings of liberty itself. It will be of little avail to the people, that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood: if they be repealed or revised before they are promulgat[ed], or undergo such incessant changes, that no man who knows what the law is today, can guess what it will be tomorrow."²

Fast forward more than 200 years and the Australian judiciary has expressed a similar sentiment for a number of years. Justice Kirby, for example, noted the High Court's longstanding concern about the complexity of tax legislation:

"This appeal from the Full Court of the Federal Court of Australia concerns the construction of the Income Tax Assessment Act 1936 (the "Act"). The complexity of the Act has long been the subject of comment and complaint."³

Against this backdrop there have been various proposals to simplify the tax laws and to reduce associated compliance costs. For example, the Tax Law Improvement Project (TLIP)⁴, and two

¹ Haydn Daw is a former Treasury and ATO official on secondment to the ANU. He has tertiary qualifications in Commerce and Accounting. This paper follows from previous work by former Commissioner of Taxation, Michael D'Ascenzo, and Assistant Commissioner, Andrew England entitled "*The Tax and Accounting Interface*" (JIA TaxTA 2; (2005) 1(1)) with the same title. I would like to thank four reviewers for their comments and suggestions.

² Madison J., *The Federalist* (1788), Essay 62

³ Kirby J, *FCT v Scully* (2000), HCA 6, para 43

⁴ The Tax Law Improvement Project was established in 1994 to rewrite the *Income Tax Assessment Act 1936*. Its main product was the *Income Tax Assessment Act 1997*, which employed a number of new drafting features. Several other Acts (for example, the *A New Tax System (Goods and Services Tax) Act 1999*) now use the same style.

proposals emanating from the Review of Business Taxation⁵, the Tax Value Method⁶, and, in relation to small business⁷, the Simplified Tax System⁸, were all mooted as possible solutions to stem rising complexity and address associated compliance costs.

The alignment of taxable income with accounting income has also been suggested as a possible solution to some of the complexity of the tax system but usually rejected. Such arguments usually included the need to preserve the different purposes for which accounting and tax have been created, difficulties in defining economic notions of income between the two, and the administrative effectiveness required of a tax system.

‘Small Business Entity’ (hereafter ‘small business’) is defined under the tax laws⁹ and are the target of the proposal in this paper. They are entities with turnover < \$10Mn and carry on a business (i.e. derive business income).

Currently, the income tax position of a small business is calculated by using the company’s accounts as a starting point. A series of increasing and decreasing tax adjustments (e.g. small business tax concessions (SBTC)) are made to arrive at their income tax position. This paper contends that the additional tax compliance costs imposed to arrive at the income tax position including the SBTC negate the benefits they’re intended to confer.

To significantly reduce tax compliance costs the paper proposes using the company’s accounts (referred to as ‘accounting income’) and not require any tax adjustments. The increasing take-up of digital accounting packages allows this to be more feasible as the accounting income is readily accessible and transmissible.

An initial step in this direction would to by apply accounting income to calculate Pay-As-You-Go instalments (PAYGI)¹⁰. Small businesses pay instalments of tax (usually quarterly unless very small) through the PAYGI system. The instalments are aggregated and offset against the year-end income tax liability. Quarterly PAYGI instalments are generally calculated by reference to the previous year’s income tax with an inflationary uplift and divided by 4. As PAYGI are estimates there is little risk of under or overpayments of tax as the aggregated amount is reconciled at year end with the actual year-end tax liability.

The paper observes there have been previous reviews into the alignment of taxable income with accounting income (although these have not been confined to small business). A literature review is assembled as well as an examination of international approaches. A survey of tax practitioners is also provided that reveals modest support for the proposal.

⁵ On 14 August 1998 the then Treasurer, the Honorable Mr Peter Costello AC, announced that businessman, Mr John Ralph AO, would chair a review of Business Taxation to form the basis of a comprehensive new business tax regime under the *New Tax System*.

⁶ Review of Business Taxation, *A Tax System Redesigned* (1999)

⁷ For the purposes of this paper ‘small business’ refers to the category of business defined as ‘small business entities’ under the tax laws. The tax laws define ‘small business entities’ are those that carrying on a business and have aggregated turnover of less than \$10 million.

⁸ Found in the *New Business Tax System (Simplified Tax System) Act 2000*

⁹ Subsection 328-110(1) of the *Income Tax Assessment Act 1997*

¹⁰ Part 2-10, *Taxation Administration Act 1953*

This paper is structured as follows: Section 2 examines the causes of income tax complexity; Section 3 examines the case for small business tax policies; Section 4 looks at the current array of small business tax concessions; Section 5 examines small business compliance costs; Section 6 summarises previous simplification proposals; Section 7 reviews the literature of previous studies into the use of accounting profits for income tax purposes; Section 8 looks at international approaches; Section 9 examines the difference between accounting and income tax; Section 10 analyses the findings of a survey of tax practitioners in relation to the topic; Section 11 identifies a pathway for reform; and Section 12 draws together a final conclusion.

2 Causes of income tax complexity

Many tax observers have opined why the tax laws are so complex. Burman and Gale contend that there are various factors at play that help explain why taxes get complicated.¹¹

First, simplicity often conflicts with other tax policy goals. Most people believe taxes should be fair, conducive to economic prosperity and societal well-being, enforceable, as well as being simple. Even people who agree on these goals often disagree about the relative importance of each. As a result, policies usually represent a balance between competing goals, and simplicity often loses out to other competing goals. For example, most countries tailor tax burdens to the characteristics of individual taxpayers through a tax transfer system¹². While this can make taxes fairer, it also makes them more complex. Income has to be traced from businesses to individuals and individual characteristics such as marital status and number of dependents, as well as aggregated income and expenditure have to be reported and documented to government.

Second, the political process creates complexity. Politicians and interest groups support tax subsidies for particular groups or activities. Targeted subsidies inevitably complicate the tax system by creating distinctions between taxpayers and eligible uses of income and expenditure.¹³

Third, some complexity is thought necessary to deter tax avoidance. While taxpayers have the right to reduce their taxes by legal means this activity inevitably raises questions about whether particular activities or expenditures should qualify for preferential tax treatment. The Executive Parliament responds with complex rules designed to limit avoidance and taxpayers in turn respond by identifying increasingly complex transactions to skirt them. This can create a vicious cycle that leads to more and more complex rules and increasingly sophisticated and complex avoidance strategies.

Lastly, complexity is hard to quantify. If members of Parliament knew that a particular provision would raise compliance costs by a particular amount, they could more easily evaluate the trade-offs between complexity and other goals. And while new bills often require a Regulation Impact Analysis¹⁴ the cumulative effect of each new measure creates a labyrinth of complexity.

In 2003, Krever provided a historical overview of how Australia's tax laws became so complex.¹⁵ The main theme from his paper is that while each participant in the tax system (the judiciary, the advisers, the drafters, the Treasury, and the legislature) has acted in a logical manner from their own

¹¹ Burman L. E. and Gale W.G., *A Golden Opportunity to Simplify the Tax System: Options for Reforming a Complex Tax Code* (2001), The Brookings Institute, Washington, DC.

¹² In their 2015 Working Paper on *Tax and Transfer Incidence in Australia*, the Productivity Commission define transfer system as payments provided by governments to individuals and families such as pensions, allowances, supplementary payments, and family payments.

¹³ Examples include the Instant Asset Write Off and tax concessions for Research and Development.

¹⁴ See the *Australian Government Guide to Regulatory Impact Analysis*, Department of Prime Minister and Cabinet, March 2020

¹⁵ Krever, R., "Taming Complexity in Australian Income Tax" (2003) 25(4) Sydney Law Review 467

perspective, no particular group has claimed responsibility for the tax system overall, leading to the current complex arrangements. According to Krever, the participant best placed to have taken overall responsibility for the tax system has been successive parliaments, who must take ultimate responsibility.¹⁶

In their September 2005 Treasury paper — *Tax System Complexity and Compliance Costs: Some Theoretical Considerations* — Oliver and Bartley explain that there are both private and public drivers of tax system complexity and compliance costs, but they are by no means independent.¹⁷ Their overall findings are that, while increased efforts could be made to assess all the costs and benefits associated with any tax proposal, it is not necessarily complex measures that lead to complex tax law. Even if it were possible to conduct a full cost-benefit analysis of each separate policy proposal, the results of such analysis may indicate that each measure produces a net benefit. Nevertheless, the cumulative impact of these measures may result in a very different story.¹⁸

3 Small business tax policy settings

Based on data collated by the Australian Small Business and Family Enterprise Ombudsman (ASBFEO), small business¹⁹ represent more than 98 per cent of all firms and account for a large proportion of national and global economic growth.²⁰ They are also strongly heterogeneous: across and within industries and sectors; in their innovation behaviours; and in their profitability and growth potential. Importantly, small business also generate a significant share of all taxable business income throughout the world. Moreover, ASBFEO explain that small businesses are important for their contribution to employment, economic growth, innovation and the diversity and competition that they can bring to markets.²¹

Nevertheless, as a large and important part of Australia's economy, small business often face challenges to their viability and growth, some of which are created by market failures²², capital market imperfections and taxation compliance costs²³.

According to the Organisation for Economic Cooperation and Development (OECD), a country's tax system should be neutral with regard to its impact on business decisions, including the creation, form and growth of small businesses.²⁴ The OECD contend, however, that many national tax systems contain certain features that inadvertently disadvantage small businesses relative to larger enterprises.²⁵

The OECD reason that, although many tax policies may appear to be relatively "neutral" for businesses of all sizes, the significant fixed costs associated with compliance represent a disproportionately higher cost for small businesses and consequently have a greater adverse impact upon small business than

¹⁶ Ibid

¹⁷ Oliver T. and Bartley S., "*Tax system complexity and compliance costs — some theoretical considerations*" (2005), Commonwealth Treasury Economic Roundup, Winter 2005

¹⁸ Ibid

¹⁹ In contrast to the tax laws, ASBFEO classify small business as those businesses with less than 20 employees.

