

## Executive Summary

This report considers findings of a study 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 this report is to present, discuss and analyse 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 17-19 October 2007 International Tax Dialogue (ITD) conference on *Taxation of Small and Medium Enterprises*.

Responses to the SME tax questionnaire 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 UK and the US. As outlined below, in addition to reporting detailed information for these 20 countries, the paper 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.

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### *Characteristics of SMEs*

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Chapter 1 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. Perhaps then not surprisingly, SMEs typically also account for the bulk of employment. The predominance of SMEs serves to heighten interest in ensuring that tax rules 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.

The prevalence of firms in a tax-loss position is also shown 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 recognised 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.

Finally, 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 unincorporated business. 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 on reinvested profits of growth-oriented firms.

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### *Income taxation of SMEs*

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Chapter 2 reviews income taxation of SMEs in OECD countries, where taxable income thresholds, tax rates, and levels of taxation depend on business structure. 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 chapter 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.

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. 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 different marginal rates and different thresholds.

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 an owner/worker in an SME. (Social security contribution systems are not considered as part of this analysis, but are included in average tax rate calculations for selected countries in Chapter 3.) 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, recognising 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.

For a top PIT rate taxpayer, differences in the overall income tax rate on unincorporated *versus* incorporated business income arise where the tax rate on capital income differs between the two cases. For countries with non-dual income tax systems, differences arise where the combined average corporate plus top personal tax rate on distributed corporate profits differs from the top personal income tax rate on self-employment income. For dual income tax systems, the relevant comparison is with the flat rate applied to prescribed capital income of an unincorporated business.

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.

Looking first at the 19 countries with a flat CIT rate structure, for mature firms ASTR differences are shown (of varying magnitudes) favouring incorporation in eight countries, discouraging incorporation in seven, with four countries found to be neutral (three due to full imputation systems, one through exempting dividend income and aligning corporate and top PIT rates). For high-growth firms, ASTR differences favour incorporation in 16 of 19 countries, discourage incorporation in one country, and are neutral in two. Turning to the 11 countries with tiered CIT rate structures, illustrative ASTRs are provided for corporate profits equal to four-times average earnings in the respective country. In the mature firm case, incorporation provides a lower ASTR in five countries, and a higher ASTR discouraging incorporation in five (although the concessionary small business tax rates are generally found to reduce the bias against incorporation), with neutrality found in one country (with a dividend tax credit fully offsetting corporate tax). For high-growth firms, an ASTR difference favouring incorporation is found in all 11 countries.

The preceding results for polar cases (immediate distribution *vs.* indefinite retention) may be generalised. 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 statutory tax rates (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 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. 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 should be noted 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, 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, 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 SSC and consider only the case of top PIT rate investors. These two assumptions are relaxed in Chapter 3 of the paper.

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*Tax distortions to SME creation, business structure and growth*

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Chapter 3 comprises four country case studies that examine possible tax distortions created by personal and corporate income taxation and social security contributions (SSC) in influencing two decision margins: 1) the decision to move from dependent employment to establishing a business (whether incorporated or unincorporated); and 2) the decision to structure an SME in incorporated or unincorporated form. The first is relevant for SME creation, while the second is particularly relevant for SME growth if it is accepted that in many, if not most, cases the incorporated form is the preferable legal form for a business to gain sufficient outside capital to develop and grow.

The analysis adds to that in Chapter 2 by introducing social security contributions, where contribution rates, base and thresholds may differ by business form. Unlike the analysis in Chapter 2 that considers a top PIT rate investor, the taxpayer considered in this chapter is assumed to have no other sources of taxable income, so the entire personal tax rate schedule is applicable in determining ASTRs. The countries considered are: New Zealand,

Norway, Sweden and the UK. The analysis of possible tax distortions is based on calculating and comparing “all-in” ASTRs (corporate and personal income tax, plus social security contributions) for a hypothetical individual taxpayer who provides both labour and capital inputs to derive income in one of three ways: as a dependent employee; as a single owner/worker of an unincorporated business; and as a single owner/worker of an incorporated business. If in business, the individual is assumed to have no employees. The calculations assume that the individual is single with no dependents.

The tax burden of the hypothetical taxpayer will vary depending on three key factors that need to be controlled for: the amount of income earned; the relative contributions of labour and capital inputs in deriving the income (which may vary significantly by type of business activity, and may be able to be manipulated), and dividend distribution policy. To take account these factors, ASTRs are provided for fixed income levels, differing levels of capital income (as a proportion of total income), and differing dividend distribution policies. As with the analysis in Chapter 2, the fixed income levels are 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.)

