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*Implications of tax policy
for SME growth and tax compliance*

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IMPLICATIONS OF TAX POLICY FOR SME GROWTH AND TAX COMPLIANCE

A. Introduction

1. This ‘issues paper’ provides a review of possible implications of tax policy for the creation and growth of small and medium-sized enterprises (SMEs).¹ Policy attention given to this area – including reviews of features of tax systems to ensure that they are not impeding to SMEs, and consideration of special tax provisions to assist SMEs – may be traced to the large number of (unincorporated and incorporated) SMEs operating in an economy, relative to the total number of businesses. Particular interest may be directed at business start-ups and SME growth, given the potential for net job creation. As innovative SMEs with growth potential may be perceived by investors as high risk compared to established ‘mature’ firms, special attention may be given to effects of tax policy on risk-taking, both on the part of entrepreneurs and other possible sources of equity capital.

2. A main objective of the paper is to highlight possible tax distortions to various decisions relevant to SME creation and growth (as well as tax compliance), created by basic structural tax design features (e.g. tax treatment of unincorporated business income; taxation of corporate profits, dividends and capital gains; social security contributions; and the treatment of losses) and administrative practices in OECD countries.² It is hoped that this will provide a useful initial basis for considering what possible structural features and/or targeted measures might be considered to address non-neutralities facing SMEs. While certain special provisions are noted as examples of targeted measures to encourage SME development and tax compliance, the review of such provisions is not exhaustive.

3. The paper also addresses SME tax evasion, ranging from the underreporting or misreporting of taxable income, to the shifting of the operation of a business to the hidden or ‘underground’ economy outside the tax net. As SME tax evasion poses a number of serious problems to tax systems based on voluntary compliance, and inhibits economic growth more generally, a key policy consideration is how tax policies and tax administration may influence tax compliance incentives and behaviour.

4. Section B begins with a review of possible tax distortions (tax impediments or incentives) to the creation of a business in *unincorporated* business form, taking employment with an established business as an entrepreneur’s alternative choice. In the discussion of tax burden comparisons focusing on statutory provisions (with compliance cost considerations addressed in section D), attention is paid to the tax treatment of both labour and capital income under the two options. Drawing on section B, section C

¹ SMEs may be defined in relation to the size of total assets, turnover, income, payroll, or some other measure, with different measures and thresholds used across (and within) countries. Given the general discussion in the paper, a definition of SMEs is not adopted.

² This paper does not address various alternatives for fundamental tax reform, although such reforms could be usefully examined to consider how they might address non-neutralities particular to SMEs. The paper also does not address inheritance or estate tax (or capital gains tax at death), which may influence SME growth decisions. For a discussion of the later, see *Taxation of Capital Gains of Individuals—Policy Considerations and Approaches*, *OECD Tax Policy Studies* No.14, 2006.

addresses possible tax distortions to the choice of business form – incorporated versus unincorporated – where this distortion may depend on the tax position of the firm (e.g. loss making in early years). Section C also reviews possible tax distortions to the creation of a business in *incorporated* business form which may be attractive based on non-tax (and possibly tax) considerations.

5. In addition to considering differences in the statutory tax burden on labour and capital income when deciding between an unincorporated business, an incorporated business, or employment with another firm, entrepreneurs can be expected to also factor in compliance costs under different scenarios. Section D considers potentially impeding effects on SME creation of tax compliance costs – that is, costs associated involved in the understanding of tax rules, maintaining records for tax purposes, filing tax returns, and other tax compliance requirements. Such costs may be substantial, in particular when starting-up a business and confronting business compliance requirements for the first time. While a number of detailed studies examining compliance costs have been undertaken in recent years, measurement difficulties persist and observations other than broad generalisations are difficult to make and include in an overview paper.

6. Section E reviews possible tax impediments to SME financing, with a focus on basic (structural) personal and corporate income tax provisions. The review considers possible impediments introduced by classical shareholder taxation of distributed profit and capital gains, corporate-level taxation of retained earnings at the basic (full) corporate tax rate, preferential tax treatment of alternative investments, as well as negative experience with certain tax preferences targeted to encourage SME financing. A selection of targeted tax provisions are noted that have been implemented in practice to offset possible non-tax related or tax driven impediments to SME financing. The review is not exhaustive, but selective, with the aim of identifying issues for consideration.