²⁰ *Small Business Counts: Small Business in the Australian Economy*, ASBFEO, July 2019

²¹ Ibid

²² Access to finance is often mentioned as a market failure affecting small business. See further *Access to Small Business Finance*, Reserve Bank of Australia, RBA Bulletin, September 2018

²³ Noting, too, that there are also significant compliance costs associated with other forms of regulation. See further *Stocktake of Regulation: Final Report*, Treasury, March 2015

²⁴ *Taxation of SMEs in OECD and G20 Countries* (2015), Tax Policy Studies No.23, OECD, page 13

²⁵ Ibid, page 13

larger businesses.²⁶ Small businesses often face higher tax compliance costs, in relative terms, due to their smaller size. When designing and implementing tax policies, the OECD contends that governments should consider whether certain measures have a disproportionate impact on small businesses and that care should be taken to ensure that measures do not increase complexity.²⁷ Moreover, the costs associated with tracking eligibility, keeping specific records and interacting with the tax system for multiple different tax concessions or simplification measures can increase the complexity of the system.²⁸

Importantly, the OECD argue that a simpler general tax system may be more advantageous to small business than a series of simplification measures: that is, “a less is more” approach.²⁹

Such an approach was validated by Lignier and Evans in their 2012 survey that found that a significant number of small businesses would prefer lower taxes and a simpler tax system than small business tax concessions.³⁰

While Lignier and Evans reported that small business favour simpler tax arrangements over concessions, Krever also declared that no sector of the Australian economy enjoys more subsidies through the tax law than the small business sector and that while “... there is little or no empirical evidence to support the case for subsidising the small business sector, there are obvious political gains to be made from support for the sector and over the years a wide range of tax subsidies have been adopted for small business.”³¹

4 Small business tax concessions

Notwithstanding the OECD’s policy position that “less is more” for small business, the tenuous policy justification that warrants government intervention highlighted by Krever, and the Lignier and Evans survey that reveals that small business would prefer simplicity over tax concessions, the Australian tax system features a plethora of small business tax concessions.

The current collection of concessions have their origins from a standardised definition of small business that was introduced into the tax system through the ‘small business framework’ project in 2007 which defined a ‘small business entity’ (SBE) as an individual, partnership, company or trust carrying on a business with an *aggregated turnover* of less than \$2 million.³²

At the time of introduction, the rationale for having one eligibility test was to reduce compliance costs and red tape for small businesses. However, when the aggregated turnover threshold was increased from \$2 million to \$10 million in the 2016-17 income year, the increase did not apply to all the small business tax concessions. The result effectively removed the simplicity of having a single SBE tax definition.

The following table illustrates the range of small business tax concessions that are available to businesses with aggregated turnover of less than \$10 million per annum.

²⁶ Ibid, page 14

²⁷ Ibid, page 15

²⁸ Ibid, page 15

²⁹ Ibid, page 15

³⁰ Lignier P. and Evans C., “*The Rise and Rise of Tax Compliance Costs for the Small Business Sector in Australia*” (2012), Australian Research Council: 40.8% of respondents said they would be better off with lower taxes and a simpler tax regime while only 5.8% supported small business tax concessions. 53.4% of survey respondents said they were “Unsure” or they the survey question was “Not Applicable”.

³¹ Op cit, Krever, 2003

³² *Scoping study of small business tax compliance costs: A Report to the Treasurer* (2007), Board of Taxation

Table 1: Small Business Tax Concession (for businesses with aggregated t/o of less than \$10M)³³

Concession	Description
Instant Asset Write-off (IAWO)	Businesses can immediately deduct business assets that cost less than a threshold amount. ³⁴
Simplified depreciation rules	Assets above the IAWO threshold are depreciated through simplified pooling arrangements at a rate of 30 per cent per year (15 per cent in the first year).
Small business restructure rollover (SBRR)	Owners of small business active assets are eligible for CGT and income tax roll-over relief for a 'genuine restructure' of their business provided the underlying economic ownership of the assets remains unchanged.
Start-up expenses	Businesses can immediately deduct a range of professional expenses and Australian government agency payments associated with starting a new business, such as professional, legal and accounting advice. Previously, these costs were deducted over a five-year period.
Prepaid expenditure	Businesses may immediately deduct prepaid expenditure subject to certain rules.
Trading stock	Businesses may choose to use a simplified trading stock regime. Under this regime, small businesses may choose not to account for the changes in the value of stock for an income year if the difference between the opening value of stock on hand and a reasonable estimate of stock on hand at the end of the year does not exceed \$5,000.
Pay-As-You-Go Instalments (PAYGI)	SBEs can elect to have their PAYGI calculated for them by the ATO by applying an adjustment to previously reported information.
Fringe benefits tax (FBT): car parking	Car parking benefits provided to employees of businesses (other than government bodies and listed public companies) are exempt from FBT if the parking is not provided in a commercial car park.
FBT: portable electronic devices	Multiple work-related portable electronic devices provided by businesses to their employees are exempt from FBT.
Goods and Services Tax (GST)	Businesses are entitled to three GST concessions including: the option to account for GST on a cash basis; the option to pay GST by quarterly instalments and to lodge an annual return; and the option to apportion

³³ Source: *Review of Small Business Tax Concessions: A Report to the Treasurer* (2019), Board of Taxation

³⁴ See further ATO website; <https://www.ato.gov.au/Business/Depreciation-and-capital-expenses-and-allowances/Simpler-depreciation-for-small-business/Instant-asset-write-off/#Thresholds>. Note, that recent announcements have changed the operation of the IAWO with the effect that the asset value and threshold amounts are: 29 January 2019 to 2 April 2019 —\$25,000 (aggregated t/o < \$10M); 3 April 2019 to 11 March 2020 — \$30,000 (aggregated t/o < \$50M); 12 March 2020 to 30 June 2020 —\$150,000 (aggregated t/o < \$500M); 1 July 2020 to 31 December 2020 —\$150,000 (aggregated t/o < \$500M)

	GST input tax credits on an annual basis for acquisitions and importations that are partly creditable.
Excise	Businesses can apply to defer settlement of excise duty and excise equivalent customs duty from a weekly to monthly reporting cycle.
Amendment period	Businesses are generally eligible for a two-year amendment period for tax assessments instead of the standard four years.

While small businesses meeting the aggregated turnover threshold were entitled to the small business tax concessions, the small business CGT concessions and the unincorporated small business tax discount, were set apart. Instead, the small business CGT concessions retained a \$2 million threshold as well as the alternative \$6 million net asset³⁵ and the threshold for the unincorporated small business tax discount was also raised but limited to \$5 million³⁶. Apart from the complexity associated with each of these concessions, the fracturing of the single definition created further complexity as decisions about eligibility to the various small business tax concessions now fell into three different definitions:

- \$2 million aggregated turnover test;
- \$5 million aggregated turnover test; and
- \$10 million aggregated turnover test.

Moreover, the company tax rate that applies to SBEs, and the rate at which they can frank dividends, further exacerbates the complexity. Such is the complexity of these rules that, including the newly minted concept of ‘base rate entity’, the topic is worthy of a review in its own right. In summary, the following table illustrates the operation of the prevailing company tax rates.

Table 2: Progressive changes to the company tax rate³⁷

Income year	Aggregated turnover threshold	Tax rate for ‘base rate entities’*	Tax rate for all other companies
2017-18	\$25M	27.5%	30.0%
2018-19 to 2019-20	\$50M	27.5%	30.0%
2020 to 2021	\$50M	26.0%	30.0%
2021 to 2022	\$50M	25.0%	30.0%

(*‘Base rate entities’ are those companies that have an aggregated turnover that is less than the prevailing

³⁵ The primary reason for quarantining the suite of CGT concessions was based on two policy grounds; first, budgetary considerations; and second, businesses with aggregated turnover greater than \$2 million were said to have greater capacity to save for their retirement and so an increased threshold was not considered necessary. Explanatory Memorandum to *Treasury Laws Amendment (Enterprise Tax Plan) Act 2016*, paragraph 4.26.

³⁶ This was also based primarily on budget considerations, but also because entities with an aggregated turnover of more than \$5 million ‘generally find it to their advantage to incorporate’ and will not access tax relief designed for unincorporated businesses. Explanatory Memorandum to *Treasury Laws Amendment (Enterprise Tax Plan) Act 2016*, paragraphs 4.26 and 4.64.

³⁷ Source: ATO website: <https://www.ato.gov.au/Rates/Changes-to-company-tax-rates/>

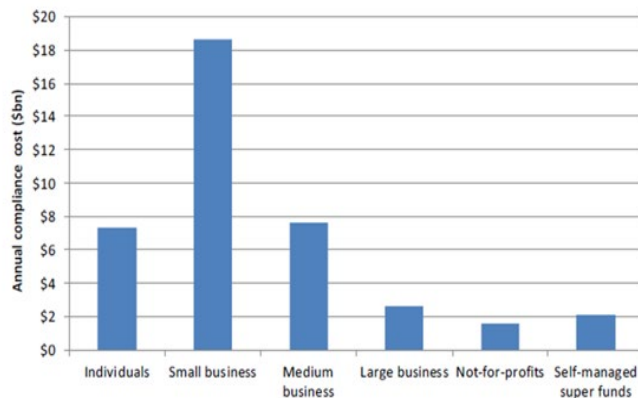
aggregated turnover threshold for the income year and 80% or less of their assessable income is ‘base rate entity passive income’. ‘Base rate entity passive income’ includes dividends, royalties, rent, interest income, gains on qualifying securities, net capital gains and trust and partnership distributions that are referable to ‘base rate entity passive income’.)

5 Small business tax compliance costs

As Section 4 illustrates successive governments have sought to introduce and expand on an array of small business tax concessions. It should come as no surprise therefore that significant compliance costs are imposed on a sector of the economy that can least afford it both financially and temporally.