While the case studies are both country specific and based on a number of assumptions, the illustrative results demonstrate the potential for tax to influence both decisions over whether to create an SME, and how to structure one, and also how these decisions depend on capital *versus* labour intensity. In two of the four case studies (Sweden and the UK) a tax distortion is found towards formation of an SME at most capital income proportions, irrespective of dividend distribution policy. For the other two (New Zealand and Norway), the potential distortion varies with both distribution policy and capital intensity. However, a tax incentive to form an incorporated SME is found in both countries where a significant fraction of corporate profits is retained, and where the business is not highly capital intensive.

As regards the SME business structure decision, the case studies show a general bias towards incorporation with full retention of profits (as with the general trend in the income tax analysis in Chapter 2). This is largely because incorporation tends to reduce SSC, and avoids possible additional taxation of capital income on distribution. Even with some distribution of profits, the incorporated form is still generally favoured in the UK, New Zealand and Norway. Sweden is the clear exception, where the ability to both retain unincorporated business income within the business, as well as have distributed income split into both capital and labour components, make the unincorporated form attractive from a tax perspective.

More broadly, the case studies also show that the capital income proportion can substantially influence the ASTR faced by an SME. In general, for the UK, Sweden and Norway, ASTRs fall as the capital income proportion increases, while in New Zealand there is a range of capital income proportions over which the ASTR is minimised. This raises two policy considerations for tax policy makers to be aware of, in addition to the possible distortions to business creation and structure decisions. First, taxpayers may have an incentive to shift production structures (*e.g.* capital/labour mix) towards factor combinations that are tax favoured but possibly not production efficient.

Second, taxpayers may have an incentive to artificially recharacterise (generally to increase) their true capital income proportions to minimise tax liability. 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. This could be

achieved by, for example, the owner/worker paying him/herself a below/above-market wage for their labour input. Audit activity would be expected to prevent gross recharacterisation away from true ratios, but may not detect small alterations.

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### Tax incentives for SMEs

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Chapter 4 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; and country examples of tax incentives to encourage SME investment based on the SME tax questionnaire responses. As noted in Chapter 1, 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.

Advocates of special tax incentives for SMEs often rely on “*market failure*” arguments. These may be based on assumptions of positive spillover benefits to society of SME investment not taken into account by private investors (leading to under-investment), or 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 may 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.

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

Where certain factors including possibly government policy (*e.g.* financial markets policy) act to impede 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.

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. In this context the following provisions are considered: the double taxation of corporate profits and implied cost of capital effects for SMEs; the inability to deduct interest expense (for business start-ups unable to access debt financing); limited loss offset provisions that may discourage risk-taking; cross-border tax planning opportunities limited to multinational firms; a relatively high compliance burden on SMEs; and taxation on sale or inheritance of an SME.

Depending on country circumstances, adjustments to such 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. For example, scope may exist to reduce double taxation, by moving further towards integration of corporate and personal taxation, or to expand accessibility to one or more flow-through vehicles. At the same time, however, possible adjustments may be very limited, depending on the particular country and tax system in question. 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 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. However, the considerable measurement and targeting uncertainties and difficulties discussed above would again arise.

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#### *SME tax compliance cost and simplification provisions*

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Chapter 5 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. 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. Compliance costs typically have a significant fixed cost component, and so tend to impose a relatively higher burden on SMEs than larger businesses. 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 compliance costs are difficult to measure, a number of comprehensive studies may be found. As a broad finding, such studies systematically conclude that while total business tax compliance costs tend to be higher for large companies, as a percentage of sales they are significantly higher for SMEs. 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.

The paper discusses provisions of VAT and income tax systems targeted at small businesses to simplify their compliance requirements and thereby lower their tax compliance costs – that is, lower the amount of time and resources required by firms to comply with the tax system (aside from their tax liability). Depending on design features, simplification measures may not only lower tax compliance costs; certain measures may also provide small businesses with the additional cost savings of reduced tax payments to government. With or without this additional cost savings, reduced tax compliance costs encourage increased SME creation and compliance with a tax system.

A number of approaches may be taken to reduce VAT compliance costs, with the SME tax 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 for small firms; and allowing less frequent filing of VAT returns for small firms.

Various measures are also observed in countries to reduce the compliance requirements on small businesses 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 small firms to adopt cash accounting and other simplified accounting procedures; and less frequent filing requirements for small firms.

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 analyse 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 with tax rules.

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.