THE TAX OFFSET FOR ENTREPRENEURS: A CRITICAL REVIEW OF THE 25 PER CENT TAX OFFSET FOR SMALL BUSINESS

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From 1 July 2005, small business taxpayers using the Simplified Tax System and with a turnover of $50,000 or less are allowed a tax offset of 25 per cent on their tax payable. If turnover exceeds $50,000, the tax offset phases out at 1 per cent until the turnover reaches $75,000. This tax concession was part of the government’s election statement made on 26 September 2004 in which the government stated that it wanted to assist and encourage small business entrepreneurs, particularly those set up from home. The steps involved in calculating the amount of tax offset that can be claimed are complicated where the business is structured as a trust or partnership and also where the taxpayer earns other income not just from the business. The offset also requires the small business taxpayer to be in a position to actually pay income tax before the tax offset provides any advantage, so that non-taxpaying small businesses receive no assistance. This paper critically reviews the 25 per cent tax offset and suggests alternative ways in which entrepreneurs could have been assisted by the tax system, for example, a reduced rate of income tax.

I INTRODUCTION

The Australian government recognises that an important driver of a strong economy is growth in small to medium enterprises (‘SMEs’). In the 2004 federal election policy statement promoting an Enterprise Culture, the government announced a number of measures designed to foster the entrepreneurial spirit of small businesses. The government stated that it would provide further incentive and encouragement to small businesses — particularly those that set up and operate from home — through the introduction of a tax offset for entrepreneurs. The proposed new tax benefit is targeted at very small, micro and home-based businesses that are in the Simplified Tax System (‘STS’). This approach is in line with the view of the OECD that ‘innovative start-ups or small firms have played an important role in spurring productivity growth in OECD countries in the 1990s’.

From 1 July 2005, small business taxpayers using the STS and with a turnover of $50,000 or less are allowed a tax offset of 25 per cent on their tax payable. If the turnover exceeds $50,000, the tax offset phases out at 1 per cent or every $1,000 until the turnover reaches $75,000. This means that when taxpayers prepare their tax returns after 30 June 2006, for the financial year 2005-2006, they will claim the 25 per cent tax offset as a reduction in the amount of tax payable. The Australian financial year runs from 1 July to 30 June, unless the Australian Taxation Office, ATO, allows a business to adopt a substituted accounting period.

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The offset is ‘targeted at very small, micro and home based businesses that are in the simplified tax system’. The Federal Treasurer said of the offset:

The 25 per cent entrepreneurs’ tax offset contained in the recently passed Tax Laws Amendment Measures No 7 Act 2004 (Cth) is expected to deliver a benefit to 540,000 Australian small businesses. The offset is available to businesses with a turnover of $50,000 or less while businesses with a turnover up to $75,000 will also benefit. The maximum possible benefit depends on the amount of tax that would otherwise be paid. By way of example, the Treasurer pointed out that if a company has a turnover of $50,000 the maximum tax it would pay is $15,000 (i.e. 30 per cent of $50,000) with the 25 per cent offset reducing this tax liability by $3,750 to $11,250. Moreover, if the business is not a company, such as a sole trader, then the maximum tax it would pay on $50,000 turnover would be $11,172 (i.e. after the application of the tax free threshold and lower marginal tax rates) which the 25 per cent offset would reduce by $2,793 to $8,379.

II Detailed Operation of the Concession

The entrepreneur’s tax offset is in Subdivision 61-J of the Income Tax Assessment Act 1997 (‘ITAA97’). In order to derive the maximum benefit of the 25 per cent tax offset, the business must be in the STS in Division 328 of the ITAA97 and must have an annual net STS turnover of less than $50,000. In that situation, the full 25 per cent tax offset applies. However, the tax offset shades out by 1 per cent for every $1,000 of net STS turnover in excess of $50,000, so that by the time the business reaches more than $75,000 in net turnover, the tax offset is no longer applicable.