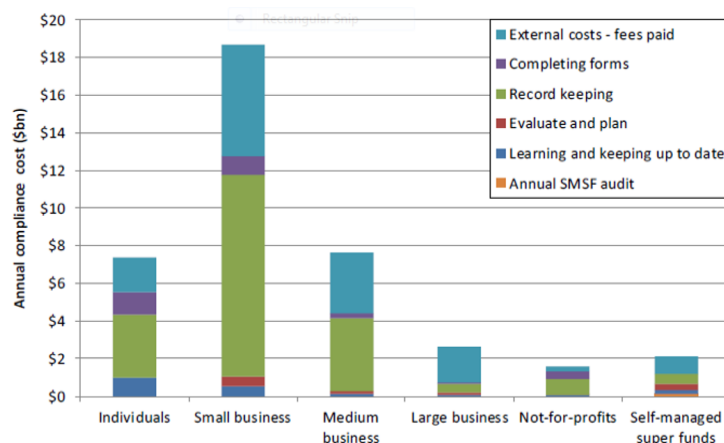
A number of studies have expressed concern about the size and regressive nature of taxation compliance costs for small business. Treasury’s Final Report — *Stocktake of Regulation*³⁸ — estimated that the total cost of complying with taxes administered by the Australian Taxation Office (ATO) was \$40Bn per year of which \$18.7Bn is referable to or on average \$10,389 for every small business.³⁹

Graph 1: Tax Compliance by Entity (source: *The Australian Government, The Treasury*)



In terms of the costliest tax compliance for small businesses, record-keeping was identified as imposing the largest single cost with external fees the second-largest cost.⁴⁰

Graph 2: Tax Compliance Costs by Entity and Activity (source: *The Australian Government, The Treasury*)



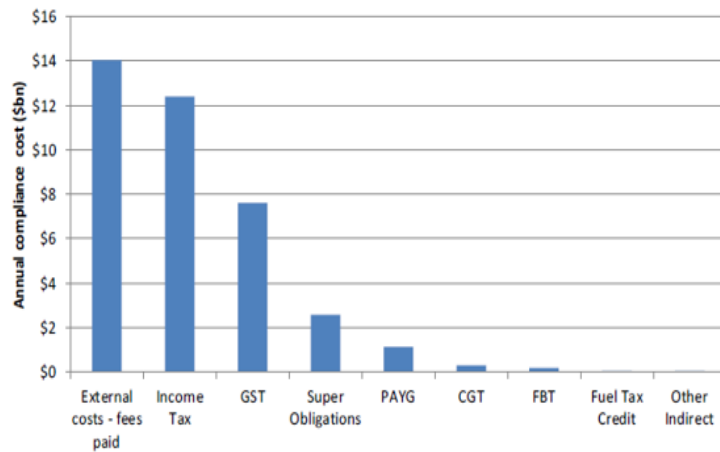
³⁸ *Stocktake of Regulation: Final Report*, Treasury, March 2015

³⁹ *Ibid*, p. 19

⁴⁰ *Ibid*, p. 20

In terms of compliance costs by each type of tax, the Treasury Report reveals that the greatest compliance burdens for small business are in the areas of income tax (\$12.4 billion) and GST (\$7.6 billion).⁴¹ Following these taxes are obligations related to superannuation (\$2.6 billion) and Pay-As-You-Go withholding tax (\$1.1 billion).⁴²

Graph 3: Tax Compliance Costs by Tax Type (source: The Australian Government, The Treasury)



A 2014 study conducted by Lignier, Evans and Tran-Nam produced similar results to the Treasury report.⁴³ Their study of 10,000 Australian small and medium enterprise (SME) business taxpayers revealed that the average gross tax compliance costs for businesses in the SME sector was A\$11,004 per firm per year (2012), an increase of 118 per cent since a previous Australian study of SME tax compliance costs conducted by Evans et al in 1995⁴⁴.

In the Board of Taxation’s December 2007 report to the Treasurer — *Scoping study of small business tax compliance costs* — the Board noted that such is the complexity of the tax system, small business need to draw on the expertise of a tax professional to comply with income tax requirements with the result that over 95 per cent of small business income tax returns in Australia are lodged by tax professionals.⁴⁵

According to a survey underpinning the Board’s report, constant change was cited as the biggest contributor to complexity and compliance costs, with tax agents suggesting that the Government may have on occasion not devoted sufficient time to the development of legislative changes.⁴⁶

Further empirical research of tax compliance costs, including internationally, has also been conducted by McKerchar and Pope.⁴⁷ A consistent theme to this research is that tax compliance costs are large

⁴¹ Ibid, p.20

⁴² Ibid, p.20

⁴³ Lignier P., Evans C., Tran-Nam B., *Tangled Up In Tape: The Continuing Compliance Plight of the Small and Medium Enterprise Business Sector* (2014), Australasian Tax Teachers Association Conference, Griffith University

⁴⁴ Evans C., Ritchie K., Tran-Nam B., Walpole M., *A Report into the Incremental Costs of Taxpayer Compliance* (1996), Commonwealth Information Services, Canberra, Australia

⁴⁵ “*Scoping study of small business tax compliance costs: A Report to the Treasurer*” December 2007, Board of Taxation

⁴⁶ Ibid, at p. 69

⁴⁷ See for example, McKerchar M., Ingraham, L., Karlinsky S. *Tax Complexity and Small Business: a Comparison of the Perceptions of Tax Agents in the United States and Australia* (2005) 8(2) *Journal of Australian Taxation* 289; and Nthathi R., Pope, J., *Business Start-Up Compliance Costs: Policy Perspectives* (2005), 1(3) *Journal of The Australasian Tax Teachers Association* 120

and fall disproportionately on small businesses (with the costs referable to increasing complexity of tax systems, the introduction of GST legislative regimes and the increased emphasis placed on self-assessment).⁴⁸

In their submission to the Independent Review of the Australian Public Service (the ‘Thodey Review’⁴⁹), McCullough and Reid highlight that there are over 800 pages of tax law solely devoted to the seemingly ‘straight-forward’ matter of taxing, or relieving from tax, gains arising from the sale of assets.⁵⁰ McCullough and Reid argue that while some compliance costs would be imposed by even the best designed taxation or other regulatory systems, the sheer size of the current compliance cost burden suggests “we must be very far from best practice” and that if it were possible to reduce the present impost by even 10% — a reduction of around \$6-7 billion per annum — the benefit to business and the community would be as large as those hoped for from many of the ambitious economic reforms pursued in recent decades.⁵¹

6 Previous simplification endeavours

There have been several attempts to simplify the tax system for small businesses each with varying degrees of success.

The Simplified Taxation System (STS), which commenced on 1 July 2001 (and ceased on 30 June 2007), was designed to reduce the tax compliance burden of eligible small businesses. The system provided an alternative method of determining taxable income for businesses with STS average turnover of less than \$1 million that held less than \$3 million in total of adjustable values of depreciating assets. Eligible businesses were required to elect into the system to be entitled to the benefits, which included immediate write-off for assets costing less than \$1,000, more generous and simpler depreciation for other assets, simplified trading stock obligations and an immediate deduction for business expenses paid up to 12 months in advance.

However, according to a 2007 study conducted by the Board of Taxation, tax agents suggested that many of their small business clients were unaware of the existence of the STS and, in many cases, those small businesses that were aware of its existence did not feel capable of determining whether the STS would benefit their business.⁵²

A subsequent 2019 study by the Board of Taxation reported that tax agents were not generally supportive of the STS for various reasons including that the perceived benefits were too modest and the various eligibility criteria and thresholds for entry had the effect of increasing compliance costs.⁵³ Ultimately, these concerns were reflected in a lower-than-expected take up rate for the STS.⁵⁴

Krever also highlighted the shortcomings with STS and remarked that the “STS rules illustrate well how tax concessions, even those allegedly adopted to simplify tax compliance, inevitably led to more complication in the law itself, as well as its application”.⁵⁵

⁴⁸ See Evans for example in Op Cit 2014

⁴⁹ Commonwealth of Australia, Department of the Prime Minister and Cabinet, *Our Public Service, Our Future. Independent Review of the Australian Public Service*, 2019

⁵⁰ McCullough P., Reid T., Treasury Submission to *Our Public Service, Our Future. Independent Review of the Australian Public Service*, July 2018

⁵¹ *Ibid*, p.2

⁵² Op Cit., Board of Taxation, 2007

⁵³ Op Cit., Board of Taxation, 2019

⁵⁴ Op Cit., Board of Taxation, 2019

⁵⁵ Krever, Richard, *Taming Complexity in the Australian Income Tax* (2003), Sydney Law Review

In the 1990s the Tax Value Method ('TVM') was proposed by the Review of Business Taxation as a fundamental reform aimed at simplifying the income tax statute although it was not intended to be limited to small businesses.⁵⁶ Although it was not aimed at aligning tax and accounting outcomes, it was based on the same conceptual framework that underlies accounting. That conceptual framework, found in former accounting standard Statement of Accounting Concepts 4 (SAC 4)⁵⁷, emphasises assets and liabilities as the basis for determining profit or loss.

In the end government decided not to proceed with the TVM following a recommendation from the Board of Taxation.⁵⁸ The Board reported significant industry concern about the cost and uncertainty associated with the TVM, including the possibility of substantial transitional costs for tax advisers and business generally.⁵⁹

7 The use of accounting profits for tax purposes (literature review)

There are frequently calls for reform to the tax law to reduce the gap between tax and accounting. Calls for reform of this kind are usually a response to the complexity of the income tax laws, both in terms of their policy and their structure and drafting. Another reason given is that compliance costs would fall because of a reduced need to maintain duplicate records and, most importantly, less need to follow duplicate processes in calculating profit or loss.⁶⁰

In putting forward that taxable income should be based on accounting profit, Toohey argued that:

"No sane person should have to wrestle with income tax legislation which has grown by 5,000 pages since the Howard Government came to power in 1996. The only way to tackle the problem is to repeal a large chunk of the law. Corporate tax is the obvious candidate for abolition ... given that 60 per cent of small companies don't make taxable profits, the revenue implications would be insignificant for this sector. Yet many small enterprises could save thousands in accounting fees if company tax were recognised as little more than a withholding tax ... For those who find the abolition of company tax too much of a break from tradition, another option would be to use normal accounting standards as the base for assessing taxable income. Company tax could then be reduced to a single paragraph."⁶¹

Previously, the 1975 Taxation Review Committee noted that it had received submissions suggesting that the net income for tax purposes should as a starting point be determined by generally agreed principles of financial accounting.⁶² While the Committee rejected the proposal it acknowledged that it might well be in the interests of both the Revenue and taxpayers if the tax laws were more flexible in its requirements both as to the computation of gross income and to deductions for related expenses.⁶³ The Committee also felt that the tax law could not resign its function of determining the

⁵⁶ Ralph Review of Business Taxation, *A Tax System Redesigned* (1994), Australian Government Publishing Service Canberra

⁵⁷ Statement of Accounting Concepts 4, *Definition and Recognition of the Elements of Financial Statements*, Prepared by the Public Sector Accounting Standards Board of the Australian Accounting Research Foundation and by the Australian Accounting Standards Board

⁵⁸ The Board of Taxation, *Evaluation of the Tax Value Method: A Report to the Treasurer and Minister for Revenue and Assistant Treasurer* (2002)

⁵⁹ *Ibid*, p. 19

⁶⁰ See, for example, Hill D. G., *The Interface Between Tax Law and Accounting Concepts* (2003), Australasian Tax Teachers Conference, Faculty of Law, University of Wollongong

⁶¹ Toohey B., *Tax reform? Turn 8,500 Pages and Weep*, Australian Financial Review, 17–18 August 2002

⁶² Asprey, K. W., Parsons, R. W., *Full Report, Taxation Review Committee* (January 1975), Commonwealth Taxation Review Committee Australia, para. 8.27

⁶³ *Ibid*, para. 8.28

base of income tax in favour of the professional bodies and business or trade organisations which at the time played a large part in formulating generally accepted principles of financial accounting.⁶⁴

In 1985, Westworth also argued against the idea and observed that accounting standards were a codification and standardisation of current practices rather than a logical extension of agreed principles.⁶⁵ They were developed by a process of consensus rather than logical reasoning and were subjective. Accounting profit could not therefore become the basis on which taxable income was calculated because it lacked certainty, and because tax rules were used to provide incentives under general economic policies.⁶⁶

Former Commissioner of Taxation, Trevor Boucher, took a different angle by declaring that one possible way to simplify the tax system was to improve accounting standards to make them robust, clear and otherwise suitable for the determination of the tax base, then to adopt them to determine taxable income.⁶⁷

The rationalisation of tax and accounting systems was also examined in 1999 by the Review of Business Taxation (RBT).⁶⁸ The Review recommended that appropriate regard be had to accounting principles in the development of the Australian Tax Code⁶⁹ and that work be undertaken with tax and accounting professionals to identify differences between tax and accounting with a view to better aligning them⁷⁰.