7. Section F considers the tax treatment of business losses and capital losses, raising questions over the degree and method of loss offset, recognizing that restrictive provisions may protect revenues but at the same time may impede investment in high-risk, high-growth potential SMEs. As high-growth potential SMEs may be a category of business that policy-makers would not wish to impede, it may be that this area of tax policy is especially important in the policy debate.

8. Section G addresses SME tax evasion, where evasion incentives on the part of SMEs would be expected to factor in statutory tax burden and compliance tax burden considerations raised in sections B, C and D. Aside from certain fundamental changes to tax systems that might be considered to contain SME tax evasion (e.g. adoption of a non-dual tax system), governments may wish consider steps to reduce the compliance burden and possibly the statutory tax burden on SMEs (as well as possibly increasing fines for tax evasion). Certain difficulties encountered with possible steps (e.g. increasing the VAT exemption threshold) are briefly noted.

B. Possible Tax Distortions to Business Creation

9. This section considers possible tax distortions arising from basic (structural) tax provisions to the creation or ‘start-up’ of an enterprise in *unincorporated business form*. Where a policy objective is to avoid distortions (impediments or incentives) to an individual’s decision over whether to be an employee of an established business owned/controlled by others, or to establish and work for a newly created company, then the identification of possible tax distortions is obviously required. Where government wishes to instead take an active role in encouraging business creation, then an assessment of possible tax

impediments to business start-ups in unincorporated business form (sole proprietorship, partnership) would also be in order.³

10. In principle, possible tax distortions to the creation of an unincorporated business may be identified by comparing the overall statutory plus compliance tax burden faced by an individual when employed by an established firm, versus the statutory and compliance burden when self-employed. If the overall tax burden under self-employment is assessed to be relatively high, then new business creation may be deterred. If the tax burden under self-employment is relatively low, then business creation may be encouraged.⁴

11. In comparing statutory tax burdens to identify possible tax distortions to business creation, relevant considerations include not only differences in the tax burden on labour income (set by personal income tax and social security contributions) under self-employment, versus employment, but also differences in the tax burden on income from capital which may vary widely depending on the type of savings vehicle.⁵ This recognizes that a decision to become self-employed often involves – and indeed may require – the allocation of all or a significant portion of an entrepreneur’s savings to his/her business, as opposed to other personal assets (e.g. housing, pension schemes, shares of mature firms, offshore funds) where tax considerations may play an important role in shaping after-tax rates of return.

12. Tax rules may impede the creation or ‘start-up’ of SMEs where the average effective tax rate on income from labour and capital employed in an unincorporated business is higher than that under the employment option, where savings may be placed in alternative assets receiving preferential tax treatment.⁶ In an average effective tax rate comparison, the main provisions in most OECD countries pertaining to labour income are personal income tax and social security contribution rules, with the latter introducing possible distortions depending on employee, employer and self-employment contribution rates (and thresholds), and the degree to which employer contributions under the employment option are factored in (incidence question). Consideration of the taxation of capital income introduces further scope for tax distortions to business creation, depending on alternative savings options and the tax treatment of returns on investment. Personal tax considerations may also include the discouraging effects to business creation of a progressive income tax rate structure applied to a possibly more variable (fluctuating) income stream with self-employment.

13. The calculation of average effective tax rates on labour and capital income for a given individual (or household) taxpayer case, under employment and separately under self-employment, would factor in personal allowances, credits and other (standard and non-standard) relief provisions. Where these

³ Similarly, policy makers may wish to address possible impediments to the creation of a business in incorporated form, and/or ensure that the tax system does not favour one form of business organisation (incorporated versus unincorporated) over the other. These issues are explored in section C.

⁴ The choice of whether to evade tax (operate a business inside or outside the law) would depend in theory on an assessment of the relative net benefits (benefits less costs) of non-compliance, alongside other factors (e.g. perceptions of the quality and strength of public governance, the degree of efficiency in the expenditure of public funds, individual risk-aversion). These issues are relevant to the discussion in section G examining SME tax evasion.

⁵ This section addresses tax liabilities arising from statutory provisions. Section D considers compliance costs – that is, additional costs associated with understanding statutory provisions, record keeping, filing returns, etc.

⁶ In comparing the statutory tax burden on labour and capital income under self-employment versus employment, the assessment would involve calculating the total amount of tax (PIT+SSC) on a discrete amount of labour and capital income, measured as a percentage of gross labour and capital income (an *average* tax rate calculation). As a number of savings vehicles are available under the employment option, a series of average tax rate comparisons may be made.

provisions apply equally to offset taxable income/tax payable under employment versus self-employment, they generally would not influence a tax burden comparison and behavioural decision. Such comparisons would of course need to take into account any special tax provisions in the system targeted at (unincorporated) SMEs.