It should be acknowledged at the start that any measure to reduce the income tax burden on business, and in particular small business in Australia, is a step in the right direction, given the comparative rates of tax that apply in the Asia-Pacific region. However, using the tax system to attempt to encourage growth in small business may not be the ideal approach, and the purpose of this paper is to critically analyse the new 25 per cent tax offset for entrepreneurs as well as propose areas that need further research and further options that may be considered to promote the financial health of small businesses in Australia. Burton, in his paper on ‘the Australian small business tax concessions’ argues that one of the reasons why STS arrangements have not been a success is because the government failed to conduct sufficient research on the needs of small business. Once again, the government acknowledged that there had been insufficient time to consult widely on the 25 per cent tax offset prior to its introduction. The government chose to provide a ‘tax offset’ rather than a tax incentive based on generating additional tax deductions such as depreciation allowances, and this means that in order to take advantage of the tax benefit, the business must be in a position where it pays income tax, otherwise the benefit is of no value. Small businesses, in their early years usually have expenses that substantially reduce the overall profitability of the business and thus the amount of tax payable. The tax offset may not be that important in the early life of a small home-based business for this reason. A tax offset reduces the amount of income tax that is payable by the taxpayer. The amount of tax payable is determined by the amount of taxable income derived by the taxpayer, multiplied by the applicable tax rate.

2 Commonwealth, Parliamentary Debates, House of Representatives, 8 December 2004, 3 (Mal Brough, Minister for Revenue and Assistant Treasurer); Commonwealth, Parliamentary Debates, Senate, 7 March 2005, 90 (Robert Hill, Minister for Defence).


4 For example, in Singapore the company tax rate is 20 per cent and in Hong Kong it is 16 per cent. Singapore also provides a partial exemption and zero tax rate for start-ups in the first three years of incorporation.


The amount of taxable income is determined by the amount of assessable income derived by the taxpayer less any allowable deductions. The following formula illustrates the way in which the tax payable is calculated:

<table>
<thead>
<tr>
<th>Gross Income</th>
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<tbody>
<tr>
<td>Less: Exempt income (s 6-20 and Div 11)</td>
</tr>
<tr>
<td>= Assessable Income (s 6-5 and s 6-10)</td>
</tr>
<tr>
<td>Less: Allowable Deductions (s 8-1 and Div 25)</td>
</tr>
<tr>
<td>= Taxable Income x Tax rate + Medicare levy (1.5 per cent) + (surcharge 1 per cent if applicable)</td>
</tr>
<tr>
<td>= Tax payable - Less: tax offsets + rebates =</td>
</tr>
</tbody>
</table>

Tax refund or payment to ATO [all sections are contained in the ITAA97]

An obvious weakness in the 25 per cent tax offset to encourage entrepreneurs is that the threshold for the benefit is only $50,000 and phases out at $75,000. This means that only very small businesses are given assistance. If this is compared with other countries such as Canada where the low corporate tax rate threshold has been lifted from $225,000 to $300,000, it makes the Australian experiment look very limited in its application.7 In British Columbia, the combined federal and provincial corporate tax rate for small businesses is as at 1 January 2006 only 17.6 per cent whereas for large businesses the corporate tax rate is 34.1 per cent.8

The extra compliance costs involved in a taxpayer claiming the 25 per cent tax offset may well outweigh any financial advantage to be gained, especially where the taxpayer has other income that must be separated from the business income. For example, the tax saving may be less than the actual accounting costs involved in claiming the tax offset due to the additional work in separating items of assessable income into ‘business income’ and ‘other income’. This weakness in the Australian experiment will be discussed in detail below.9

III SIMPLIFIED TAX SYSTEM - STS

A prerequisite for an entrepreneur to be eligible for the tax offset is that the business must qualify as an STS taxpayer. It is important to understand what is involved in being an STS taxpayer and the benefits associated with being in the particular tax system. The Australian government introduced the Goods and Services Tax (‘GST’) on 1 July 2000 as well as further tax reforms relating to the payment of income tax by business either quarterly or monthly depending

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9 Michael Dirkis and Brett Bondfield, ‘The RBT ANTS Bite: Small Business the First Casualty’, (2004) 19 Australian Tax Forum 107, contend that instead of simplifying the tax legislation, the government has introduced tax concessions as a means of compensating small business for the increase in compliance costs. However, the 25 per cent tax offset simply adds to the compliance costs and adds further layers of complexity to the legislation. Dirkis and Bondfield conclude that the STS and the tax concessions have not provided sufficient compensation for the additional compliance costs to small business.
on the turnover of the business. After the first year with GST and the new payment arrangements, small business was faced with extensive compliance costs and the government introduced a range of tax benefits to compensate business in the form of the STS.\textsuperscript{10}

For income years starting after 30 June 2001, taxpayers whose income and assets do not exceed specified limits can use the simplified tax system in Division 328 of the \textit{ITAA97}. A taxpayer enters the STS by electing to be ‘an STS taxpayer’. In order to be eligible to be an STS taxpayer, the business must satisfy the following two-eligibility criteria:

1. The entity must carry on a business during the year; and
2. The STS average turnover of the business and related businesses for the year must be less than $2 million net of GST credits.\textsuperscript{11}

The way in which assessable income is calculated is varied for an STS taxpayer, and the following arrangements apply:

1. When the STS was first introduced, the business could only account for its income and deductions on a cash basis. However, the mandatory use of cash accounting ceased from 1 July 2005 and now STS taxpayers have a choice of using cash or accruals accounting to calculate their assessable income.

