

Draft Report on Taxation and Small and Medium-size Enterprises, and Possible Future Work on Tax Implications of Globalization

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Discussion points

- Draft OECD report on the taxation of small and medium-size enterprises (SMEs) to be published in March 2009 – jointly carried out by:
 - Working Party on Tax Policy Analysis and Tax Statistics (WP2) of the OECD Committee on Fiscal Affairs, and
 - Working Party on SMEs and Entrepreneurship of the OECD Committee on Industry, Innovation and Entrepreneurship.
- Possible future work examining the implications of globalization to the taxation of SMEs.
- Questions and comments during MENA/OECD country roundtable (*tour de table*).

Structure of the Draft Report

- Executive summary

- I. Introduction

- II. Characteristics of SMEs

- III. Income taxation of SMEs

- IV. Tax distortions to SME creation and growth

- V. Tax incentives for SMEs

- VI. SME tax compliance and simplification provisions

Characteristics of SMEs

- Data show most firms are SMEs – heightens interest in ensuring tax system does not impose impediments.
- Varying degrees of innovation. As some SMEs are innovative (high potential return/high risk), interest in ensuring that the tax system is not discouraging to risk-taking – raises interest in tax treatment of business losses relative to profits (data show prevalence of firms in loss position; asymmetric treatment of profits/losses).
- Incorporation increasingly common with firm size – interest in ensuring tax system is not distorting choice of business form.

Income taxation of SMEs

- Taxable income thresholds, tax rates, and levels of taxation depend on business structure.
- Unincorporated business income (blend of returns on labour and capital of owner/worker) taxed at progressive personal income tax (PIT) rates in most countries.
- Some countries tax prescribed capital component at a reduced rate.
- Incorporated business – wage component taxed at PIT rates, capital component subject to corporate income tax (CIT) and to personal (shareholder-level) income tax upon distribution.

Income taxation of SMEs

- Most (19) OECD countries tax corporate profits at a flat rate. Others apply a tiered (graduated) rate structure providing SMEs with tax rate relief (different approaches observed).
- Comparisons made of tax rates on personal business income, and tax rates on corporate profits, distinguishing small firms from large.
- Compare mature firms (immediate distribution of profits) and high-growth firms (indefinite retention of profits) as polar cases. Other cases can be considered falling within the range of results.

Income taxation of SMEs

- For mature firms, some tax systems found to impose an income tax impediment to incorporation; others found to encourage incorporation; few countries found to be tax rate neutral.
- High-growth firms, tax distortion favouring incorporation found in most countries – in particular, where CIT rate is low (e.g. with preferential small business tax rate) and no PIT rate reduction provided on retained personal business income.
- Analysis carried out for top PIT rate investor.

Tax distortions to SME creation and growth

- This part of the paper considers possible tax distortions to two decision margins:
 - Whether to remain in dependent employment or instead create an SME.
 - Whether to structure the SME in unincorporated or incorporated business form.
- Today's discussion will focus on the second decision margin.
- We calculate “all-in” average statutory tax rates for a single owner/worker of an SME earning a fixed amount of income in either unincorporated or incorporated form.
- “All-in” rates: PIT, CIT plus SSC.

Impact of PIT, CIT and SSC on business structure decisions

- Consider a simplified example
 - Single owner/worker of an SME.
 - They earn 2 times the average wage in their country.
 - 50% of income is derived from their labour input.
 - 50% of income is derived from their capital input.
 - Decision problem: should they structure in incorporated or unincorporated form?

- Let's look at 2 countries: United Kingdom and New Zealand.

Average statutory tax rates: UK and NZ

	Incorporated	Unincorporated
Labour income		
UK	17.6%	26.6%
NZ	29.2%	29.2%
Capital income		
UK	33.9%	26.6%
NZ	29.2%	29.2%
Social security contributions		
UK	19.9%	8.7%
NZ	-	-
Total income		
UK	35.7%	30.9%
NZ	29.2%	29.2%

Factors affecting average tax rates

- Differing capital income / labour income mixes.
- Differing distribution policies.
 - » We extend the analysis to account for these factors

Tax distortions to SME creation and growth

Five average statutory tax rates are calculated:

- Dependent employee.
- Unincorporated business.
- Incorporated business with full immediate distribution.
- Incorporated business with full indefinite retention.
- Incorporated business with half immediate distribution.