14. The discussion in this section considering the statutory tax burden on income under employment versus self-employment assumes the latter generates positive taxable income. Also critically important to consider is the tax treatment of business losses (e.g. carry-forward/back rules, scope for setting business losses against personal income), recognizing that profits for certain SMEs will be cyclical, and that many if not most SMEs will be in a loss position over an initial 'start-up' period. Consideration of issues associated with the tax treatment of business losses are examined in section F on taxation and risk-taking.

15. The review in this section of tax burden comparisons addresses the case where taxable income is accurately and fully reported. As addressed in section G, various tax evasion schemes may be used to underreport or mischaracterize taxable business profit (e.g. by reporting labour income as capital income), which have the result of lowering taxable income below levels implied by statutory provisions and true (accurate) labour and capital income amounts. Issues concerning SME creation driven by tax evasion possibilities are considered separately in section G.

1. Statutory tax burden on labour income

16. In most OECD tax systems, wage or salary income from employment is subject to personal income tax (PIT) levied at progressive rates, and to an employee social security contribution (SSC^{ee}) levied at a flat or tiered rate up to some threshold labour income level.⁷ These amounts may be withheld at source by the employer, or paid through self-assessment and individual filing of returns. In either case, the statutory tax burden on labour income from employment would include these amounts (PIT+SSC^{ee}). The effective statutory tax burden on labour income for an individual may also include an amount linked to the employer social security contribution (SSC^{er}) on labour income. This recognizes that the gross wage/salary paid to employees may be lower as a result of this tax charged to employers, with the degree of shifting-back onto gross wages/salaries of this tax dependent on a number of factors (e.g. the bargaining strength of employees, the profit position of the employer). The effective statutory tax burden on labour income is uncertain to the extent that the incidence of the SSC^{er} is uncertain.

17. Income from self-employed business activity (in unincorporated business form) comprises a return on labour and capital, with the capital component equal to some rate of return on the (beginning-of-period) stock of savings invested in the business by the entrepreneur.⁸ Under most non-dual tax systems, self-employed business income would be subject to PIT at progressive rates, and to a self-employment social security contribution (SSC^{self}) levied at a flat or tiered tax rate up to some threshold level, where the contribution rate (and in some systems the threshold) may differ from the corresponding measure in the employment case. In general, differences in contribution rates (SSC^{self} versus SSC^{ee} plus some portion of SSC^{er}) reflect differences in tax base (combined return on labour and capital in the self-employment case, versus labour income in the employment case), and possibly different social security entitlements.

⁷ Social security systems typically include a number of plans (e.g. health care, old age security, disability) levied on labour income at different rates and possibly different thresholds/limits. Where this is the case, the combined social security contribution rate (for employees, employers, the self-employed) will be tiered.

⁸ The actual or true rate of return on capital invested by an entrepreneur in his/her unincorporated business is generally unobservable. In principle, this return is the total net income of the business, less the wage/salary that compensates the entrepreneur for his/her labour input (i.e. the wage that could be earned by providing the same labour input to an unrelated company).

18. Under dual income tax systems, the return on self-employed business activity is decomposed into a notional return on capital (determined by a fixed rate of return applied to invested capital), and a residual return on labour. Under this separation, the labour component of self-employment income may be taxed at progressive rates, including a personal income tax (PIT) and a social security contribution (SSC^{self}) component. In accordance with the intention of a dual income tax, the notional capital income component is taxed at a separate relatively low (flat) personal tax rate (the dual tax rate on capital income).

19. A possibly important difference between the statutory tax burden under self-employment versus employment concerns social security contributions where considerations include contribution rates, income thresholds, and tax incidence. Under the employment option, the employer social security contribution (SSC^{er}) may not be factored into a tax burden comparison by potential entrepreneurs, as the percentage of this tax borne by an employee (through reductions to gross wages) is generally uncertain, as noted above. In contrast, the self-employed social security contribution (SSC^{self}) would likely be fully factored in by the owner/worker of an unincorporated business. Whether this tax is discouraging to self-employment would depend on the rates and thresholds of the SSC^{self} charge, in comparison to the rates and thresholds of SSC^{ee} plus SSC^{er} , and the degree to which the later charge is factored in by an employee.