2. The capital allowance rules are varied to provide:
   
   (a) An immediate deduction for assets costing less than $1,000;
   
   (b) Pooling for other depreciating assets into 2 pools, with accelerated depreciation rates applying to each of the 2 pool balances; and
   
   (c) Simplified accounting for the private use of depreciating assets: Subdivision 328-D.

3. The taxpayer is permitted to ignore the difference between the opening and closing value of trading stock up to $5,000: Subdivision 328-D.

4. Prepayments are deductible when paid if they relate to ‘things’ that will be completed within 12 months.

Once a taxpayer qualifies as an STS business, they become eligible to claim the 25 per cent tax offset when they complete their tax return. Given that a business must have a turnover of less than $2 million to enter the STS system, it may have been of more benefit for the entrepreneur to have been allowed a lower tax rate with a turnover limit of $2 million rather than the $50,000 for the tax offset.\textsuperscript{12}

\textsuperscript{10} For details on why the government introduced the STS regime see ch 17 of Commonwealth Government, \textit{A Tax System Redesigned} (1999). The Explanatory Memorandum to the \textit{New Business Tax System (Simplified Tax System) Bill 2000} reinforces the point that potentially 850,000 businesses, being 95 per cent of all eligible businesses, would be able to adopt the STS because their turnover was less than $1 million. The government relied upon the report into compliance costs by C Evans, K Ritchie, B Tran-Nam and M Walpole, \textit{A Report into Taxpayer Costs of Compliance} (1997).

\textsuperscript{11} In the May 2006 Federal Budget, the government announced that as from 1 July 2006 the additional requirement for a business to have less than $3 million of depreciating assets before they can enter the STS has been removed. The Budget also increased the turnover requirement from $1 million to $2 million: www.budget.gov.au.

\textsuperscript{12} The then-leader of the Opposition, the Honourable Kim Beazley in his address to the Confederation of Small Business of Australia at the National Small Business Summit in Sydney on 17 May 2005, was critical of the 25 per cent entrepreneurs offset on the basis that the business must satisfy the STS requirement of having a turnover of less than $1 million, (as was the case at that time), but now $2 million, when some small businesses have a greater turnover but less than $50,000 of taxable income. He cited two examples of businesses with very high turnovers but low profit margins, Enjo and Nutrimetics that would not be eligible for the 25 per cent tax offset.
they are using the simplified system so this would assist in deterring tax avoidance with a lower
tax rate. The ATO has a record of all STS taxpayers so that the auditing process could be
conducted effectively, if required.

One issue peculiar to Australia is that small businesses are structured in one or more of the
following ways:

1. Sole trader;
2. Partnership;
3. Company; or
4. Trading trust with either the trustee paying tax or the beneficiaries.

A lower company tax rate would benefit businesses structured as companies but it would not
help businesses structured as trading trusts where most of the income is taxed at individual rates.
In Australia, the individual rates of tax are considerably higher than the company tax rate. The
following resident individual rates apply for the financial year 2006-2007 under Schedule 7 of
the Income Tax Rates Act 1986 (Cth):

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>Tax payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 – $6,000</td>
<td>Nil</td>
</tr>
<tr>
<td>$6,001 – $25,000</td>
<td>15 per cent for each $1 over $6,000</td>
</tr>
<tr>
<td>$25,001 - $75,000</td>
<td>$2,850 plus 30 per cent for each $1 over $25,000</td>
</tr>
<tr>
<td>$75,001 – $150,000</td>
<td>$17,850 plus 40 per cent for each $1 over $75,000</td>
</tr>
<tr>
<td>Over $150,001</td>
<td>$47,850 plus 45 per cent for each $1 over $150,000</td>
</tr>
</tbody>
</table>

Individual resident taxpayers also pay a further 1.5 per cent of their taxable income towards
medical expenses incurred by the government, known as the ‘Medicare levy’.13

IV HOW THE 25 PER CENT TAX OFFSET WORKS

The government recognised that when small businesses are being established proprietors may
need to supplement their income by working as a salary or wage earner and this income has to be
taken into account when calculating the 25 per cent tax offset if there is business income. There
may even be situations where a taxpayer is engaged in more than one business and each business
is eligible to claim the 25 per cent tax offset. It is for these reasons that the 25 per cent tax offset
rule in Division 61 of the ITAA97 is perhaps more complex than would have been expected and
may result in substantial compliance costs being incurred by the taxpayer. The different scenarios
are not discussed in this article other than the basic example.14 The different scenarios covering
situations where the taxpayer is structured as a trading trust or with non-business income are
described in full in the Explanatory Memorandum.

