DRAFT REPORT ON THE TAXATION OF SMES

EXECUTIVE SUMMARY

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EXECUTIVE SUMMARY

(Not for circulation)

This note gives an executive summary of a draft OECD report on the taxation of small and medium-size enterprises (SMEs) carried out jointly by the Working Party on Tax Policy Analysis and Tax Statistics of the OECD Committee on Fiscal Affairs, and the Working Party on SMEs and Entrepreneurship of the Committee on Industry, Innovation and Entrepreneurship. Aside from interest in revisiting an important policy topic, a main purpose in preparing the report is to present and discuss information gathered from a questionnaire issued to OECD countries in 2006 on current policy and administrative aspects of taxing SMEs (the 'SME tax questionnaire'), used as background material to discussions at the 17-19th October 2007 International Tax Dialogue (ITD) conference on Taxation of Small and Medium Enterprises.

Responses to the SME tax questionnaire, forming the basis of the draft report, cover the following 20 OECD countries: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Germany, Greece, Ireland, Italy, Japan, Mexico, New Zealand, Norway, Poland, the Slovak Republic, Spain, Sweden, the U.K., and the U.S. As outlined below, in addition to reporting detailed information for these 20 countries, the report presents further information on the tax treatment and characteristics of SMEs in all OECD countries, gathered by the OECD Centre for Tax Policy and Administration, and the OECD Centre for Entrepreneurship, SMEs and Local Development.

Characteristics of SMEs

Part II of the report begins by discussing characteristics of SMEs in OECD countries, including the percentage of firms that are SMEs, by sector (manufacturing, industrial, service sectors), with a percentage breakdown distinguishing micro, small and medium-size firms; the contribution of SMEs to employment, by sector; the percentage of unincorporated versus incorporated firms, measured for firms of varying sizes based on employment; and the distribution of the number of firms by taxable profits and business form. These data, provided as background information relevant to policy analysis in this area, highlight the importance of the SME population, while encouraging policy makers to consider the diversity of SMEs in terms of their size, age, risk characteristics, growth potential, and market and framework conditions under which they operate.

A simple yet striking fact from the data is that most firms are SMEs, whether looking at industrial, manufacturing or service sectors, with the smallest of firms (micro-firms) generally the

most common.[1] Perhaps then not surprisingly, SMEs typically account for the bulk of employment, with figures varying by sector and by country. Amongst 22 OECD countries for which data are available, SMEs in 14 countries account for more than two-thirds of total employment in service-related activities, and in 8 countries account for more than two-thirds of total employment in industrial activities. These data serve to heighten interest in ensuring that tax rules are supportive of SMEs, and in particular, do not place SMEs at a competitive disadvantage with regard to the tax burden on other firms, taking into account not only taxes paid to government (tax liabilities), but also resources involved with the 'compliance burden' of preparing, documenting and filing tax returns.

Data are also presented showing that SMEs generally lag behind large firms in terms of in-house technological and non-technological innovation, consistent with the fact that while certain SMEs are highly innovative, others are less so, and some not particularly.[2] However, while not all SMEs can be expected to be innovative (even under policy regimes that encourage risk-taking), entrepreneurial SMEs, those engaged in business activities with potentially very high but uncertain returns, are seen as an important source of innovation, recognized as key to economic growth. Given this, governments are encouraged to ensure that policies, including tax policies, are not discouraging to risk-taking inherent in investing in new, innovative products, production processes and technologies. A key consideration on the tax side, as regards possible effects of public policy on risk-taking, is the tax treatment of business losses and capital losses on SME shares, and in particular loss offset (deductibility) provisions determining the degree of symmetry between the tax rate on profits, and the rate of relief for business and capital losses.

The prevalence of firms in a tax-loss position is shown in Part II to be an important consideration, although the data do not provide a breakdown of loss-making firms that are small, medium-size and large. While this detail is needed for a thorough assessment of SMEs most affected by tax loss offset provisions, it is recognized that the development of certain SMEs involves long gestation periods with limited revenue from sales but significant start-up costs – implying business losses for one or more years. This fact, combined with data showing a prevalence of firms in a tax loss position, serves to encourage policy makers to ensure that tax loss offset rules are not impeding to risky investment in young, innovative firms.

The data also show that incorporation is increasingly common the larger is firm size. In particular, for small firms that begin as unincorporated businesses, growth to a significant size (e.g. 10-50 employees, and up) is likely to involve incorporation. One possible reason is that SMEs may need to issue equity shares to raise sufficient capital to grow, with investors possibly attracted by the continuity of business life that incorporation can provide. Another possible reason is that incorporation may provide investors with more limited liability than an

[1] Amongst the OECD countries examined, only in the case of industrial activities in Ireland are small-size firms (fewer than 50 employees, with turnover and assets less than Euro 10 million) more numerous than micro-firms (fewer than 10 employees, with turnover and assets less than Euro 2 million).

[2] Examples would include certain SMEs providing certain professional services (doctors, dentists), 'hobby farms', and various other businesses limited to serving local markets, exhibiting decreasing returns to scale, with possibly limited competition and limited incentive to innovate.

unincorporated business.[3] Where governments aim to avoid policy-related impediments to growth, it follows that tax rules should aim on balance to not discourage (or encourage) incorporation, where relevant considerations include scope for double taxation of corporate profits, while recognizing at the same time that incorporation generally involves application of relatively low corporate income tax rates profits of growth-oriented firms that are reinvested.

Income taxation of SMEs

After considering various characteristics of SMEs, Part III of the paper reviews income taxation of SMEs in OECD countries, where taxable income thresholds, tax rates, and levels of taxation depend on business structure.[4] Average personal tax rates on unincorporated business income, and combined corporate and shareholder tax rates on corporate profits reported in the paper are average statutory rates, as opposed to effective tax rates, as they do not factor in tax base considerations, nor do they factor in tax credits (other than imputation credits). While shedding light on within-country differences in tax rates, they do not provide a basis for assessing differences in effective tax rates between or across countries.

The review begins with unincorporated businesses, including sole proprietorships and other flow-through entities including partnerships, where unincorporated (personal) business income is subject to personal income tax rates. The paper reports top marginal personal tax rates and average personal statutory tax rates calculated at different income levels, using multiples of average wage earnings in each country (as per *Taxing Wages*) to enable comparable information. While not a perfect basis for assessing how average statutory tax rates vary by firm size, the paper argues that the approach is preferable to relying on some arbitrary amount of business income held fixed across all countries, given differences in income per capita across OECD countries.