RBT also looked at the prospect of an alternative minimum company tax (AMCT) on the basis that in some circumstances an entity's taxable income may be significantly less than its accounting income.⁷¹ However, the RBT rejected the proposal on the basis that there are many major components of accounting income which it would simply be inappropriate to subject to taxation.⁷² RBT justified its position by providing the examples of where companies may have substantial dividend income which has already been subject to company tax and foreign source income that is included in accounting income but, if it has been subject to a comparable tax rate in the source country, it is not subject to Australian tax.⁷³ In rejecting the proposal RBT reasoned that AMCT is likely to result in additional complexity and costs to the extent that taxpayers would be required to undertake two calculations to determine which approach had to be applied.⁷⁴

The Board of Taxation has at various times examined the prospect of aligning the tax laws with accounting concepts. In their 2017 Report — *Exploring Potential to Align Accounting and Tax Systems (Appropriateness of Allowing Small Businesses to Calculate Pay AS You Go Instalments Based on Accounting Income)* — the Board's Working Group concluded that broad-spectrum alignment

⁶⁴ Ibid, para. 8.28

⁶⁵ Westworth C., *Accounting Standards: A Framework for Tax Assessment* (1985), Australian Tax Forum, p. 243

⁶⁶ Ibid, p.243

⁶⁷ Boucher T., *The Simplification Debate — Too Simplistic* (1991), Taxation in Australia, November, pp 272-282

⁶⁸ Op Cit., Review of Business Taxation, 1994, p. 52.

⁶⁹ Ibid, Recommendation 4.23

⁷⁰ Ibid, Recommendation 4.24

⁷¹ Ibid, 279–86.

⁷² Ibid 51–3

⁷³ Ibid 279–86

⁷⁴ Ibid 279–86

between the accounting and tax system within Australia's current taxation framework would be neither feasible nor desirable, given the disparate purposes of the tax and accounting systems.⁷⁵

In a subsequent 2018 report — *Exploring Potential to Align Accounting and Tax Systems* — the Board formed a similar view but acknowledged that there may be particular areas of the law where greater alignment with accounting practices can create net benefits by reducing compliance costs and improving certainty, without prejudicing tax policy objectives. The Board's Working Group considered that it is appropriate to consider such areas on a case by case basis to identify situations where greater alignment could be warranted and could be achieved in a simple and targeted fashion.⁷⁶

The UK's Office of Tax Simplification (OTS) in their July 2017 report — *Simplification of the Corporation Tax Computation* — recommended that the computation of a company's tax should be drawn from their accounts. The OTS reasoned that the company's accounts reflect the commercial reality of its business operations. Financial accounts are compiled under an extensive set of well understood accounting rules: it is logical for income tax to be based as far as possible on these accounts, with the minimum of adjustments. In practice, financial accounts are the basis of the income tax so to the extent calculations and decisions for tax differ from accounting, complexity and administrative burdens are introduced.⁷⁷

The OTS added that while this principle of 'follow the accounts' might raise concerns among some who have said that accounting standards are in practice flexible in some areas, they nevertheless offer the prospect of simpler system. The principle here is 'do it once': if small companies have to prepare accounts, the work that they put in should suffice to deal with their tax computation with only minimal additional input. While the OTS accept that these reforms would come with revenue costs, such costs would be modest and the simplification dividend significant. Accordingly, the OTS recommended that these reforms should be taken forward, to better align the tax system with the accounts and modern commercial reality.⁷⁸

On the other hand, Freedman previously argued that, while the move towards International Accounting Standards could be seen as an impetus for reviewing the tax position, these developments do not give rise to the opportunity to use global accounting standards as a step towards harmonising the tax base.⁷⁹ Freedman asserts that the objectives of accounting standards are moving away from those of the tax system, making complete alignment between taxable and accounting profits inappropriate and identification of tax principles all the more important. Freedman adds that it is widely agreed that, whilst the commercial accounts are a starting point for calculating taxable profits, there is a continuing role for tax legislation in providing for modifications in some cases to meet specific tax objectives.⁸⁰

In his 1997 study of 549 listed Australian companies, Tran concludes that the alignment of tax rules with accounting rules presupposes suitability of accounting rules to achieve the objectives and criteria of the income tax system and that given the existing institutional arrangements, a complete alignment

⁷⁵ Board of Taxation, *Exploring Potential to Align Accounting and Tax Systems (Appropriateness of Allowing Small Businesses to Calculate Pay AS You Go Instalments Based on Accounting Income)* July 2017, (Unpublished)

⁷⁶ Board of Taxation, *Exploring Potential to Align Accounting and Tax Systems* 2018

⁷⁷ Office of Tax Simplification (UK), *Simplification of the Corporation Tax Computation* 2017, p. 6

⁷⁸ *Ibid*, p. 7

⁷⁹ Freedman J., *Aligning Taxable Profits and Accounting Profits: Australian Standards, Legislators and Judges* (2004), eJournal of Tax Research, vol. 2, no. 1, pp. 71-99

⁸⁰ *Ibid*, p. 98

of tax rules with financial accounting rules is neither feasible nor desirable. However, in areas where there is no conflict between the objectives and the required standards of the two systems, the two sets of rules could be aligned to reduce compliance costs.⁸¹

The December 2012 study by Carlon, Tran and Tran-Nam found that taxable profits are very close to accounting profits through the examination of the effective rates of tax of 20 large listed Australian companies.⁸² The study concluded that this result is in some way attributable to the income tax base broadening that has taken place during the past 25 years in Australia.⁸³

The results of these two studies cannot be directly compared because of the differences in study periods, sample sizes and research methods. Australia introduced dividend imputation in 1987. It took time to companies to gradually adjust their mentality and behaviour to the dividend imputation system, especially the simplified dividend imputation system from 2002 when individual shareholders are allowed to claim a refund of excessive franking credit, so that company tax paid is no longer a real cost to domestic investors. The narrowing of book-tax income gap over time in Australia is at least partly explained by the gradual reduction of tax avoidance by listed companies under the dividend imputation system. Another reason is other changes in tax laws as a results of tax reviews (such as the introduction of capital gains tax and the changes in capital allowance rules) which are described as broadening of the income tax base in the Carlon et al (2013) paper.

In their 2005 paper, former ATO Commissioner Michael D’Ascenzo and Assistant Commissioner Andrew England observed that, unlike some European countries, Australia operates as an ‘Anglo-Saxon’ type system that has a disconnect rather than dependence between accounting and tax requirements. For these reasons the authors explained that, notwithstanding repeated calls for a convergence of the tax and accounting treatments of income and expenses, a comprehensive alignment seems a “dim prospect given basic differences in purpose and policy, and practical realities”.⁸⁴

Rather than support the alignment of tax with accounting treatment or the alignment of accounting with tax, Zilva argued for the development of a new set of common rules that would apply for both tax and accounting purposes.⁸⁵

8 International Approaches

Hoogendoorn observed in his review of accounting and taxation in Europe that some countries exhibited a strong dependence between accounting and taxation while other countries did not.⁸⁶

Table 3: Dependence on accounting standards

Independent	Dependence
Czech Republic	Belgium
Denmark	Finland

⁸¹ Tran A., *Relationship of Tax and Financial Accounting Rules: An Empirical Study of the Alignment Issue* (1997), Thesis Submission to the Review of Business Taxation, Australian National University

⁸² Carlon S., Tran A., Tran-Nam B., *How Close are Taxable Income and Accounting Profit? An Empirical Study of Large Australian Companies* (2012), Australian Tax Forum, September 2013

⁸³ *Ibid*, p. 25

⁸⁴ D’Ascenzo M., England A., *Tax and the Accounting Interface* (2005), Journal of The Australasian Tax Teachers Association 24

⁸⁵ Zilva A., *The Alignment of Tax and Financial Accounting Rules: The Case for a New Set of Common Rules* (2005), Journal of the Australian Tax Teachers Association 66

⁸⁶ Hoogendoorn M.N., “*Accounting and Taxation in Europe – A Comparative Overview*” (1983), The European Accounting Review 783,786

Ireland	France
Netherlands	Germany
Norway	Italy
Poland	Sweden
United Kingdom	

Hoogendoorn explained that the development towards more independence between accounting and taxation was linked to the transition to a market economy for some Eastern European countries as well as to accounting harmonisation which interferes with the basic structure of dependence.

In a similar vein, the OECD in their 1987 Working Group on Accounting Standards identified 3 main types of relationships between financial accounting rules and tax rules.⁸⁷ First, there were countries like Norway where accounting practices were dictated by tax rules. Second, there were countries such as the USA, UK, and the Netherlands where the accounting rules and tax rules were independent of each other. Third, there were countries such as France, Germany, and Italy where the financial statements are drawn up according to accounting rules are used to determine the basis of tax.

Nobes and Parker identified factors such as respective country legal systems, finance providers to business, taxation influences, and strength of accounting profession as the main causes to explain the differences in a country's relationship between financial accounting and taxation rules.⁸⁸

In their July 2018 report, the Board of Taxation noted that, historically, most jurisdictions have set their own accounting standards as well as tax policy but this paradigm has shifted since the introduction and adoption of International Financial Reporting Standards (IFRS).⁸⁹ The Board explained that the link between tax and accounting in the United Kingdom and European countries has historically been strong but has been eroded since the adoption of IFRS to allow greater flexibility for domestic policy makers in relation to taxation policy.⁹⁰ According to the Board, some European countries such as Germany have chosen to maintain strong links between domestic accounting standards and tax laws, and have chosen not to adopt IFRS. In contrast, jurisdictions such as the Australia, United States and New Zealand have historically had weaker links between accounting and tax but have sought to make linkages between the two systems where possible and where the benefits outweigh the costs.⁹¹

9 The Nature of the Difference Between Accounting and Income Tax

As policy and law makers adopt concepts which reflect the different objectives of accounting and tax, differences will inevitably emerge. These differences usually occur because of variations in revenue and expense recognition principles. In general, the differences between accounting and taxable income fall into two categories: permanent differences and temporary differences. Permanent differences are items of revenue or expenditure that are recognised by accounting rules but not tax rules, and vice versa. For example, tax concessions such as research and development where the taxpayer receives an extra deduction above actual expenditure. Temporary differences are those

⁸⁷ Organisation for Economic Co-Operation and Development (OECD), Working Group on Accounting Standards, "Accounting Standards Harmonisation Report No.3: The Relationship Between Taxation and Financial Accounting", Paris, 1987

⁸⁸ Nobes C.W. and Parker R., "Comparative International Accounting", 4th Edition, Prentice Hall, 1995

⁸⁹ Board of Taxation, *Exploring the Potential to Align Accounting and Tax Systems in Australia*, July 2018, Australian Government, p. 12

⁹⁰ Ibid, p.12

⁹¹ Ibid, p.12

where the amount of the revenue or expense is the same under accounting and tax but are recognised in different reporting periods.