The law relating to the 25 per cent tax offset is contained in Subdivision 61-J of the ITAA97.
The offset is available to the following range of taxpayers:

- The STS taxpayer in the case of an individual or company operating as an STS taxpayer;

13 A further 1 per cent Medicare Levy surcharge is paid by the individual taxpayer if they do not have private
hospital insurance and there taxable income exceeds $50,000 for a single person and $100,000 for a family with
one child. The threshold increases with each additional child.

• The partners of a partnership that is an STS taxpayer; or
• The trustee or beneficiaries of a trust that is an STS taxpayer, depending on who is liable for tax on the trust income.

The Explanatory Memorandum provides the following information on the implications of claiming the offset. Small businesses in the STS will need to calculate their turnover and their net income from business. Taxpayers with other non-business income will need to isolate their business income from their total income. This measure will increase administrative costs for the ATO as well as taxpayers. The ATO will have to change the tax return forms and systems changes will also be required to capture the required data and undertake the calculation of the tax offset. It will also require extending the STS.

A taxpayer may be eligible for more than one tax offset. For example, if a taxpayer is a sole trader who has elected into the STS and that taxpayer is also a partner in a partnership that has also elected into the STS, the taxpayer may be entitled to a tax offset in respect of their income as a sole trader and also in respect of their share of the STS income from the partnership, s 61-500 of the *ITAA97*. However, if the sole trader and the partnership are grouped entities, the amount of STS group turnover is relevant to determining eligibility for an offset.

V Net STS Income and STS Annual Turnover

Regardless of whether the tax offset is available to the STS taxpayer, a partner, a trustee or a beneficiary, there must be an amount of net STS income before an entitlement to an offset arises. That is, the entity claiming the offset must have net STS income for the year. The entity eligible for the offset must have a share of that net income included in its assessable income in order to be eligible for an offset.

An entity’s net STS income for an income year is the amount by which:

\[
\text{the entity’s STS annual turnover for the year} - \text{the sum of the entity’s deductions attributable to the turnover},
\]

Where STS annual turnover for a year is the total of the value of the business supplies the entity made in the year, ss 61-525(1) and (2) of the *ITAA97*. The deductions attributable to the STS turnover are the allowable deductions that the entity can claim against its assessable income which specifically relate to that turnover.

The Explanatory Memorandum specifically introduces these terms of ‘net STS income’ and ‘STS annual turnover’ for the first time into the income tax law. The definition section, s 995-1(1) *ITAA97* is amended to include a definition of those two terms. The way in which the ‘net STS income’ is determined is in practice no different from the way a taxpayer calculates their ‘taxable income’, namely assessable income less allowable deductions.

The question must be asked, why overly complicate the new law relating to the tax offset with new definitions? What was wrong with calculating the taxable income of the STS business but excluding expenses that are not directly associated with the business, such as share trading...
activities or a negatively geared investment property? The following example is used in the Explanatory Memorandum to illustrate this point.\(^\text{15}\)

**A Example**

Fred is an STS taxpayer who sells home-made greeting cards via the Internet. Fred’s STS annual turnover is $35,000 for the year. Fred runs his business from a home office. Fred claims deductions for his business expenses such as the cost of the materials used in making the greeting cards, stationery, postage and the electricity expenses relating to the home office. These business expenses total $5,000. Fred also has salary and wage income of $75,000 for the year. He is a member of a trade union and he subscribes to a professional journal. His work-related expenses total $1,200. Fred also has a negatively geared share portfolio from which he receives $5,000 worth of dividends and has $6,000 of interest expenses related to borrowings to acquire the shares. Fred therefore makes a loss for taxation purposes of $1,000 from his share investments.

Fred’s net STS income for the year is the amount by which his STS annual turnover of $35,000 exceeds his deductions attributable to that turnover of $5,000. Therefore, his net STS income is $30,000. Fred’s work-related expenses and the expenses relating to his share of investments do not affect his STS annual turnover. The income from Fred’s share investments is not included in his STS annual turnover, as the dividends do not constitute taxable supplies.