Turning to incorporated businesses, involving two levels of income taxation (corporate and personal shareholder-level taxation), the review first considers the use of graduated (tiered) corporate tax rate structures in 11 OECD countries, versus reliance on a single (basic) corporate tax rate in the other 19 countries, and within the former group different approaches in the targeting of small business (low tier) tax rates to SMEs. Interestingly, basic corporate rates in some countries applied to firms of all sizes are lower than small business tax rates in certain other countries with a graduated corporate tax rate structure. As when analyzing the tax burden on unincorporated businesses, average corporate statutory tax rates are reported at various multiples of average earnings for the countries with a graduated rate structure, in order to capture the influence of application of different marginal rates and different thresholds.

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[3] As a business grows in size and complexity of operations, making it increasingly difficult for investors to assess the range and level of possible risks, greater protection against possible lawsuits with a claim on personal assets may be realized by structuring a business in incorporated form (as a separate legal entity). Relative advantages that incorporation may provide depend on the scope for limiting personal liability under alternative business structures (e.g. limited partnerships) possible under commercial law in a given country.

[4] Social security contribution systems, with rates and contribution thresholds for the self-employed that may differ from those for a worker/owner of an incorporated business, are reviewed and included in average tax rate calculations for selected countries in Part IV of the report.

The above-noted information is used to consider how statutory income tax rates on unincorporated business income compare with corresponding tax rates on incorporated business income for a top personal income tax (PIT) rate investor, taking into account the treatment of returns to labour and capital invested by a worker/owner in an SME. Such comparisons are useful where policy makers wish to address cases where the tax system has the potential to impede or distort the choice of business form, recognizing that structuring a business in an unincorporated form may provide certain non-tax advantages relative to incorporation, or possibly the reverse, depending on a taxpayer's situation.

Establishing an unincorporated business may be relatively less costly if significant legal fees and other resources are involved in drafting and registering articles of incorporation, and may give business owners (sole proprietors, general partners) greater control over business decisions. On the other hand, incorporation may be relatively attractive in enabling improved access to finance, continuity of life, and greater protection of personal assets. In general, efficiency losses may arise where the choice of a particular business form, offering a taxpayer greater non-tax advantages on balance relative to another, is discouraged by the tax system. While avoiding certain distortions imposed by a tax system may not be administratively feasible or otherwise possible, policy makers are generally interested in establishing where distortions exist, to help establish policy approaches to take.

The comparisons for all OECD countries focus on possible differences between the PIT rate on the capital component of unincorporated business income and the corporate and personal income tax (CIT/PIT) rate on corporate profit – where the former is a flat rate in dual income tax system countries, notably Finland and Sweden, and is the top PIT rate on the general income basket in non-dual income tax system countries. Where such differences exist, they tend to matter more (less) in influencing differences in the overall tax burden between the two business types where capital income accounts for a higher (lower) percentage of total business earnings.

In comparing statutory tax rates on corporate profit with top PIT rates on personal business income, dividend tax rates (DIVTR) are reported which factor in both corporate income tax (CIT) and shareholder-level personal income tax (PIT) and represent the 'mature firm' case involving immediate distribution of earnings. Also compared are CIT rates alone that exclude shareholder-level taxation, representing a 'high-growth' company case involving indefinite profit retention and deferral of shareholder taxation of dividends.

Considering the mature firm case in the 19 countries with a *flat CIT rate*, within-country comparisons find that the DIVTR is higher than the top PIT rate on personal business income in seven of these countries, with differences ranging from (+3.4) percentage points in the Czech Republic, to (+19.6) points in Sweden.[5] These differences imply a tax rate distortion favouring unincorporated business form linked to varying degrees of double taxation of distributed corporate profit. In contrast, the DIVTR is shown in the charts to be lower than the top PIT rate in other

[5] Results for Sweden, Finland and Norway are sensitive to assumed rates of return on capital, and prescribed versus actual proportions of business income that are capital versus labour income.

countries, ranging from (-1.6) points in Turkey, to (-15) points for Greece. These STR differences imply a tax rate distortion favouring incorporated business form linked to relatively low CIT rates and limited PIT rates on dividends.

In Italy and Portugal, the difference in tax rates is less than 1 percentage point. In Australia, Mexico, New Zealand and the Slovak Republic, the tax rates are identical, with tax rate neutrality in Australia, Mexico and New Zealand resulting from dividend tax systems that provide full imputation credits to shareholders. Tax rate neutrality in the Slovak Republic results from the waiving of shareholder level tax on personal dividend income and identical top PIT and corporate tax rates.

Where after-tax profit is retained indefinitely (high-growth case), the applicable statutory CIT rate is shown in many cases to be considerably lower than the top PIT rate on unincorporated business income taxed on a current basis.[6] For the seven countries noted above where an income tax rate distortion against incorporation is found in the 'mature firm' case, a tax distortion favouring incorporation is found in the 'high-growth' case involving indefinite retention of profit. For example, in Ireland, the difference between the top PIT rate on personal business income and the basic CIT rate on retained profit approaches 30 percentage points. In Sweden there is no difference, given that retained (reserve) income of an unincorporated business is taxed at a preferential rate of 28 per cent, which matches the basic corporate income tax rate. In other flat CIT rate countries, an income tax rate advantage provided by incorporation increases further when profits are retained rather than distributed.

In Australia and New Zealand, where dividend tax rates and top PIT rates are the same when profits are immediately distributed, incorporation creates a gap (provides a lower tax rate) where profits are instead retained. In the Slovak Republic and Mexico, tax rate neutrality continues to hold when profits are retained. In the Slovak Republic, this result applies because shareholder tax does not apply to distributions. In the case of Mexico, tax rate neutrality is explained by the fact that the CIT rate matches the combined tax rate on distributions with full imputation credits.

For 8 of the 11 countries with a *tiered CIT rate structure*, the combined tax rate on dividends is shown to exceed the top PIT rate on personal business income in the mature *large* firm case (where small business tax rates do not apply), implying an income tax rate distortion against incorporation. When analyzing illustrative results for SMEs that assume business profits equal to four-times average wage earnings, preferential small business tax rates applied to SME earnings are found (with one exception) to reduce the tax rate discrepancy between incorporated and unincorporated business form, and in two cases reverse it.