Example: New Zealand



Example: United Kingdom



Tax incentives for SMEs

- Possible/potential arguments for tax incentives for SMEs:
 - Positive externalities.
 - Capital market imperfections resulting from information asymmetries (leading to adverse selection, moral hazard).
 - Double taxation of corporate profits and cost of capital effects.
 - Non-deductibility of interest expense:
 - Limited scope for deductions for start-ups.
 - Tax subsidy for loans by MNEs to finance FDI.

Tax incentives for SMEs

- Other possible arguments for tax incentives for SMEs:
 - Limit loss offset provisions.
 - Business losses, capital losses on SME shares.
 - Discouraging to risk-taking (innovative firms).
 - Significant variation across countries in provisions.
 - Cross-border tax-planning opportunities (e.g. use of hybrid securities)
 - available to MNEs (requires cross-border investment/transactions).
 - Relatively high compliance tax burden for SMEs (high fixed costs)

Tax incentives for SMEs

- Arguments against tax incentives for SMEs:
 - Difficulties with market failure arguments (how measure?)
 - Possible opportunities and constraints in adjusting basic tax provisions.
 - Tax-planning opportunities for SMEs.
 - Efficiency and revenue considerations with the use of tax incentive.
- Main tax incentives for SMEs, framework of analysis.
- Examples of tax incentives for SMEs in OECD countries.

SME tax compliance and simplification provisions

- Rationale for simplification (compliance costs have large fixed cost component).
- VAT simplification measures:
 - Exemption from VAT collection (turnover below SME threshold)
 - Reliance on simple (single) VAT rate structure
 - Simplified VAT remittance calculation (presumptive taxation)
 - Cash accounting for SMEs
 - Less frequent filing requirements

SME tax compliance and simplification provisions

- Income tax simplification measures:
 - Replacement of regular income tax with presumptive tax (patent, turnover-based tax)
 - Cash accounting for SMEs
 - Less frequent filing requirements
- Other simplification measures
 - Improved access to info, provision of software, education

Possible future work on implications of globalization

- Issues: possible increased cost of capital for SMEs, relative to MNEs (concerns over SME competitive position):
 - Globalized capital markets tend to lower the cost of funds (increased access to foreign savings) – may benefit primarily MNEs with access to international capital markets.
 - Increased scope to avoid tax on returns on offshore investments (e.g. offshore mutual funds) – may make investment in local SMEs less attractive, and raise pre-tax hurdle rates of return for SMEs (subject to tax).
 - Increasing opportunities for tax-planning by MNEs (alongside largely unchanged opportunities for tax-planning by SMEs) – increasing competitive advantage for MNEs.

Possible future work on implications of globalization

- Further issues to consider:
 - Trend towards reduced tax rates on domestic interest, other investment returns (other than SME profits) given concern of policy-makers of non-reporting of investment income taxed at full personal tax rates – examples:
 - dual income tax systems
 - other scheduler tax systems taxing interest and other forms of investment income at low tax rates.
 - At the same time, personal business income taxed at full personal tax rates – tending to make creation and growth of SMEs less attractive.

Possible future work on implications of globalization

- Further issue to consider:
 - Movement away from integrated treatment of corporate and personal tax on dividends and capital gains, tending to increase double taxation of profits:
 - Expected to raise the cost of capital for SMEs relying on local investors.
 - In general, no effect on cost of capital for MNEs (access to global capital markets).

Possible future work on implications of globalization

- Further issues to consider considerations:
 - Relatively high costs associated with complying with VAT, and obtaining VAT input tax credit refunds, on cross-border sales (high fixed cost element).
 - Relatively high costs associated with complying with transfer pricing requirements (e.g. on transactions with distributions) (again, a high fixed cost component).

**Questions and comments welcome
during MENA/OECD country
roundtable (*tour de table*)**