Permanent differences

- entertainment expenses
- R&D expenditure
- goodwill/intangibles
- specific industry/sector incentives (e.g. small business CGT discount)
- penalties/fines
- transfer pricing (including thin capitalisation)

Temporary differences

- depreciation of plant and property
- doubtful debts
- employee entitlements like employee annual leave and long service leave
- revenue or expenses received or paid in advance
- financial instruments

As a result of these difference a tax reconciliation process is required as accounting profit takes into account different items and may use different amounts. The process is a series of increasing⁹² and decreasing⁹³ adjustments to the accounting profits to arrive at a taxable income figure.

The origins for the differences between tax and accounting income can be traced to the different evolutionary courses they took over the last 100 years or so. Originally, under the *Income Tax Assessment Act 1922* and the *Income Tax Assessment Act 1936*, there was little or no difference between the taxable income and net profit of an enterprise.⁹⁴ However, since the early 1940s there has been a significant divergence of the financial accounting rules and taxation laws largely stemming from a considerable expansion of the coverage of the Australian income tax law from its initial focus on the narrowly defined concept of 'ordinary oncome' to the inclusion of virtually all realised gains and losses of a non-private nature.⁹⁵

⁹² Increasing adjustments under the income tax law may result from an accounting expense that is not an allowable deduction (such as entertainment expenses), an accounting expense that is an allowable deduction, but the expense is more than the deduction; assessable income that is not accounting revenue, for example a notional or deemed amount (such as the amount by which franked dividends are grossed up); and assessable income that is accounting revenue, but the income is more than the revenue.

⁹³ Conversely, decreasing adjustments under the income tax law may be made for: an allowable deduction that is not an accounting expense, (such as carry forward tax losses); an allowable deduction that is an accounting expense, but the deduction is more than the expense; accounting revenue that is not assessable income, (for example, upward asset revaluation reserves); and accounting revenue that is assessable income, but the revenue is more than the assessable income.

⁹⁴ Herring L., *The Impact of Accounting Principles upon the Determination of Taxable Income* (Paper presented at the Seventh National Convention of the Taxation Institute of Australia, Hobart, April 1986) p. 49

⁹⁵ These include the following base broadening reforms: the introduction of Fringe Benefits Tax (1986) according to which employers pay taxes on the taxable value of specific benefits provided to employees, including certain travel and entertainment ; the inclusion in the corporate income tax base of capital gains

In contrast, the development of accounting standards has tracked a different evolutionary course. Accounting standards in Australia were initially developed by the professional accounting bodies, and were enforceable under their codes of ethics. From 1966, the professional bodies jointly operated the Australian Accounting Research Foundation (AARF), which ultimately encompassed both the Accounting Standards Board (AcSB) and the Public Sector Accounting Standards Board (PSASB).⁹⁶

At the start of 1984, the Accounting Standards Review Board (ASRB) was established by the Ministerial Council for Companies and Securities to review the standards produced by the profession and give them the force of company law. The ASRB was re-established under the Australian Securities Commission Act 1989 and in 1991 was renamed the Australian Accounting Standards Board (AASB) with the AASB's standards applying under the Corporations Law. In more recent years Australian accounting standard setters have contributed to the development of international accounting standards under the International Accounting Standards Committee (IASC) and began adoption of pronouncements issued by the IASB – the International Financial Reporting Standards (IFRSs) in 2002.⁹⁷

The different institutional arrangements that have applied to their evolutionary courses has resulted in various divergences relating to their respective objectives, evaluation criteria and principles. Porcano and Tran summarised these in the following manner:⁹⁸

Table 4: Divergence Between Tax and Accounting: Objectives, Evaluation Criteria and Principles
Progressive changes to the company tax rate

Taxation	Accounting
Objectives	
<ul style="list-style-type: none"> • Raise revenue 	<ul style="list-style-type: none"> • Provide useful information for: <ul style="list-style-type: none"> ○ Making economic decisions ○ Evaluating economic options
<ul style="list-style-type: none"> • Manage economy 	
<ul style="list-style-type: none"> • Achieve social and political goals 	
Evaluation criteria	
<ul style="list-style-type: none"> • Equity 	<ul style="list-style-type: none"> • Relevance
<ul style="list-style-type: none"> • Neutrality 	<ul style="list-style-type: none"> • Reliability
<ul style="list-style-type: none"> • Efficiency 	<ul style="list-style-type: none"> • Materiality
<ul style="list-style-type: none"> • Certainty 	<ul style="list-style-type: none"> • Timeliness
<ul style="list-style-type: none"> • Continuity 	<ul style="list-style-type: none"> • Comparability

(1985–86), income from the life insurance industry, income from the gold mining industry (1990–91) and foreign source income; replacement of accelerated depreciation with a regime based on effective life (1999–2000); the removal of the general investment allowance (1988–89); and the removal of inter-corporate dividend rebate (1999–2000) with the effect that companies now pay taxes on the unfranked portion of dividends received from domestic companies.

⁹⁶ Australian Accounting Standards Board (AASB), *What is the History of Accounting Standard-Setting in Australia?*, 2020, Australian Government, AASB website

⁹⁷ Ibid, AASB, 2020

⁹⁸ Porcano T.M. and Tran A. V., *Relationship of Tax and Financial Accounting Rules in Anglo-Saxon Countries*, *The International Journal of Accounting*, University of Illinois, Vol. 33, No. 4, p 448

• Convenience	• Understandability
• Economic or cost effective	
Basic principles	
• Wherewithal to pay	• Realisation
○ Receipt or control of funds	• Matching
○ Payment or definite liability	• Conservatism
• Neither profit nor loss can be anticipated	• Substance over form
• Income capital distinction	

10 Views of the tax profession

To elicit the view of the tax profession in relation to the topic, a survey was developed (see Attachment A) and circulated through various tax associations and accounting firms in late June and July 2020.

These firms included:

- The Chartered Accountant's (CA ANZ) weekly tax bulletin, *Tax News*.
- The Taxation Institute's weekly tax bulletin, *TaxVine*.
- Email invitations to the largest accounting firms: Ernst and Young (EY), PriceWaterhouseCoopers (PWC), Deloitte and Klynveld Peat Marwick Goerdeler (KPMG).
- Email invitations to the following mid-tier accounting firms: Pitcher Partners, Binder Dijker Otte (BDO) and Grant Thornton.
- Participation invitations through the Tax and Transfer Policy Institute's (TTPI) monthly newsletter.

The survey used the MonkeySurvey Application and was open from 15 June 2020 to 31 July 2020. To encourage participation survey responses were confidential.

The questions posed to respondents were assembled into 3 Parts. Part A was intended to gauge initial perspectives about the alignment of taxable income with accounting income by posing the following question:

- 1 Small businesses should be able to use their financial accounting income as revealed by their accounting software to determine their income tax liabilities

Respondents could select an answer from a rating scale based on the following options: strongly disagree, disagree, neutral, agree, and strongly agree.

Part B was intended to elicit perspectives about the Small Business Tax Concessions (SBTC) by posing the following questions:

- 2 For small businesses, the compliance cost benefits of determining income tax liabilities based on financial accounting income outweigh the benefits of the SBTC

- 3 SBTCs are a waste of time and would be better off with lower taxes and a simpler system
- 4 I ensure my small business clients understand the benefits of the SBTCs
- 5 SBTCs are so complex that it is hardly worth the effort
- 6 SBTCs have saved my clients tax dollars

Once again respondents could select an answer from a rating scale based on the following options: strongly disagree, disagree, neutral, agree, and strongly agree.

Part C was intended to understand the demographic of respondents by posing the following questions:

- 7 The following best describes the size of tax firm I work within: (Responses drawn from: Big Four, Second Tier, Small (e.g. suburban or regional), industry, government, not-for-profit)
- 8 The firm I work within focusses mainly on taxation issues: (Responses drawn from: Yes, Even distribution across other core activities, No)

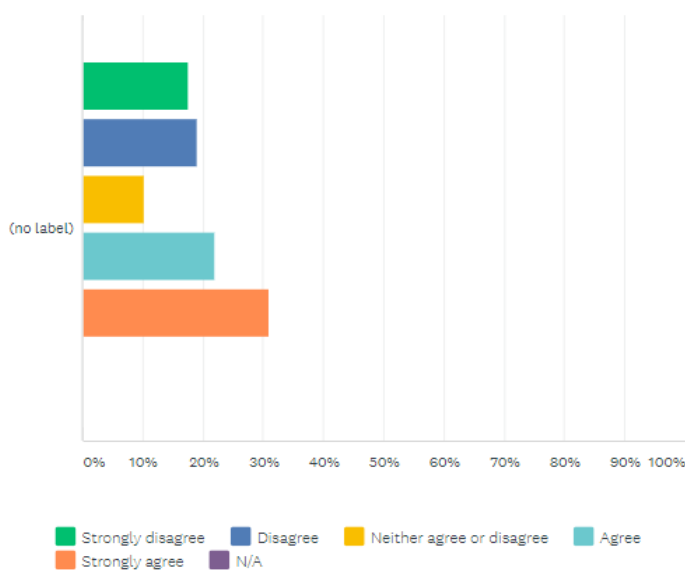
Survey results

At the end of the survey period 68 responses were received. This is lower than the expected response rate possibly due to conflicts with end of financial year tax obligations and small business advising work in relation to COVID 19 and *JobKeeper* payments.

Nevertheless, the response rate is commensurate with similar surveys and with response rates for Treasury and ATO consultation processes on proposed taxation measures.