For example, in Hungary, the difference between the combined tax rate on dividends paid out by SMEs and the top PIT rate on unincorporated business income is (+9.7) percentage points, compared with (+12) in the large firm case. In the U.K., the difference between incorporated and unincorporated rates is eliminated for SMEs (0 versus +7.5 for the large firm case), with

[6] Indefinite retention of corporate profits implies negligible shareholder tax on dividends on a present value basis.

imputation credits providing a full offset to corporate-level tax. In Canada and Spain, shareholder dividend tax credits in the SME case reverse the difference. While the combined tax on dividends paid out by large firms exceeds the top PIT rate on personal business income in Canada by (+5.4) percentage points, the combined tax on SME distributions differs from (is less than) the top PIT rate by (-7.8) percentage points. In the other countries with a tiered CIT rate structure, where the combined tax rate on dividends is less than the top PIT rate on personal business income even in the large firm case with profits taxed at the basic CIT rate, the tax rate gap favouring incorporation is slightly increased in the SME case.

The preceding results for systems with tiered CIT rates consider the 'mature firm' case. In the high-growth case, where after-tax profits are retained indefinitely and shareholder tax (PIT) does not factor in, the average corporate statutory tax rate (ACSTR) is typically lower, in some cases significantly, than the top PIT rate on personal business income. In other words, retention in some cases significantly increases the gap for high-growth SMEs between PIT rates on personal business income and ACSTRs on corporate profits, with differences ranging from (-27.8) percentage points in Canada, to (-7.9) in the U.S. These differences imply significantly lower income tax rates for high-growth SMEs that are incorporated, compared to unincorporated, on account of preferential small business tax rates, combined with indefinite deferral of personal tax on distributed corporate profits (with unincorporated business income taxed on a current basis, implying no deferral).

The preceding results for polar cases (immediate distribution vs. indefinite retention) may be generalized. In particular, where earnings are initially retained but later distributed, implying that shareholder taxation is deferred but not indefinitely, the present value of future dividend taxes factors into STRs for the incorporated business case, with values falling between the polar cases, tending to the retention/tax deferral case the longer the growth (reinvestment) period. As a general result, incorporation may involve a higher income tax burden on a top PIT rate investor, owing to some degree of double taxation of profit (with this difference pronounced in certain countries, and not in others with imputation/integration systems). For high growth-oriented firms reinvesting their earnings (generally a cheaper source of finance than new equity), the taxation of corporate profits at a low rate, compared with a top PIT rate on personal business income, combined with the ability to defer shareholder taxation of profits, tends to increase the relative attractiveness to profitable SMEs of incorporation as a choice of business form, at least for a top personal tax rate investor, and in particular where small business tax rates apply.

For SME owner/workers without other sources of income, the average personal STRs on unincorporated business income will be less than the top PIT rate (the applicable rate for a top personal tax rate investor, considered in the results discussed above), and determined by the level of business income and the structure of the tiered personal tax rate schedule (i.e. marginal PIT rates, levels and thresholds, basic personal allowance (if any)). For relatively low levels of business income, the average personal STR on unincorporated business income may be below the basic corporate tax rate (and possibly zero). Thus for relatively small firms, incorporation may involve a higher tax rate being applied to business profits even for growth-oriented firms reinvesting their earnings.

It is important to again be reminded that the preceding comparisons, while useful in considering how statutory tax rates may factor in to potentially distort decisions over the choice of business form, the comparisons may or may not reflect differences in effective income tax rates upon which decisions are presumably based. To the extent that tax base and tax credit differences arise, the statutory tax rates may be misleading indicators. Also, as noted at the outset, the differences in STRs across countries cannot be used in any case to infer differences in effective tax rates across countries, given differences across countries in both tax base and tax credit rules. Last to recall is that the results ignore social security contributions (accounted for in Part IV) and consider only the case of top PIT rate investors. These two assumptions are relaxed in Part V of the paper.

Tax distortions to SME creation and growth

Part IV of the paper examines possible tax distortions relevant to SME creation, structure and growth, taking account of personal and corporate income taxation and social security contributions. The analysis adds to Part III by introducing social security contributions, where contribution rates, base and thresholds may differ by business form.[7] Unlike the analysis in Section III that considers a 'top PIT rate investor', the taxpayer considered in this part is assumed to have no other sources of taxable income, so the entire personal tax rate schedule is applicable in determining average tax rates. Rather than provide a comprehensive analysis for all OECD countries, the presentation of results is limited to four OECD countries to illustrate relevant considerations: New Zealand, Norway, Sweden and the U.K.

In assessing possible tax distortions, three related decision margins are considered. One is the choice of an individual taxpayer of whether to remain or search for dependent employment, or create one's own business. The second is whether to structure a business in unincorporated or incorporated business form. A third is whether to artificially report labour income as capital income (or vice versa) in order to reduce tax liability, where tax-planning incentives may be created where the combined income tax and social security contribution rate on labour income differs from that for capital income. The modelling approach also considers 'all-in' average tax rates at different levels of business income, which may be used to assess possible tax effects on the growth of SMEs.

The approach used to analyze tax effects makes a number of simplifying assumptions. It is assumed that business creation involves the investment of one's time (hours worked) and savings. In other words, possible outside sources of funding are ignored (e.g. bank loans, external equity). The analysis of possible tax distortions is based on calculating and comparing average "all-in" tax rates (corporate and personal income tax plus social security contributions) for an individual

[7] The analysis considers the case of a single worker/owner of a company, and assumes that the burden (incidence) of self-employed social security contributions is borne entirely by the worker/owner (reducing personal business income, with no shifting of the burden onto output prices). Similarly, the burden of employer and employee social security contributions levied on income of the single/owner worker are absorbed by the worker/owner (not passed onto prices). Possible behavioral responses to income taxation and social security contributions are not modeled.

taxpayer earning a fixed amount of combined capital and labour income, either as a dependent employee, or as a single owner/worker in a business structured in either incorporated or unincorporated form. If in business, the individual is assumed to have no employees. The calculations assume that the individual is single with no dependents. As with the analysis in Part III, the fixed income considered is set equal to a multiple of average wage earnings in the relevant country, so as to provide comparability across these countries. (The base case is two-times average wage earnings).

Often two key determinants of average tax rates are the breakdown in income source between capital and labour (which may vary significantly by type of business activity, and may be able to be manipulated), and the distribution policy of an incorporated business. To take account these factors, average tax rates are provided for differing levels of capital income (as a proportion of total income), and differing dividend distribution policies.