The definition of ‘STS annual turnover’ is consistent with the broader definition of STS group turnover in s 328-375 of the ITAA97. The turnover of a business reflects the ordinary activities of carrying on that business, such as the sale of goods and the provision of services, and also includes interest received on amounts deposited in business banking accounts. The turnover does not include items such as dividends, rental income where the rental activities do not form an ordinary part of the business or amounts resulting from realisation of an investment. This distinction will cause small business operators to have to change their accounting system and incur additional accounting costs in having their tax return prepared.

**VI Example of a claim for the tax offset for an individual or a company**

A taxpayer is entitled to a tax offset for an income year under s 61-505(1) of the ITAA97 if the following conditions are satisfied:

- the taxpayer is an individual, operating as a sole trader or a company;
- it has elected to be an STS taxpayer for the year;
- it has STS group turnover of less than $75,000 for the year; and
- it has net STS income for the year.

**A Calculation of the Offset**

If the STS group turnover is $50,000 or less, the taxpayer is entitled to a tax offset of 25 per cent of their income tax liability that is attributable to STS income. If the STS group turnover is more than $50,000, the tax offset is phased out until it equals zero at turnover of $75,000. The offset is calculated using the following method in s 61-505(2) of the ITAA97:

\(^{15}\) Ibid 16.
Step 1: Calculate taxable income for the year.

Step 2: Calculate 25 per cent of the basic income tax liability for the year on the taxable income; that is, using the applicable tax rates and taking into account any special provisions that affect the calculation of the liability. Note: the basic income tax liability does not take into account any tax offsets.

Step 3: Calculate the STS percentage, which cannot exceed 100 per cent, as:

\[
\text{The taxpayer's net STS income for the year} \times \frac{100}{\text{The taxpayer's taxable income for the year}}
\]

Step 4: If the STS group turnover is $50,000 or less, multiply the step 2 amount by the STS percentage to determine the amount of the tax offset.

B Example: Sole trader with other non-business income

Jenny runs a physiotherapy practice from her home and she is an STS taxpayer for the income year commencing 1 July 2006. The net income from her practice is $20,000 (i.e. $30,000 turnover less $10,000 business expenses). In addition, she has a part-time job as a shop assistant from which she receives salary and wages of $25,000.

Step 1: Jenny’s taxable income for the year is $45,000.

Step 2: Basic income tax liability is $8,850.

\[
25 \text{ per cent of her basic income tax liability is: } 25 \text{ per cent} \times 8,850 = 2,212.50
\]

Step 3: The STS percentage is:

\[
\frac{20,000 \times 100}{45,000} = 44.44 \text{ per cent}
\]

Step 4: Jenny’s STS group turnover is $30,000; therefore, the tax offset is:

\[
2,212.50 \times 44.44 \text{ per cent} = 983.24
\]

Step 5: Not applicable.

Therefore, Jenny’s entrepreneurs’ tax offset is $983.24.

VII The Recommended Option Chosen by the Australian Government

The government had three options to consider when introducing the tax offset. Given that the individual tax rates are not the same as the corporate tax rate and with individuals being eligible for the first $6,000 being tax-free and the income tax rates being progressive from there up to 45 per cent, there is an advantage if you operate as an individual and the top slice of income is subject to the offset, but at a disadvantage if the bottom slice of income is taken into account in determining the tax offset. The other option was to take the top slice of income and make that eligible for the tax offset, but that would advantage individuals over companies. In the end the

\[16\] Ibid 26.
government opted to take the average tax rate as the preferred approach. The government was of the opinion that this approach would deliver the required policy objective with reduced compliance costs to taxpayers and the ATO.

**VIII Revenue Cost to the Government**

The financial cost to the revenue as a result of the introduction of a 25 per cent entrepreneurs’ tax offset is expected to be as follows, based on average rates of tax: 17

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td></td>
<td>Nil</td>
<td>Nil</td>
<td>-$400 m</td>
<td>-$390 m</td>
</tr>
</tbody>
</table>

**IX Issues for Concern — Will the 25 per cent Tax Offset Encourage Entrepreneurs in Australia?**

The following areas of tax law are of concern in reconciling the value of the 25 per cent tax offset with the additional compliance costs facing small business. First, is the home-based business a hobby and therefore not eligible for the tax offset? Second, why do we have the non-commercial loss provisions in Division 35 of the *ITAA97* if the government believes that home-based businesses are making a profit and will pay tax in order to claim the tax offset, and how will small business become more profitable as a result of the tax offset? The new law appears to be an overly complicated implementation of a good idea aimed at reducing costs for a small business. The complications arise from the requirement to use specific calculations and formulas where a business is being conducted, for example, by a husband and wife partnership, where business and non-business income is being mixed. A simple idea of having the tax offset now appears to be part of a very complex tax system that appears to be in conflict with other parts of the *ITAA97*, in particular the non-commercial loss provisions.