Response to Question 1

Graph and Table 1: Small businesses should be able to use their financial accounting income as revealed by their accounting software to determine their income tax liabilities



Perception	Results	Number (n=68)
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Strongly disagree	17.65%	12
Disagree	19.12%	13
Neither disagree or agree	10.29%	7
Agree	22.06%	15
Strongly agree	30.88%	21
N/A	0%	0

The results illustrate that the question is quite polarising amongst the tax profession with a small preference recorded in the “Agree/Strongly Agree” category (52.94%) over those in the “Disagreed/Strongly Disagreed” (36.77%) category. While the strength of Disagreement was evenly poised between Strongly Disagree (17.65%) and Disagree (19.12%) there was a stronger preference for Strongly Agree (30.88%) over Agree (22.06%).

The “Neither Disagree/Agree” cohort was represented by 10.29% of respondents which could have possibly swayed the result in either direction should more work be done to explain the effect of the proposal and how it might be implemented.

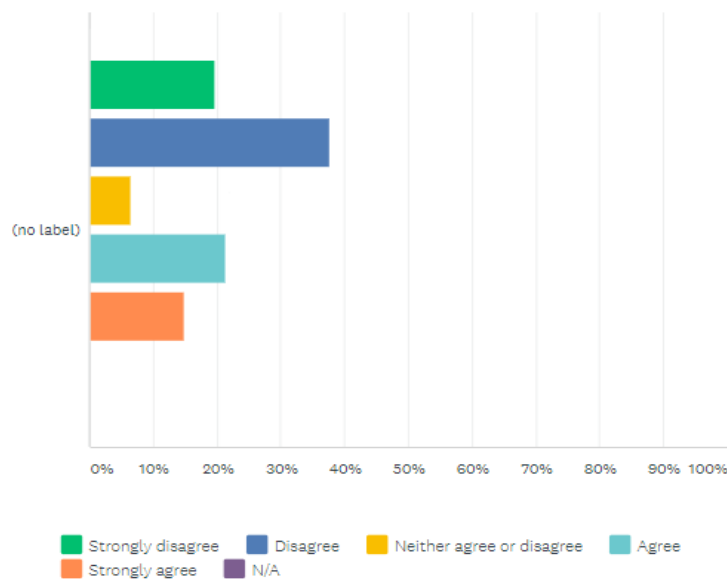
There was a mixture of comments received from respondents both supporting and not supporting the proposal. These included:

- “Small business vary and the way they account varies significant (cash basis, basic accruals, full accounting standards).
- “Your question is ill informed because there can be huge differences between accounting income and taxable income.”
- “It is not at all clear to me what the purpose of this would be. There are established principles in the tax law for determining when income has been derived and when expenditure has been incurred. These are well understood by practitioners. In many cases the timing of income and expense recognition will be the same for accounting and tax, though some adjustments may be required for expenses that are not deductible in the current year (e.g., accruals, unpaid super). Further, aligning taxable income with financial accounting income may even be a hindrance to some small business entities that claim the small business depreciation concessions.”
- “If a bookkeeper handles recording”
- “Simple, and easy. Net cash flow tax could be another alternative”
- “Accounting software has no regard for small business tax concessions”
- “The accounting skills required to get the right accounting income other than using a cash basis may be unattainable by the SME without additional costs”
- “The reverse is true for non-listed companies and small business”
- “Accounting profit and taxable income are governed by a host of different considerations and principles”
- “So long as accounts are prepared in accordance with Generally Accepted Accounting Principles (GAAP) or similar rules/guidelines to ensure some measure of consistency and prevent tax avoidance.”
- “Without a more robust framework for determining "financial accounting income" for small business this is problematic”
- “There are no rules to accounting which would make it a free for all”
- “Some minor adjustments may be needed”
- “No need to undertake tax rec calculations will save time and money”

- “Doesn't reflect some items may not be taxable - ie cash basis v. accruals”
- “The question mentions accounting software, accounting software does not produce income, the processing of transactions does”
- “Provided they have appropriate records and a bookkeeper”
- “Why not the reverse. Accounting standards for SMB are onerous”
- “With the same information 10 accountants would produce 10 different sets of accounts for any business, small or large.”
- “Financial accounting income must comply with accounting standards. Notwithstanding the role of Australian bodies such standards are in substance developed and reformed internationally. Change is slow, the standards do not necessarily cover all scenarios and do not necessarily cover local conditions. Australian tax law - I thought I would never say this - is more flexible about dealing with Australian situations than what are effectively international accounting standards.”
- “Financial accounting income is whatever the computerised accounting package arrives at. A cash basis of accounting is simple and a better basis for matching cash flows and tax liabilities.”
- “The costs of forcing small businesses to comply with full accounting standards would be extraordinary and unnecessary. The definition of 'income' within Trust Deeds is so varied that there would be no consistency - especially given the re-characterisation clauses in most Deeds.”

Response to Question 2

Graph and Table 2: For small businesses, the compliance cost benefits of determining income tax liabilities based on financial accounting income outweigh the benefits of the Small Business Tax Concessions (SBTC)



Perception	Results	Number (n = 61)
Strongly disagree	19.67%	12
Disagree	37.70%	23
Neither disagree or agree	6.56%	4
Agree	21.31%	13
Strongly agree	14.75%	9

N/A	0%	0
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The results also illustrate that this question is polarising amongst the tax profession with a preference recorded in the “Disagreed/Strongly Disagreed” category (57.37%) over those in the “Agree/Strongly Agree” category (36.06%). The strength of Disagreement was skewed towards “Disagree” (37.70%) over “Strongly Disagreed” (19.67%) while the strength of Agreement was skewed towards “Agree” (21.31%) over “Strongly Agree” (14.75%). The results indicate that respondents were more ‘middle of the road’ in their responses in comparison to Question 1 which featured more strength at each end of the continuum.

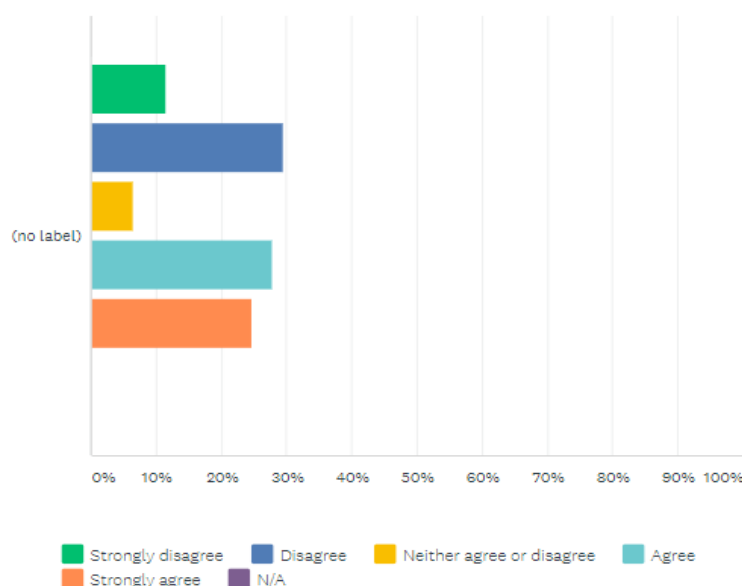
A possible explanation for the disparity in the results between Question 1 and 2 is that the Assistant Treasurer bolstered the attractiveness of the \$150,000 Instant Asset Write Off immediately before the survey period by announcing an extension to the application period to 31 December 2020. [ref to treasurer PR of 9 June]

Comments received from respondents in respect of Question 2 included:

- “Not sure what the SB CGT concessions would be impacted”
- “There are no compliance cost benefits to small businesses from reporting on financial accounting income.”
- “Small Business CGT saves a lot of money, the instant asset write-off and other SBTC is marginal. Instant asset write off should apply for all trading entities, not just small business.”

Response to Question 3

Graph and Table 3: SBTCs are a waste of time and would be better off with lower taxes and a simpler system



Perception	Results	Number (n=61)
Strongly disagree	11.48%	7
Disagree	29.51%	18
Neither disagree or agree	6.56%	4

Agree	27.87%	17
Strongly agree	24.59%	15
N/A	0%	0

This question was modelled on a question posed by Lignier and Evans in their 2012 study of small business compliance costs [ref] although their study focussed on responses from small businesses rather than the tax profession. The results from the Lignier and Evans study revealed 40.8% agreed that small business would be better off with a simpler system in lieu of the SBTCs while 5.8% disagreed with the proposition (with 53.4% of respondents recording an “Unsure”/“Not applicable”/“Not relevant” response). The results in this study, however, revealed that 52.46% of respondents agreed that small business would be better off with a simpler system in lieu of the SBTCs while 40.99% disagreed with the proposition.

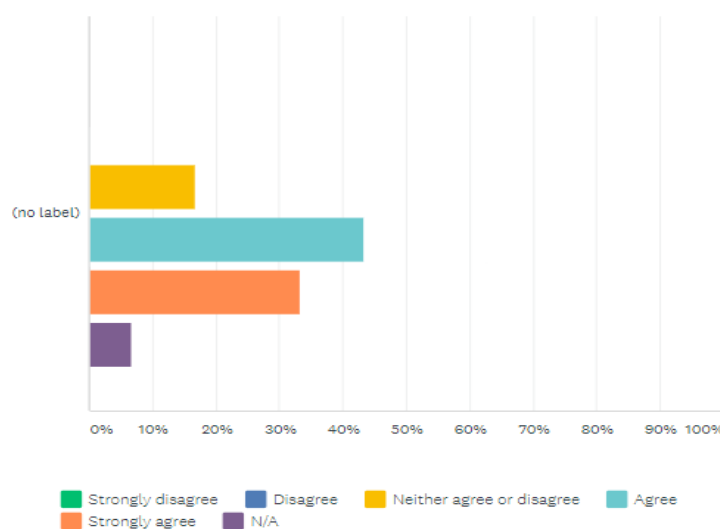
The strength of Agreement was evenly spread between “Agree” (27.87%) and “Strongly Agree” (24.59%) while the strength of Disagreement was skewed towards “Disagree” (29.51%) over “Strongly Agree” (11.48%).

Comments received from respondents in respect of Question 3 included:

- “If only we had the choice! usually the academic answer is just tax the rich which for academics and lefties is everyone who does not agree with the academic & leftie”
- “Small Business CGT saves a lot of money, the instant asset write off and other SBTC is marginal. Instant asset write off should apply for all trading entities, not just small business”
- “Rates are low enough already.”
- “Allows for targeting of benefits by governments maybe offset by grants”
- “No such thing as a 'simpler' system where Treasury and ATO are involved!”
- “Yes, in terms of annual taxable income excluding CGT concessions”
- “Agree with simpler system (to reduce compliance costs). Agree with lower tax rates, so long as doesn't lead to additional integrity rules and complexity (similar to Division 7A).”