While the results are country specific, they illustrate how markedly tax may influence both the decision to form an SME and the decision over how to structure an SME. In three of the four countries, a tax distortion is found towards formation of an SME at almost all capital income proportions, irrespective of dividend distribution policy. For the fourth (Norway), a tax incentive is found to form an SME as long as significant retention of corporate profits is possible, and the business is not extremely capital intensive.

Turning to the SME business structure decision, the results find a general bias towards incorporation as long as full retention of profits is possible. This is largely because it tends to reduce social security contributions, and eliminates additional taxation of capital income from shareholder distribution. In the context of a growth-oriented SME, retention would seem likely to be a preferred policy. However, even if some distribution of profits is required, the incorporated form is still generally favoured in New Zealand, the UK and Norway. The ability to split personal business income in Sweden between capital and labour results in the unincorporated form generally being preferable if significant corporate profits must be distributed.

More broadly, the results emphasise that the capital/labour ratio can influence the average tax rate substantially. Consequently, there will almost always be a tax incentive to alter the capital/labour income ratio to lower the tax burden. In general, in the UK, Sweden and Denmark, average tax rates fall as the capital income proportion increases. This means there is a clear incentive to attempt to maximise the amount of capital income attributed to the business. While the nature of a business will determine broadly the capital/labour income ratio, there is likely to be a margin around the "true" capital/labour income ratio that can be exploited. For example, this could be achieved by the owner/worker paying him/herself a below-market wage for labour input. Audit activity would be expected to prevent gross recharacterisation away from true ratios, but may not detect small alterations. Even in New Zealand, which operates a full imputation system there is a tax incentive to recharacterise labour income as capital income at low capital income proportions. At relatively high capital income proportions, the provision of full imputation credits means that distribution policy can be more easily and costlessly manipulated to ensure the tax burden is minimised for an incorporated business.

These results suggest that policy makers need to be aware of possible incentives to artificially increase the level of capital income in a business, and of the need to develop measures to minimise this ability. Sweden has a number of such measures already in place that will place a limit on the amount of recharacterisation possible.

Tax incentives for SMEs

Part V of the paper considers the use of tax incentives to encourage investment in SMEs, reviewing arguments for and against their use; main categories of income tax incentives differentiated on the basis of expected impact on net revenues, costs and discount rates; and examples of corporate and shareholder-level tax incentives to encourage SME investment based on the questionnaire responses. The coverage in the last section considering tax incentives in place for SMEs is largely restricted to a description of the basic types and targeting of SME tax incentives, as reported by OECD countries that participated in the SME tax questionnaire exercise.

As noted in Part II, with data showing most businesses being SMEs, and accounting for the bulk of employment, it is understandable that governments are keen to ensure that tax and non-tax policies do not place SMEs at a competitive disadvantage, for example through relatively high effective tax rates. Moreover, recognizing that large companies are typically created as small or medium-sized companies, governments are equally keen to ensure that policies are supportive of SME growth. The undeniable importance of SMEs in the economy raises questions over whether SMEs should be targeted for special tax treatment.

Arguments for and against SME tax incentives

Advocates of special tax incentives for SMEs often rely on *'market failure' arguments*, based on assumptions of positive spillover benefits to society of SME investment not taken into account by private investors, leading to under-investment. Market failure may also result from asymmetric information, leading to various forms of capital market imperfection (involving adverse selection or moral hazard) creating difficulties in raising finance or other impediments to SME investment.

However, market failure arguments themselves raise certain questions and an assortment of practical difficulties. One question is whether positive spillover benefits and asymmetric information applies only in the case of SMEs. And even if one accepts these arguments, consideration of how one would design and implement a tax incentive in practice to correct market failure is fraught with many unsolvable questions. It is not clear for example how to measure the degree of market failure and thus assess the level of under-investment relative to some socially optimal level. Also required is some estimate of the sensitivity of the relevant activity (e.g. investment) to a relevant tax indicator (e.g. the effective tax rate on profits from investment), where plausible elasticity estimates may cover a wide range, and where the identification of the relevant tax indicator is not certain.

What is clear is that some precision is required, as 'getting it wrong' in terms of the rate of tax relief provided or the targeting of relief could potentially result in a misallocation of resources (implying efficiency losses), with too much capital being directed to targeted investment, and/or capital being unwittingly encouraged towards (or away from) non-targeted investment. In this likely scenario, efficiency losses caused by imprecision may more than offset intended efficiency gains from reducing market failure.

In addition to market failure arguments for and against tax incentives for SME investment, the paper presents arguments that address the possibility that uniform application to firms of all sizes of certain basic tax provisions – that is, non-targeted, generally applicable tax policies and tax administration rules and procedures – may result in a relatively high tax burden on SMEs, and thereby discourage SME creation and growth, at least in certain cases. Depending on country circumstances, adjustments to basic tax policy and/or administration provisions may be justified on the basis of cost-benefit assessments of likely effects, including efficiency and revenue losses. Where adjustments to basic provisions are not warranted, attention may turn to the possibility of tax relief targeted at SMEs to counter a relatively high tax burden, where a variety of measurement and targeting uncertainties and difficulties would arise. Given these difficulties, policy makers may be understandably encouraged to concentrate efforts on ensuring a proper balancing of considerations when addressing possible impediments to SMEs creation, growth and compliance linked to tax policy and administration.

The list of basic income tax provisions uniformly applied to firms of all sizes, which may negatively impact SMEs (and in particular, risky start-up firms) compared to large firms, includes: double taxation of corporate profits and implied cost of capital effects for SMEs; non-deductibility of interest expense (business start-ups); limited loss offset provisions that may discourage risk-taking; cross-border tax planning opportunities limited to MNEs; and relatively high compliance burden on SMEs.

Amongst this list, perhaps the most commonly cited impediment to SME investment is double taxation of profits of incorporated SMEs, encountered to some degree in most countries when investors in an SME decide to incorporate (possibly to broaden the shareholder base, or limit investor liability), with double taxation tending to increase required pre-tax 'hurdle' rates of return on investment financed at the margin by new equity supplied by local investors. This argument recognizes that increased hurdle rates of return linked to double taxation are an issue primarily for SMEs with limited access to international capital markets where the cost of funds is generally unaffected by domestic shareholder tax rates.[8]

The report considers how governments have addressed this area, in different ways and to varying degrees, for example by moving towards integration of corporate and personal taxation of

[8] Additionally, double taxation may impede SME financing where it encourages mature companies to retain profits to avoid dividend taxation (so-called 'corporate lock-in' effect), limiting capital available to shareholders to invest in SMEs. Also, while large companies and already-capitalized SMEs may benefit from 'patient capital' encouraged by 'lock-in' effects under realization-based taxation of capital gains, this result does not apply to new SME business start-ups, which have yet to raise external equity financing.

dividend income and capital gains, or expanding the set of alternative business forms – for example, limited partnership, trust, special corporate entities – that provide flow-through taxation (so that corporate-level tax and thus double taxation is avoided), while possibly providing other advantages that corporate status would otherwise provide (e.g. limited liability to shareholders).