**A Hobby versus Business**

Many small home-based businesses are run as a hobby and not strictly as a business. In many instances the tests laid down in the case of *Ferguson v Federal Commissioner of Taxation*, 18 that are used to determine whether or not a business is being conducted would not be satisfied by the home-based business, especially if the turnover is likely to be less than $50,000. There may be many small home-based businesses that may miss out on the 25 per cent tax offset for this reason. This is an issue that will need further clarification from the government in the future.

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17 Given that as at 17 April 2003 only 14 per cent of eligible taxpayers had adopted the STS arrangement it is highly unlikely that the above figures are a true indication of the cost to revenue of the 25 per cent tax offset. See Australian Tax Practice, ‘Simplified Tax System (STS): 14 per cent Take-up Rate So Far’, *ATP Latest Tax News*, Issue 163, 25 August 2003.

18 (1979) 9 ATR 873.
B Structure of the Business

When deciding to establish a business, most people ask for advice on what is the best structure to use. Any advice on the ideal choice of business structure focuses on a number of concerns such as the following:

1. The need for capital now and in the future and the best way to obtain this either through loan capital or share capital;
2. Asset protection in case the business fails or there are problems within the family that require assets to be out of reach of family members;
3. Tax minimisation using the current law such as income splitting through the use of a discretionary trading trust; and
4. Ease of disposal of the business in the future and being able to utilise the small business capital gains tax concessions in Division 152 of the ITAA97 on the sale of the business.

These are just a few of the issues that are taken into account in choosing a structure in which to operate a business. The age of the entrepreneurs, their marital status, numbers of dependants, their risk profile, health are all factors that must be taken into consideration. People that have retired before the age of 65 years, and are still active and wish to supplement their retirement income are now generating much of the growth in small home-based business. These businesses are being established in the services sector, such as home help with cleaning, gardening, and home maintenance. The 25 per cent tax offset, which was introduced without wide public consultation, appears to have missed the issue of how a small business is structured.

C Actual Tax Saving

If a husband and wife decide to retire from their salaried positions and establish a small home-based business, the following scenario illustrates the actual tax benefit of the 25 per cent tax offset for a carefully structured small business. Assume that the husband and wife establish a company because they want to trade as a separate legal entity for asset protection purposes and continuity of business benefits, as the company will not die. They have also been advised that they can be employed by the company and the company can make provision for superannuation contributions (their retirement fund).

An assumption is made that in the first year the company makes $60,000 gross STS income. They deduct business expenses of $10,000 and total salaries for each of them of $19,000, being total expenses of $48,000. The remaining profit of $12,000 is paid to their superannuation fund which pays tax at the rate of 15 per cent on the contributions. The end result is that the company makes no taxable income for the year and no claim is made for the 25 per cent tax offset. If the business had paid income tax on the $50,000 at the company rate of tax they would have paid – 50,000 x 30 per cent = 15,000 x 25 per cent tax offset, their total tax payable would have been $11,250 with the tax offset saving the company $3,750.

If the husband and wife team proceed on the basis outlined above, their total tax payable is as follows, ignoring low-income rebate and other rebates and ignoring the fact that their superannuation contribution could have been increased.

\[
\text{Individual income tax on } \$19,000 = \$1,950 \times 2 \text{ for the husband and wife } = \$3,900. \\
\text{Tax on the superannuation contribution is } \$12,000 \times 15 \text{ per cent } = \$1,800. \\
\text{Total tax paid } = \$5,700. \\
\text{This provides a tax saving of } \$5,550 \text{ without using the 25 per cent tax offset.}
\]
The fact is that small home based businesses try to avoid paying any income tax in the business entity (here, a company) if there are options to distribute the income in the form of a salary to an individual who can take advantage of the tax-free threshold of $6,000. In the case of small businesses being operated by semi-retired people, the focus is on generating superannuation contributions that attract a 15 per cent tax rate.