Response to Question 4

Graph and Table 4: I ensure my small business clients understand the benefits of the SBTCs



Perception	Results	Number (n=60)
Strongly disagree	0%	0
Disagree	0%	0
Neither disagree or agree	16.67%	10
Agree	43.33%	26
Strongly agree	33.33%	20
N/A	6.67%	4

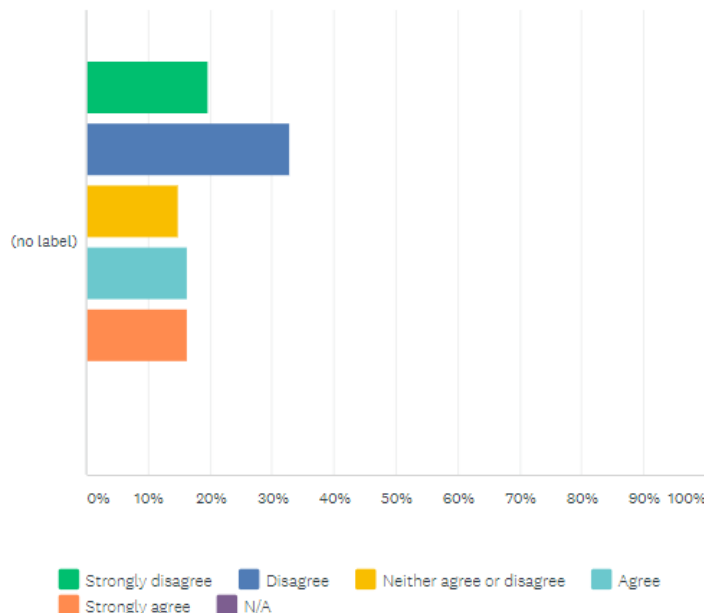
This question was also modelled on a question in the Lignier and Evans study that posed the question of whether small business felt well advised by their accountant regarding the benefits of SBTCs. The study found that 26.8% of respondents agreed with the statement, 11.7% in disagreement and 62.2% “Unsure/Not applicable/Not relevant”. In contrast, this survey focused on the tax profession with respondents asked whether they ensured their small business clients understood the benefits of SBTCs. The results revealed that 76.66% were in agreement with the statement 16.67% “Neither agreeing or disagreeing” with the statement. Perhaps, unsurprisingly no respondents disagreed with the statement.

The strength of agreement was skewed towards “Agree” (43.33%) rather than “Strongly Agree” (33.33%).

Comments received from respondents in respect of Question 4 included that the “Cost vs benefit makes this an arduous task” and “Education and information are readily available”.

Response to Question 5

Graph and Table 5: SBTCs are so complex that it is hardly worth the effort



Perception	Results	Number (n=61)
Strongly disagree	19.67%	12
Disagree	32.79%	20
Neither disagree or agree	14.75%	9
Agree	16.39%	10
Strongly agree	16.39%	10

N/A	0%	0
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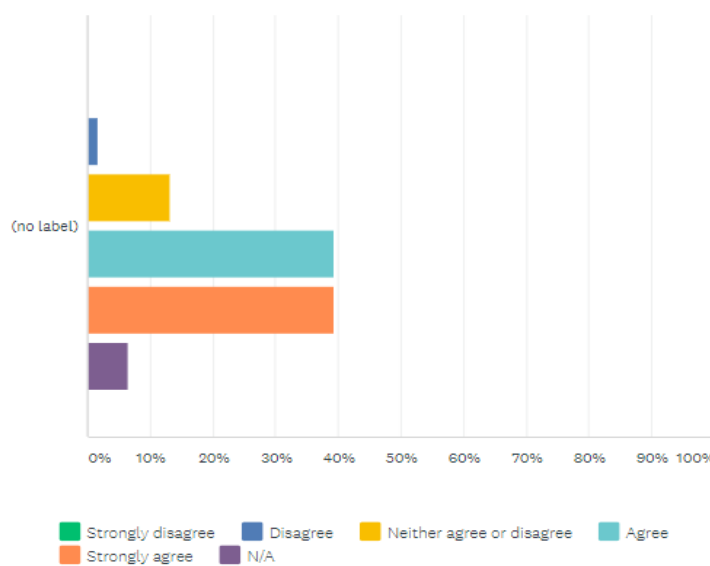
Respondents disagreed with the statement with 52.46% disagreeing while 32.78% agreed with the statement. The strength of disagreement was skewed towards “Disagree” (32.79%) over “Strongly Disagree” (19.67%) while the strength of agreement was evenly distributed between “Agree” and Strongly Agree (both 16.39%). 14.75% of respondents “Neither disagreed or agreed” with the statement.

Some of the comments received in relation to this question indicated that the CGT SBTCs were a significant incentive that had a bearing on the response:

- “SBTC is not worth it for everything except for small business CGT”
- “Small business CGT concessions are usually worth the effort (benefits outweigh cost of advice in most cases). However, depreciation concessions are hardly worthwhile in most cases.”
- “With the exception of the CGT Concessions.”

Response to Question 6

Graph and Table 6: SBTCs have saved my clients tax dollars



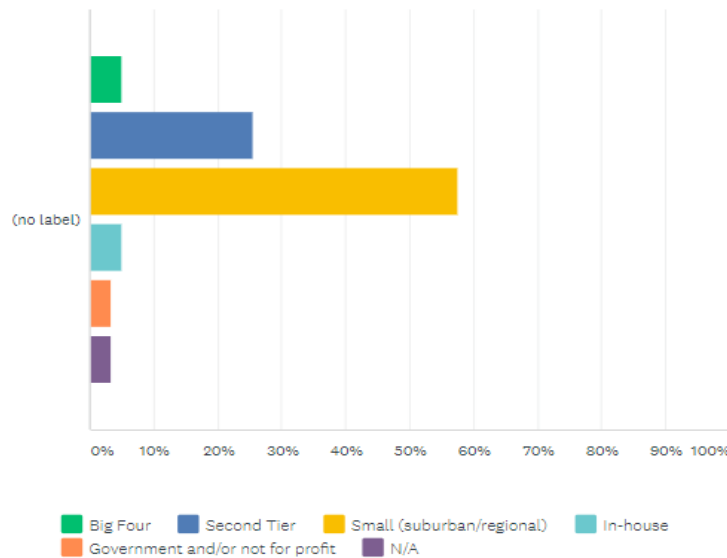
Perception	Results	Number (n=61)
Strongly disagree	0%	0
Disagree	1.64%	1
Neither disagree or agree	13.11%	8
Agree	39.34%	24
Strongly agree	39.34%	24
N/A	6.56%	4

Respondents overwhelmingly agreed with the statement with 78.68% of respondents agreeing while only one respondent disagreed with the statement. 13.11% of respondents “Neither disagreed or agreed” with the statement. The strength of agreement was evenly shared between “Agree” (39.34%) and “Strongly Agree” (39.34%).

Comments received from respondents in respect of Question 6 included that the “Only for small business CGT, the rest is marginal” and “Small business capital gains tax concessions are very effective in reducing tax liabilities.

Response to Question 7

Graph and Table 7: The following best describes the kind of firm I work within

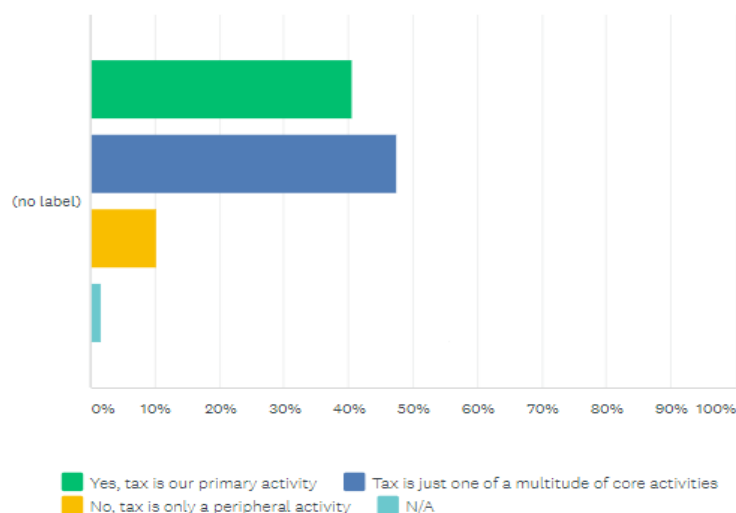


Demographic	Results (n=67)	Number (n=5(
Big 4	5.08%	3
Second tier	25.42%	15
Small suburban/regional	57.63%	34
In-house	5.08%	3
Government/Not-for-profit	3.39%	2
Other	3.39%	2

The majority of respondents were represented by the Small Suburban/Regional type practice making up 57.63% of all respondents. This is probably not surprising given that Small Suburban/Regional type practices are more likely to be interested in the topic with a disproportionately larger small business client base than the larger firms. Second Tier firms made up 25.42% of all respondents with similar representation from the Big 4 and In-house (5.08% each) and Government/Not-for-Profit (3.39%).

Response to Question 8

Graph and Table 8: The firm I work within focusses mainly on taxation matters



Perception	Results (n=67)	Number (n=59)
Yes, tax is our primary activity	40.68%	24
Tax is just one of a multitude of core activities	47.64%	28
No, tax is only a peripheral activity	10.17%	6
N/A	1.69%	1

The majority of responders reported that “Tax is just one of a multitude of core activities” making up 47.64% of all respondents with “Tax is our firm’s primary activity” making up 40.68% of respondents. 10.17% of respondents reported that “Tax was only a peripheral activity”.

11 A Pathway Forward

Previous arguments into the possible use of accounting income to calculate income tax liabilities have been dismissed primarily on the basis of the need to preserve the different purposes for which accounting and tax have been created and the administrative effectiveness required of a tax system.

Such arguments, however, did not have the benefit of observing the ever-increasing accumulation of small business tax compliance costs and the increasing prevalence of digital accounting packages that capture accounting data.⁹⁹

Moving from a complicated taxable income calculation to directly using the accounting income revealed by digital accounting packages (and assembled in accordance with GAAP) would not impose additional accounting obligations and would significantly reduce compliance costs for small businesses.

Inevitably, the prospect of allowing small businesses to use their accounting income to calculate their income tax liabilities leads to an analysis of the trade-off between the compliance cost savings and the loss of access to the small business concessions.

⁹⁹ According to the ABS the proportion of small businesses (0-19 employees) using paid cloud computing continues to grow, with 42% of all businesses reporting the use of cloud computing compared to 31% in 2015-16. Australian Bureau of Statistics (ABS), *Characteristics of Australian Business 8167.0*. 2 August 2019.