Another commonly cited impediment relates to limits to interest deductibility, where a basic provision of virtually all income taxes is a deduction for the cost of debt finance (but not the cost of equity).[9] Interest deductibility is beneficial to firms that are i) able to secure loans, and ii) earning profit to deduct interest expense against. Where large firms are better positioned to obtain loans by presenting a lower risk to creditors (i.e. with more tangible capital, and/or more diversified revenue streams), and to the extent that small start-up firms tend to be in a loss position during initial years when up-front costs are high relative to revenues (with profits of both small and large firms affected by business cycles), it follows that tax relief from interest deductibility tends to favour primarily large profitable firms. Where this tends to lower the after-tax cost of debt finance for large firms, relative to SMEs, the implication is a competitive disadvantage for SMEs.

A relatively high after-tax cost of debt finance for SMEs may arise in the context of SMEs and large firms operating in the domestic market. Somewhat surprisingly, relatively little attention appears to be paid at least in public circles to the implications to SMEs of interest deductibility afforded to multinationals to support outbound investment. The issue here is that tax systems typically provide multinationals with significant tax relief by allowing a tax deduction for interest on funds borrowed to finance outbound investment – a tax break not available to SMEs with solely domestic investment. Some countries have tracing rules that aim to limit interest deductions on outbound investment, given that foreign profits earned on outbound investment are generally free of home country tax.[10] Without effective limitations, interest expense may be deducted against domestic source income – implying effectively a tax subsidy for foreign direct investment (resulting from a mismatch between taxable profits and allowable tax deductions). However, in general, tracing rules are difficult to enforce and are generally recognized as having limited effect. The implication is significant tax relief for firms with cross-border investment, tending to further place at a competitive disadvantage SMEs without cross-border investment.

Given interest in supporting innovative, relatively high-risk businesses, it is not surprising that the *asymmetric tax treatment of business losses* would come under review, given that asymmetric treatment of business profits and business losses may discourage risk-taking. (At the same time, caution is required given scope that may be created for unintended tax-planning

[9] The allowance for corporate equity (ACE) system in Belgium is unique amongst OECD countries in providing a deduction for a notional return on equity.

[10] This observation holds both in OECD countries with territorial (dividend exemption) international tax systems, and in countries operating worldwide (dividend credit) systems. In countries operating a dividend credit system, net home country corporate income tax may be imposed on foreign dividends taxed in a foreign host country at a relatively low rate. However where the host country corporate plus dividend withholding tax rate equals or exceeds the home country corporate tax rate, generally no net home country tax would be imposed (to avoid double taxation).

opportunities with fully symmetric treatment.) A review of country provisions reveals that while all countries tax business profits on a current basis (that is, in the year earned), systems differ considerably in the scope that they provide for deducting business losses.

Governments are understandably reluctant to provide full refundability for business losses – that is, to provide a cash refund (cheque) for the value of business losses that a taxpayer cannot write-off, due to a lack of sales and taxable income to deduct business losses against – given difficulties in guarding the tax base against tax-planning incentives that would be created for individuals to mischaracterize consumption expenditures (e.g. in running a hobby farm) as business expenses. However, other options include allowing flexible business loss carryover provisions (e.g. allowing losses to be carried forward indefinitely to offset taxable income in future years); allowing business losses to be carried forward with interest (to maintain their present value); and allowing flexible loss-offset rules that would permit business losses to be deducted against other types of taxable income, such as interest or other taxable investment income, and possibly against taxable wage income from dependent employment, with safeguards against tax planning.

The survey responses reveal a diversity of approaches in this area. Some countries ring-fence business losses to be deductible only against future business income, with a fixed number of carry-forward years. Some countries have moved to an indefinite loss carry-forward, and currently allow business losses to be deducted against investment income. And some allow business losses to be deducted against employment income as well, with different approaches taken to target loss offset relief to legitimate business activities, while aiming to lift restrictive treatment could inhibit SME creation and growth, with systems in Australia and Germany as examples.

A further consideration relevant to the competitive position of SMEs concerns *aggressive forms of cross-border tax planning of MNEs* which would appear to be increasingly used by multinational firms, while for the most part unavailable to SMEs, in particular resident-owned SMEs with activities limited to domestic investment. The report reflects on the fact that the effective tax rate on foreign profits and domestic profits of MNEs may be considerably lower than the effective tax rate on domestic profits of SMEs, through the use by MNEs of hybrid instruments, hybrid structures, tax haven finance affiliates and other arrangements. An illustrative example is provided in the report of tax savings resulting in higher net rates of return from the use of cross-border hybrid securities, in place of conventional debt.

The example illustrates the fact that tax provisions that do not distinguish between firms according to size can have the effect of providing tax relief to a limited set of firms (i.e. with cross-border holdings)[11], to the exclusion of SMEs that do not fall into this category. To the extent that MNEs are increasingly able to access tax relief on cross-border investment – because of increased cross-border activity, or a relaxation of foreign tax credit, anti-deferral, and thin

[11] Cross-border tax planning opportunities arise both in the context of outbound investment of resident-owned firms, and inbound investment (non-resident owned firms) including non-resident owned SMEs.

capitalisation rules that would counter tax-planning, or some combination of these factors – possible non-neutralities and distortions to the allocation of capital (and corresponding efficiency losses) tied to developments in this area may increasing over time.