The conclusion that follows from the above scenario is: Why not consider a tax-free threshold for small business, such as the first $6,000 of taxable income being tax-free or even no income tax in the first three years?

D Compliance Costs

The calculation for claiming the 25 per cent tax offset is quite complex where the taxpayer has other income as well as business income. If the taxpayer is relying on their tax agent to prepare the tax return on the basis of claiming the 25 per cent tax offset, then additional fees will be incurred. The tax offset, given the small turnover allowed, namely $50,000, means that the tax saving may be less than the additional costs involved in having the financial accounts and annual tax return prepared so that the offset can be claimed.

X Issues with the Effectiveness of the Offset and Alternative Forms of Assistance

Successive Australian governments have used the tax system to influence the financial behaviour of individuals and businesses. The STS is a perfect example of the tax system being used to assist small business by attempting to reduce the tax compliance costs of doing business but also increasing tax deductions through generous depreciation allowances. The introduction of a Pooled Development Fund (‘PDF’) regime and the very generous tax concessions for research and development partnerships were designed to attract investment into risky businesses and the research and development industry. The PDF regime provides tax benefits through providing a tax rate of 15 per cent for PDFs on their business income and a 25 per cent rate on investment income. There is no income tax on PDF dividends in the hands of shareholders or capital gains tax on the sale of the shares.19

The new entrepreneur’s tax offset appears to be overly complicated because of the need to allow for owners of these small home-based businesses to earn other income from salaries or wages. The compliance requirements would appear to add substantially to the costs of these small businesses. The government acknowledges that the compliance costs will add to the costs of the ATO in monitoring the new tax offset.

Would it be very difficult to provide small business with a similar tax concession of a 15 per cent tax rate on income up to say $50,000 or $300,000 as is the case in Canada?20 At least there would be an incentive to pay income tax and any dividends received by shareholders, if a company structure was used, could be tax-free for the shareholders in exactly the same way as a PDF is treated for taxation purposes. Alternatively, or in addition, it may be appropriate to consider a system of direct grants to be available for small business similar to the grants being offered for commercialisation of new products and services.21

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19 Section 124ZY of the Income Tax Assessment Act 1936. In the May 2006 Federal Budget, the government announced that measures would be introduced to replace the existing PDF arrangements, www.budget.gov.au
20 Fletcher, above n 7.
21 Austrade and AusIndustry grants and loans for business development.
assistance do require administrative support and cost the government money. However, based on the cost to revenue of the entrepreneur’s tax offset as calculated by Treasury, the government could spend $400 million in 2006-07 and $390 million in 2007-08 and still be revenue neutral.\textsuperscript{22}

In summary, the following tax and financial options could be considered in light of the above discussion, as alternative ways to assist small home-based business in Australia:

1. A 15 per cent tax rate similar to the arrangements for a PDF.
2. Forms of direct grants to assist in establishing the business such as costs of incorporation etc. — say $2,000 to $10,000 as a direct grant or a loan at concessional rates of interest.
3. Introducing a tax-free threshold for small businesses similar to the individual tax-free threshold of $6,000.
4. Increasing the turnover threshold from $50,000 to say $1 million, in line with the STS eligibility, so that the tax saving more than covers the additional compliance costs for the taxpayer and the ATO can monitor taxpayers in the STS.
5. Providing start-up small businesses with a tax-free holiday for a period of three years similar to Singapore.

XI CURRENT RESEARCH ON THE EFFECT OF TAXATION AND ENTREPRENEURSHIP

Apart from research by the OECD on entrepreneurship and taxation involving Australia as a member of the OECD, very little research has been conducted in the last few years in Australia by other researchers. A recent article has examined the response of surveyed entrepreneurs to the Australian income tax.\textsuperscript{23} The survey asked the following questions and the respondents were required to provide answers on the basis that they either agreed strongly, strongly disagreed or did not know. The same survey was used in ten other countries including the USA, Singapore, UK and a number of European countries. The statements put to respondents were as follows:

- The level of income taxes discourages people from starting new firms;
- The level of income taxes effectively stops people from growing firms;
- The level of income taxes deters people from seeking to become rich; and
- Income taxes reduce peoples’ interest in attempting to accumulate wealth.