As set out in Section 5 above, more than 50 per cent of the total tax compliance costs for *all* taxpayers is attributable to income tax. To the extent that this ratio serves as a proxy for small business, then small businesses annual income tax compliance costs amount to nearly \$9.5Bn per annum (based on annual total compliance costs for all taxpayers of \$18.7Bn).

In contrast, the two main and most valuable small business tax concessions, the small business capital gains tax (CGT) concessions and the Instant Asset Write Off, produce annual tax expenditures of \$2.6Bn¹⁰⁰ and \$4Bn¹⁰¹ respectively (nearly \$3Bn shy of small business income tax compliance costs).

There are two points worthy of remark in relation to both of these small business concessions. First, in respect of the SB CGT concessions, the Board of Taxation recently recommended to Government that the concessions be reformed as they raise questions about “the sustainability of the system” and that “the overall cost to the revenue is substantial and growing, whilst the overall benefit is not widely distributed across the small business sector with a large proportion of the benefits being accessed by a relatively small number of businesses”.¹⁰² At the time of writing it remains to be seen whether the Government will reform these concessions to address the sustainability issues raised. Second, the IAWO does not provide a permanent tax benefit as the availability of the immediate deduction is clawed back as small businesses are denied subsequent depreciation deductions in out years. In other words it produces no larger deduction than what would be available during the life of the asset.

This comparison illustrates the compliance cost savings parameters at play and the opportunity for government to pursue reforms that cut through these costs. When Tran (1999) surveyed the possible alignment of taxable income with financial accounting income, 37% of respondents (the most supported category) thought such a proposal would reap compliance costs savings of between 75% and 100%.¹⁰³ Tran’s results were based upon a sample of listed Australian companies which are required to follow accounting standards and have their financial reports audited. They were not small businesses. However, if we think that these results also reflect costs for small businesses, the current compliance cost savings is potentially \$7.13Bn to \$9.5Bn for small business in today’s terms.

While further feasibility work is necessary, an initial proposal would be to allow small business to use their digital accounting software to calculate their Pay-As-You-Go Instalments (PAYGI)¹⁰⁴, noting that PAYGI is not a final tax but an instalment that is applied towards year-end income tax liabilities. This reduces the risk of any over or under-collections of income tax as PAYGI instalments are reconciled with the actual year-end tax liabilities.

Such an approach would also provide the benefit of addressing shortcomings identified with the current PAYGI system by, first, better aligning PAYGI instalment liabilities with small business cashflow and, second, reducing compliance costs by leveraging off existing internal business systems.¹⁰⁵ The

¹⁰⁰ The Australian Government, The Treasury 2019, Tax Benchmarks and Variations Statement, Canberra.

¹⁰¹ The Australian Government, Treasury Factsheet, *Economic Response to the Coronavirus, Delivering Support for Business Investment*

¹⁰² Board of Taxation, *Review of Small Business Tax Concessions 2019*, Australian Government, p. 52

¹⁰³ Ibid, Tran (1997), Table 6.8

¹⁰⁴ Part 2-10 of the ITAA 1997. Under PAYGI, instalment payments are collected from taxpayers in anticipation of their year-end income tax liability. The PAYGI instalments are determined, generally speaking, by using the taxpayer’s most recent income tax liability although there is the capacity for taxpayers to vary this amount.

¹⁰⁵ Prior to the current PAYGI arrangements, the Company Tax Instalment (COIN) system applied under which businesses were also required to pay income tax by instalments. However, COIN was criticised under the ANTS review as providing little flexibility for payments to reflect current trading conditions or income flows. The inflexible nature of COIN was also previously highlighted in the Bell Report. Against this backdrop, ANTS recommended that taxpayers with fluctuating incomes should be able to make payments that more closely aligned to their income receipts and trading conditions and that businesses should pay quarterly

Assistant Treasurer's 10 June 2020 announcement¹⁰⁶ that PAYGI indexation would be suspended for the 2020/21 income year is essentially an admission that the current PAYGI arrangements for small business do not serve as a good proxy for year-end tax liabilities.

Allowing the calculation of PAYGI instalments to be drawn from digital accounting packages could be modelled on New Zealand's Accounting Income Method (AIM). In New Zealand, small businesses (with annual turnover of less than \$5 million) can use their accounting software to calculate their company tax instalments throughout the year. In effect, AIM seeks to leverage natural business systems that record accounting data to also calculate company tax instalments. This ensures that the instalments are based on a more accurate and up-to-date perspective of the company's taxable income. AIM capable accounting software must be approved by the Commissioner of the Inland Revenue Department (IRD) be capable of generating comprehensive financial statements and, importantly, must be assembled in accordance with 'good accounting and tax practices'.¹⁰⁷

The full compliance cost benefit of New Zealand's AIM is not realised, however, as it requires more than 11 tax adjustments¹⁰⁸ to transfer accounting notions of income into taxable income which undermines the purpose of having it in the first place.

Rather than adopt the New Zealand approach requiring multiple tax adjustments, it would be desirable to base an Australian proposal on the raw accounting data so that the compliance cost savings can be realised. Such an approach would be consistent with a broader reform pathway towards allowing small business to use their accounting income to calculate their income tax liabilities.

12 Conclusion

The proposal to allow small business to use their accounting income as revealed by their digital accounting packages for income tax purposes provides a tremendous opportunity to address small business compliance costs and associated cashflow problems.¹⁰⁹ As the survey of the tax profession illustrated there is support for the proposal with nearly 53% of respondents agreeing with the

instalments (based on income actually received) after the end of a quarter. In response to the ANTS recommendations, the government ushered in PAYGW and PAYGI systems (ref and spell out], replacing 11 other collection systems including PAYE, PPS reportable payments, provisional tax and COIN. However, the shortcomings previously identified by ANTS continue to inhibit the PAYGI system. The January 2018 Inspector General of Taxation (IGoT) Report into the PAYGI system explained that 'the current system is not user-friendly for those with a one-off spike in income or who have fluctuating income and have to continue to move in and out of the system each year. This creates cash flow difficulties and can impact savings habits.' The IGoT Report noted that, while a taxpayer may vary their instalments, if the amount collected under varied instalment arrangements ends up being less than 85 per cent of the final income tax assessment then the general interest charge and penalties may apply. Furthermore, the IGoT Report noted that the variation facility within the PAYGI system creates high levels of confusion and most businesses chose not to vary their instalments because of the risk of penalties. Instead they may end up choosing to pay more than.

¹⁰⁶ Minister for Housing and Assistant Treasurer Press Release, '*Suspending indexation of tax instalments*', Canberra, 10 June 2020.

¹⁰⁷ See <https://www.classic.ird.govt.nz/resources/b/c/bc511634-421c-4336-9013-0a5cfe56372f/aim-paying-prov-tax.pdf>

¹⁰⁸ Broadly, the Commissioner for IRD issues technical determinations under section 91 AAX of the Tax Administration Act 1994 that detail for software developers the minimum tax adjustments required within the AIM capable software to calculate provisional tax payments and the information required to be provided with AIM payments. For the full list and explanation see: https://www.taxtechnical.ird.govt.nz/whats-new?publication_type={F6A09A7F-43D1-417E-8FB9-4D5620245704}

¹⁰⁹ Although beyond the scope of this study, the alignment the calculation of income tax payments with cashflow is also likely to assist small business tax problems that manifest downstream from the current PAYGI shortcomings including: undisputed small business tax debt — \$16Bn (65% of all undisputed debt 2017-18); and the small business tax gap— \$11.1Bn (2015-16)

statement that ‘small businesses should be able to use their accounting income as revealed by their accounting software to determine their income tax liabilities’. The survey also revealed the view that, of the Small Business Tax Concessions (SBTC), only the CGT concessions provided any material benefit to small business. A solution may be to develop a hybrid system whereby the CGT concessions are preserved. As discussed in Section 11 an initial pathway would be to allow small business to calculate their PAYGI calculations based on their digital accounting packages.

Finally, the Prime Minister in his address to the APS in 2019, challenged the APS to pursue ‘a culture of regulatory congestion busting’ and to ‘grasp the productivity opportunity of the digital economy’. Moreover, the Prime Minister expressed the view that ‘harnessing the power of digital technology is not an option for the Australian Government. It’s the future of it.’¹¹⁰

The reform proposal set out in this paper fits squarely into this agenda.

¹¹⁰ Prime Minister’s Speech, 19 Aug 2019, Parliament House, Canberra (see <https://www.pm.gov.au/media/speech-institute-public-administration>)

ANU SURVEY: ACCOUNTING VERSUS TAXABLE INCOME

From time to time there are calls for the alignment of taxable income with financial accounting income in order to address some of the complexity and compliance costs associated with the Australian tax system. Such calls, however, have previously been rejected.

The Australian National University (ANU) is conducting some research into whether, having regard to the advances in technology and digital take up rates, the cashflow benefits and compliance cost savings of applying accounting income to determine the tax liabilities for small business now outweigh previous arguments that rejected such proposals. Such a change, however, inevitably raises issues about the trade-off between compliance cost savings of using financial accounting income and the loss of small business tax concessions (SBTC) that apply under the tax laws.

To obtain feedback from the tax profession the following survey has been assembled. The survey should only take a few minutes to complete and does not contain any unique identifying properties (to ensure responses remain entirely confidential).

By participating in the survey you will be helping to inform the analysis and contribute to the debate on whether taxable income should be aligned with a small business' financial accounting income.

Access to the survey can be made through the following link: [link inserted]

The questions posed to respondents were assembled into 3 Parts. Part A was intended to gauge initial perspectives about the alignment of taxable income with financial accounting income by posing the following question:

- 1 Small businesses should be able to use their financial accounting income as revealed by their accounting software to determine their income tax liabilities

Respondents could select an answer from a rating scale based on the following options: strongly disagree, disagree, neutral, agree, and strongly agree.

Part B was intended to elicit perspectives about the Small Business Tax Concessions (SBTC) by posing the following questions:

- 9 For small businesses, the compliance cost benefits of determining income tax liabilities based on financial accounting income outweigh the benefits of the SBTC
- 10 SBTCs are a waste of time and would be better off with lower taxes and a simpler system
- 11 I ensure my small business clients understand the benefits of the SBTCs
- 12 SBTCs are so complex that it is hardly worth the effort
- 13 SBTCs have saved my clients tax dollars

Once again respondents could select an answer from a rating scale based on the following options: strongly disagree, disagree, neutral, agree, and strongly agree.

Part C was intended to understand the demographic of respondents by posing the following questions:

- 14 The following best describes the size of tax firm I work within: (Responses drawn from: Big Four, Second Tier, Small (e.g suburban or regional), industry, government, not-for-profit)

- 15 The firm I work within focusses mainly on taxation issues: (Responses drawn from: Yes, Even distribution across other core activities, No)