The report acknowledges that MNEs are not the only entities with opportunities to tax-plan (within or outside the tax law). Establishing a business, rather than seeking or remaining in dependent employment, may be attractive to a taxpayer for a number of reasons, including the possibility to influence ones' tax liabilities. In particular, certain personal expenses may be characterized as business expenses – given difficulties faced by policy makers in drafting tax laws and regulations clarifying what can be considered eligible deductible business expenses, and the inevitable 'grey areas' in interpretation that arise – implying a degree of tax relief not possible with dependent employment. However, it may be that, on balance, the competitive position of SMEs has been weakened over recent years, as regards tax-planning opportunities available to SMEs versus MNEs.[12]

Lastly, the report considers, as a further argument to improve the competitive position of SMEs, the fact that SMEs tend to face a *relatively high tax compliance burden*. This recognizes that resource costs involved in completing and filing tax returns for income tax, VAT, and other taxes may involve a significant fixed cost component, largely invariant to firm size, as measured by turnover or assets. This means a relatively high tax compliance burden measured as a percentage of turnover or profit for SMEs compared with large firms. It may be argued that a relatively high compliance cost on SMEs results in a misallocation of resources, with under-investment in SMEs relative to a case where compliance costs are reduced or vary more proportionately with firm size, and that this misallocation could be possibly addressed by retaining existing tax incentives for SMEs if consideration is being given to removing those incentives, or possibly introducing a new tax incentive to compensate for relatively high SME tax compliance costs.

Possible opportunities and constraints in adjusting basic tax provisions

Uniform application to firms of all sizes of certain basic (generally applicable) statutory and administrative provisions of income and consumption taxes may discourage the creation and growth of SMEs in certain cases. Moreover, uniform application of basic provisions may discourage tax compliance for some individuals. In an effort to support SME creation and growth, foster SME tax compliance, and possibly meet other objectives, policy makers may find means to adjust basic provisions affecting all firms, regardless of their size, where feasible and appropriate, to address these goals. As noted, scope may exist to move further towards integration

[12] In an effort to establish whether the competitive position of SMEs has weakened or improved relative to MNEs, on account of tax-planning, it would be necessary to assess (if possible) whether tax-planning opportunities for SMEs have expanded over time to the same degree as (the different set of) tax-planning opportunities for MNEs. To the extent that SME tax-planning opportunities have remained the same or been reduced with improved tax administration, while tax-planning opportunities for MNEs have increased (possibly as a deliberate policy choice, given concerns over increasing capital mobility of MNEs), one could argue that the competitive position of SMEs has weakened in recent years, in relation to tax-planning considerations.

of corporate and personal taxation, or to expand accessibility to one or more flow-through vehicles. Similarly, some scope may exist for liberalizing general loss offset rules, tightening interest deductibility rules, increasing effective tax rates on MNEs, and providing increased simplicity in complying with administrative aspects of the tax system.

At the same time, however, possible adjustments to generally applicable tax provisions (e.g. to reduce double taxation) may be very limited, depending on the particular country and tax system in question, taking into account (estimated) revenue losses and concerns and uncertainty over efficiency and equity effects. Moreover, it may be that while certain basic provisions may be particularly impeding to certain SMEs, they may not be to others, whilst being impeding to certain large firms (e.g. those without international transactions enabling aggressive tax planning). Targeting firms that are particularly constrained by a uniform set of tax rules should be expected to be imprecise (inexact), to a degree dependent on the targeting criteria (with highly specific criteria raising some difficulties).

Where certain factors including possibly government policy (e.g. financial markets policy) are constraining the financing of 'quality' SMEs, it makes sense to consider first whether the relevant factors or policies can be adjusted, and at what cost. That is, well before considering a targeted 'tax fix', generally the first-best approach is to consider whether and how the contributing factors can be addressed directly, and avoid reliance on the tax system to somehow correct for impediments arising elsewhere. For example, if on account of asymmetric information, capital markets are denying financing to SMEs in cases where funds would be provided under symmetric information, it may be that government can play an effective role in facilitating transparency including the dissemination of information.[13] Similarly, scope may exist for strengthening laws affecting a firm's ability to protect property rights, and thereby contain certain types of 'spillover' benefits so that a firm's owners more fully reap the rewards of their investments, leading to greater private investment in the absence of special tax incentives.

Similarly where basic provisions of the tax system are posing an impediment to SME creation or growth, the costs and benefits of adjusting the relevant provisions should be addressed. For example, where business costs of maintaining tax accounts, filing returns and otherwise complying with the tax system are found to be excessive and particularly burdensome for small businesses, consideration should be given to the costs and benefits of introducing targeted simplification measures (with a number of country examples considered in Part VI).

General experience with tax incentives

Given difficulties in identifying and targeting instances of market failure, and limiting tax incentive relief to just offset under-investment resulting from market failure, it must be accepted that tax incentive regimes will cause misallocations of capital in certain areas and corresponding efficiency losses. While the objective may be to ensure an overall (net) efficiency gain by

[13] Examples might include public provision of training programs for young firms, providing guidance on how best to develop a business plan, with key verifiable information on determinants of revenues and cost, for consideration by potential suppliers of finance.

countering market failure, it is difficult to be confident *ex ante* that such an outcome will in fact occur.

Indeed, as emphasised in Part V of the report, a central challenge in targeting tax incentives – for example, to small businesses engaged in a particular activity (e.g. R&D) – is containing relief to targeted firms/activities, recognizing that targeting criteria will be carefully analyzed by all taxpayers, with attempts made to access tax relief to minimize tax paid and increase after-tax profit. For example, a non-qualifying (medium or large) firm may reorganize itself into two or more new business entities to access tax relief conditional on firm size, determined on the basis of turnover, profit and/or capital (depending on the amount of tax relief possible, relative to cost of business reorganization, and the existence or not of anti-fragmentation rules). Boundaries of qualifying business activities will be tested with companies attempting to characterize or re-characterize certain activities so that they fall within the letter of the law or administrative rule. For example, establishing what expenditures qualify to receive R&D tax incentives is not straight-forward, as reflected in the significant tax administration expenses incurred in many countries to manage the delivery of these incentives.

Inevitably, governments come under pressure to extend tax incentive relief to taxpayers/activities not initially targeted (e.g. on the basis that competitive positions have been disadvantaged). Governments also come under pressure to ensure that all parties in a targeted group receive equal treatment. A key issue here concerns the fact that not all firms are profitable in a given year, and, due to their tax status (taxable versus non-taxable) have a varying ability to claim or benefit from tax incentive relief. This can pit taxpayers against government, with the latter charged with ensuring that tax revenue losses and efficiency losses are contained by limiting tax-planning opportunities and the pools of human resources directed in the economy towards developing various market schemes aimed at transferring tax incentives from taxpayers that cannot currently claim them to those that can.