The authors found that the response of the participants to income taxes indicated that they did not believe that income taxes in Australia encouraged entrepreneurial activity. It is of interest to note that in the survey Australia finished third highest out of the ten countries with only the USA and Singapore rating higher as regards the attitude towards income taxes. This may be largely due to the fact that in the USA and Singapore, the rate of income tax is considerably lower than Australia, but the rate in Australia is considerably lower than that in European countries such as Sweden, Denmark, Finland and Norway.\textsuperscript{24} The authors reached the following conclusion based on their research:

\begin{itemize}
  \item Revenue costs as shown in the Explanatory Memorandum, Tax Laws Amendment Measures No 7 Bill 2004, 33.
  \item See the survey by the Australian Chamber of Commerce and Industry, ‘2004 Pre-Election Survey Small Business Priorities: Taxation, Economic Management & Workplace Relations’, <http://www.acci.asn.au/text_files/issues_papers/Pre_Elect_Survey/Small per cent20Business per cent20Priorities per cent20September per cent202004_.pdf> at 28 September 2006. The ACCI found that 83 per cent of
\end{itemize}
The statements about income taxes are phased negatively, so that high scores would indicate a culture less conducive to entrepreneurs in respect of income taxes…. It would appear that the Australian income tax regime does not too strongly deter people from seeking to become rich, but does deter them from starting new firms. There is a possible contradiction here, in that starting a business is an important way for Australians to become rich. Overall, income taxes in Australia do not seem to be as encouraging of entrepreneurial activity as they could be.25

Based on this research it would appear that the introduction of the 25 per cent tax offset by the Australian government is an important step in encouraging entrepreneurial activity in Australia. The only area of concern is whether it is the right type of development and whether it is enough. Only time will tell.

XII FURTHER ISSUES FOR RESEARCH

In the Explanatory Memorandum to the entrepreneur’s tax offset, under the heading ‘Other Issues — Consultation’, it is stated that:

The Department of the Prime Minister and Cabinet and the ATO have been consulted on this issue. In view of the requirement to introduce legislation on 9 December 2004, there is not sufficient time to consult more widely.26

This is perhaps the most obvious criticism of the new initiative: small business was not consulted and the government is taking it for granted that this measure will ‘provide an incentive to kick-start small business and provide encouragement for small business growth’.27 There are a number of associations in Australia that exist to help small business, as well as accountants, banks, and state government agencies. All of these bodies should now be consulted and after a period of, say, two years; the new tax offset should be assessed for its effectiveness in promoting and developing small business in Australia. There is, perhaps, a feeling that the 25 per cent tax offset was introduced as an election sweetener for small business and the tax benefit was not thought through sufficiently. There are enough reasons discussed above, to suggest that the 25 per cent tax offset may not be as warmly received by small business proprietors, as the government would like.

Both the government and small business associations when reviewing the effectiveness of the 25 per cent tax offset should consider the following list of issues:

1 What is the preferred choice of structure for a small business — company, trust or sole trader or partnership?
2 What is the demographic of the proprietors of the small businesses in Australia — retired or semi-retired or young entrepreneurs?
3 What is the impact of this tax offset on the desire of business owners to pay income tax rather than look for legal means to minimise tax such as the use of discretionary trusts?
4 The government specifically targeted small businesses operating from ‘home’. Why is this important and is it consistent with other government policies?
5 What impact will the tax offset have on the generation of imputation credits for shareholders in small companies that want to receive fully franked dividends or even a superannuation fund as the shareholder?

respondents to their survey considered that personal tax was too high and 69 per cent considered that company tax was too high.

25 M Jackson, above n 23, 96.
26 Explanatory Memorandum, above n 6, 18.
27 Ibid, 18.
XIII Conclusion

As was stated in the introduction to this article, any government measure to reduce the income tax burden on small business is to be applauded. It is also important to acknowledge the fact that the government recognises the need for Australia to encourage entrepreneurs to start and grow new businesses. This initiative should be seen as the start of future government initiatives in support of small business. It will be interesting to see what use is made of the offset by small businesses in Australia and the actual cost to the revenue. Given the history of the negative attitude of Australian small business taxpayers to the STS as evidenced by the very low up-take of that regime, it is hardly likely that the 25 per cent tax offset will be widely accepted by eligible taxpayers. Treasury has estimated the cost to be $400 million in 2006-07 and $390 million in 2007-08. If this is not the actual cost and the figure is less, will the government then consider some other options for developing an entrepreneurial culture in Australia, say based on the discussion above?

28 Australian Tax Practice, above n 17. The report goes on to state that the government anticipates that in a mature system around 60 per cent of eligible businesses would take up the STS. It is highly doubtful that a figure of 60 per cent has been achieved to date. It has been impossible to obtain any current published figures on the take-up rate now from the ATO or the Treasury websites.