As discussed in Part V, tax incentives that provide a full or partial profit exemption tend to provide windfall gains to investors. Up front incentives including accelerated depreciation, enhanced allowances and investment tax credits share an attractive feature of limiting tax relief to cases of investment. However, when combined with flexible business loss carryover and tax credit carryover rules, they can lead to a significant build-up of unutilised tax deductions and credit – that is, earned but unused tax offsets that can be carried forward by the taxpayer to offset tax in future years. This build up in unused tax offsets is typically matched by increased pressure on government to allow firms in a loss position (e.g., start-up firms) to somehow access the tax relief, with minimum expectations being the ability to carry forward balances of business losses and unused investment tax credits to be claimed in future years.

To deny this to firms that are profitable over the longer term but currently non-taxable introduces anon-neutrality that tends to place them at a competitive disadvantage relative to currently profitable firms able to take advantage of the tax incentives. The existence of large balances of unused business losses and tax credits creates incentives for firms in a loss position to 'sell' these amounts to firms outside the target tax incentive group that are profitable and able to use them to reduce their tax liability. This in turn puts pressure on host governments to ensure

that rules and administrative practices are in place to limit unwanted loss and credit trading, typically with new tax loopholes created as old ones get shut down. The revenue costs resulting from loss transfers can be huge and dwarf foregone revenues from the targeted investment activities.[14]

SME tax compliance and simplification provisions

Part VI of the paper addresses the second main component of the overall tax burden on SMEs, in addition to tax liability (payments to government) – namely costs associated with compliance requirements (e.g. permitting simplified accounts, simplified tax calculations, less frequent filing). Compliance cost considerations may factor importantly into a number of decisions, for example, whether to become self-employed, and whether or not to operate in the formal economy.

Rationale for simplification

Compliance costs, which typically have a significant fixed cost component, tend to impose a relatively higher burden on SMEs. Compliance costs also tend to increase with the number of taxes that an entrepreneur is subject to, the complexity of the tax rules, the frequency of submitting tax returns, and the number of levels of government involved in levying and collecting tax.

While the compliance tax burden facing an SME is case specific and thus difficult to measure, a broad conclusion to be drawn is that the compliance burden generally is high for SMEs relative to large companies and relative to the tax compliance burden for payroll employees. This suggests that if the tax liability (statutory tax burden) on a given amount of labour and capital income is roughly the same for a dependent employee as for a self-employed individual, then a higher tax compliance burden in the latter case may discourage SME creation. By reducing tax compliance costs and thereby lowering the overall tax burden on small businesses, simplification provisions help achieve more neutral tax treatment of firms of varying sizes, implying efficiency gains, and encourage compliance with (adherence to) the tax laws of a country, including business operating in the 'formal' rather than informal (underground) economy, and full reporting of all amounts required to determine the true tax base.[15]

[14] At the same time it is important to recall that transparency of the tax law and administrative certainty are typically ranked ahead of special tax relief by investors. Moreover, changes to the tax law, including introducing incentives and then refining or removing them on account of cost overruns can contribute more than the provisions themselves to a perception that the tax system is complex and difficult to comply with. Frequent changes can make tax administration more difficult and may have other undesirable, unintended effects. At the same time, tax incentives, even those introduced on a temporary basis may be difficult to purge from the system, with pressures for the provisions to be extended, or made permanent features of the tax system.

[15] While addressing underreporting of taxable sales and profits is a challenge in dealing with certain businesses of all sizes, the problem of informality – that is, businesses operating outside the tax system – is a particular challenge in dealing with small firms, where remaining below the 'radar screen' of tax authorities is generally less difficult.

Simplification provisions of various types can be expected to impact small businesses differently, given the heterogeneity of the small business population. In particular, certain measures may directly encourage business creation and tax compliance for some small businesses, but not others, suggesting the need to analyze a range of measures. For example, allowing simplified accounting or less frequent filing of tax returns may be of little practical consequence to small businesses with very low turnover (e.g. street vendors) that may regard the tax compliance burden of a relatively simple regular tax system as excessive and discouraging to participation in the formal economy. But the same measures may operate to encourage other larger-scale small businesses to establish, and to comply.

For very low turnover businesses for the most part unaffected by simplified accounting and filing measures, tax compliance may call for the introduction of a simple replacement tax, for example a turnover-based presumptive tax, to replace regular income tax and/or VAT for firms with turnover below some (micro) business threshold. In such cases, a key design consideration is the setting of the tax burden under a presumptive (replacement) tax, and in particular the avoidance if possible of large upward adjustments in tax burden when a business size threshold is passed and the taxpayer is required to migrate from a replacement regime to the regular regime.

VAT simplification provisions

A number of approaches may be taken to reduce VAT compliance costs, with the questionnaire responses identifying approaches adopted by the OECD countries surveyed in this report. The main options include: introducing a VAT collection threshold; using a single VAT rate; allowing a simplified VAT remittance calculation ('presumptive approach') for small firms; allowing cash accounting; and allowing less frequent filing of VAT returns.

Many argue in favour of *waiving VAT collection for firms with low turnover* (below a small business threshold) as an effective means to reduce tax compliance costs, while also containing the costs of tax administration. The threshold issue is important recognizing that with some firms being part of the VAT system (firms above the threshold) and others not (firms below the threshold), the VAT system can be expected to affect the relative competitiveness of firms. In particular, non-participating firms may be negatively impacted owing to their inability to claim tax credits in respect of VAT paid on inputs, encouraging some countries to allow voluntary VAT registration and participation in the system by firms below the threshold. Providing this option increases tax administration costs, and introduces compliance costs on those that elect to be in the system to protect their competitive position. But the trade-off may be viewed as necessary.

A relatively high VAT threshold, by excluding possibly large numbers of firms, may also frustrate policy efforts to have all persons actively participate in the formal economy, recognizing that once 'outside' the system it may be less likely that individuals would decide at some point to fully participate. However, this concern may be partly addressed if firms below a VAT threshold (and not opting into the normal system) are required to pay another, simpler form of tax (e.g. a simple lump sum patent, with minimal compliance costs) – and be part of the 'formal' economy.

Another consideration is that a relatively low VAT threshold, while encouraging participation by a greater number of firms in the regular tax system, and avoiding distortions to competition, may broaden the scope for taxpayer fraud, committed for example by firms forging false invoices to claim fictitious input tax credits. However, such challenges would also be expected in systems with higher threshold values that permit voluntary participation for those below the threshold (but possibly with a reduced rate of fraud if taxpayers opting into a system can be more carefully screened, with fewer firms in the regular system).

Studies suggest that a *multiple rate VAT structure* may contribute considerably to VAT compliance costs. For example, a study of VAT compliance costs in Sweden estimates that compliance costs would be reduced on average by roughly 30 per cent if a single rate system replaced a multiple rate system. While a multiple rate system may satisfy public demands for lower rates on certain products, for a variety of reasons, adhering to a single or simple rate structure can both limit tax distortions to consumption, and production, and at the same time reduce compliance costs. However these advantages are difficult to measure and articulate to the public, implying considerable difficulty in imposing a simple VAT rate structure, and the need for policy makers to look for other means to bring down compliance costs.

For example, compliance costs may be lowered by allowing small firms with turnover above a collection threshold, but below some second tier 'small firm' turnover level, to calculate VAT payments to government under a *simplified 'presumptive' approach* that applies a single flat rate to turnover, possibly varying by sector (instead of requiring a detailed VAT calculation). An alternative approach relies on simplified input tax credit calculations, with VAT charged on sales remaining unchanged from the regular system.

Another possibility is allowing *cash (rather than accrual) accounting for VAT*, based on daily cash entries of payments and receipts. Lastly, allowing less frequent filing of VAT returns for firms satisfying a small business (turnover) test may reduce tax compliance costs, while at the same time provide firms with a cash-flow advantage (i.e. savings in present value terms, owing to the time value of money). Cash-flow savings realized by less frequent payments of tax may be viewed as a form of subsidy to help defray remaining compliance costs.

Income tax simplification provisions

Various measures are also observed in countries to reduce the compliance requirements on small business of (self-assessed) regular income tax, in support of the creation and tax compliance of small businesses, including: exempting firms with turnover under a small business threshold from regular income tax, replaced by some form of 'presumptive' tax; allowing cash accounting and other simplified accounting procedures; and less frequent filing requirements.

Consider first *replacement of regular income tax with a presumptive tax*. As in the case of VAT, allowing firms with turnover below some threshold level to opt out of the regular income tax system may be an effective means to reduce tax compliance costs and costs of tax administration. At the same time, strong arguments may apply to tax exempted firms with some simpler replacement tax, despite the compliance and administration costs that such a system could

entail. Aside from contributing to tax revenues and supporting good governance by aiming to include participation by all, including the very small, domestic businesses in the tax system, imposing a replacement tax may ease the transition of firms into a country's regular income tax regime when a small business turnover threshold is crossed (and thereby encourage continued participation in the formal economy). Additionally, to the extent that the economic incidence of regular income tax falls on business owners, providing an income tax exemption for firms under a small business turnover threshold may place them at a competitive advantage relative to firms just over the same threshold. Non-neutral treatment implies welfare (efficiency) losses, and may encourage businesses over the threshold and subject to regular income tax to operate in the informal economy.

Presumptive tax bases and tax burdens may differ significantly from those under a regular income tax, to a greater or lesser extent depending on the type of presumptive tax and its design features (and the taxpayer's profit position), with examples including: a patent, an indicator-based tax, a gross-basis turnover tax, and a net (adjusted) turnover tax. A common form of presumptive tax is a turnover tax, levied on gross revenues. Unlike a patent or indicator-based tax, a turnover tax varies directly with firm size measured by turnover, and thus goes some way towards avoiding the competitive distortions of profit-insensitive taxes. However, turnover taxes impose a relatively low effective tax rate on businesses that are more profitable than others. Thus turnover tax, in addition to imposing a higher tax burden on less efficient firms, would tend to discourage the allocation of capital to business activities where profit margins are relatively thin.

Turnover taxes may be applied to firms gross revenue below a small business threshold using a single flat rate or a tiered rate schedule, and may be uniformly applied or vary by type of business sector. While introducing some degree of complexity, one potential advantage of a tiered rate structure that applies a relatively low rate on low turnover, is encouraging tax compliance amongst young start-up firms. Low compliance costs under a turnover tax, together with a relatively low tax rate on low turnover in initial years, may provide an effective combination to encourage participation in the tax system. Once in the system, firms may decide to remain operating in the formal economy, a decision encouraged where the top tax rate of a tiered rate structure is set to avoid, on average, large upward adjustments in tax burden when the small business threshold is crossed.

Given that a tax based on turnover tends to impose a higher tax rate on profits of businesses with low profit margins, some countries apply reduced tax rates to turnover of businesses in sectors where profit rates on average are relatively low. With sector differentiation, complexity may be contained by applying a flat rate rather than tiered rate schedule, with the rate set lower (higher) in sectors where profit margins on average are lower (higher). Under a flat rate system, with variable flat rates across sectors, the effects of a graduated (tiered) rate structure to encourage tax compliance amongst start-ups may be introduced by relying on standard deductions from the turnover base.

In addition to providing a better proxy to income than patent and indicator-based taxes, with a turnover tax base going some way towards avoiding competitive distortions of profit-insensitive taxes, turnover taxes also facilitate the adjustment of firms to a regular income tax system by

requiring the maintenance of cash accounts measuring turnover. And, as with other presumptive taxes, by reducing tax compliance costs (and possibly reducing for some firms tax liability), small business creation and compliance with the tax system is encouraged.[16]

Another approach is *simplified cash (rather than accrual) accounting* for small firms. Cash accounting systems targeted at SMEs, determining taxable profit based on entries of revenues actually received and costs actually incurred (including immediate expensing of capital purchases), may significantly reduce compliance costs, to a degree depending on the additional supporting documentation that taxpayers are required to assemble and maintain. Other simplification measures may include simplified book-keeping requirements.

As in the case of VAT, *less frequent filing requirements for income tax* (typically with a small business test based on taxable turnover in the prior year) may reduce tax compliance costs while at the same time provide a cash-flow advantages to small firms. Most countries require (large) firms to submit business income tax returns on a monthly basis. Where small firms are allowed to report less frequently, for example quarterly, semi-annually or annually, compliance costs may be significantly reduced. Cash-flow savings realized by less frequent payments of tax may be viewed as a form of subsidy to help defray remaining compliance costs.

Lastly, the report briefly reviews simplification provisions in relation to payroll deductions, where SMEs are required to withhold social security contributions and/or income tax on wages paid to employees. Other simplification measures of particular benefit to SMEs, including the wider use of information technologies to assist taxpayers in understanding and complying with the tax system, are also briefly discussed.

[16] Whether a turnover tax reduces the tax liability of a small business, relative to that under regular income tax, depends on the specific design features of both taxes, and the level of turnover and profit (or loss) of the business (including the flexibility of business loss provisions of the regular income tax).