20. The preceding discussion assumes that in each case social security contributions are regarded as a tax, not directly related to social security benefits received. Where social security contributions are actuarially fair and are recognized as being so, they may not factor into tax burden comparisons in the way outlined above. The comparison is obviously more complicated where (all or certain) social security contributions are partially actuarially fair, so that they are factored in, but only in part. This consideration highlights the country case-specific nature of the tax burden comparison (which in principle should take into account whether individuals are likely to be aware of the contribution/benefits linkage).

21. A further consideration is that self-employed individuals may be provided with greater scope to claim tax deductions for expenses related to earning labour income. Where allowable deductions for an employee are restrictive compared to those available for the self-employed, a tax bias would be created favouring self-employment. Conversely, where the tax system does not adequately provide for deductions for expenses incurred in operating a business, tax distortions may result in the other direction.

22. These considerations relating to the tax treatment of labour income, together with those relating to the tax treatment of capital income (as elaborated below) would be incorporated (in principle) into an overall assessment of the average effective tax rate on labour and capital income under employment versus self-employment. An average (as opposed to marginal) tax rate calculation is appropriate, under the assumption of a decision involving a discrete choice between employment or self-employment. Main tax considerations raised in this section and the next are summarized in Table 1.

2. *Statutory tax burden on capital income*

23. A comprehensive assessment of possible tax distortions to business creation would consider distortions arising on account of tax rules applied to income from capital. As noted above, where an individual considers establishing a business, the financing of the business may involve or require the allocation of one's own personal savings towards the purchase of business assets used to begin a business, as well as net income from the business that is reinvested in the business as it develops. The statutory tax burden on returns on savings so invested would depend, as noted above, on personal income tax and social security contributions assessed on combined capital and labour income from self-employment (non-dual income tax). Under a dual income tax where self-employed social security contributions are assessed on labour income only, the statutory tax burden on capital income is determined solely by personal income tax provisions.

Table 1

Possible Differences in the Statutory Tax Burden on Labour and Capital
(employment versus self-employment versus incorporated business)

Tax system	Employment (E)	Self-employment (S)	Incorporated business (I) of owner/worker
pre-tax income to worker/investor	W-C _L = labour income R ^B = investment income	Y-C _L -C _K = return on labour and capital	Y-C _L -C _K = return on labour and capital
CIT	NA	NA	$u(Y-W^I-\beta^I C_K)$
non-dual PIT	$m(W+\lambda R^B-\alpha^E C_L-A)$	$m(Y-\alpha^S C_L-\beta^S C_K-A)$	$m(W^I-\alpha^I C_L-A)+\theta m((Y-W^I-C_L-C_K)-u(Y-W^I-\beta^I C_K))$
SSC	$(t^{ee}+\gamma t^{er})(W-X)$	$t^{self}(Y-Z)$	a) $(t^{ee}+t^{er})(W^I-X^I)$ b) $t^{self}(Y-Z)$
dual PIT	$m^L(W-\alpha^E C_L-A)+m^K(\lambda R^B)$	$m^L(W^{SN}-\alpha^S C_L-A)+m^K(R^{SN})$ where $W^{SN}=Y-R^{SN}$	$m^L(W^I-\alpha^I C_L-A)+\theta m^K((Y-W^I-C_L-C_K)-u(Y-W^I-\beta^I C_K))$
SSC	$(t^{ee}+\gamma t^{er})(W-X)$	$t^{self/dual}(W^{SN}-Z^{dual})$	a) $(t^{ee}+t^{er})(W^I-X)$ b) $t^{self/dual}(W^I-Z^{dual})$
	Variable definition W=gross wage/salary income C _L =costs incurred in earning labour income R ^B =investment income (e.g. on offshore funds) λ=inclusion rate for investment income (e.g. on offshore funds) α ^E =deductible portion of C _L under employment option A=PIT allowance m=PIT rate schedule m ^L =PIT rate schedule for labour income (dual system) m ^K =PIT rate for capital income (dual system) t ^{ee} =employee SSC rate schedule t ^{er} =employer SSC rate schedule γ=fraction of employer SSC shifted-back onto wages X=SSC threshold (employee and employer)	Variable definition Y=gross revenue from self-employment C _L =costs incurred in providing labour services C _K =capital costs (including actual depreciation) α ^S =deductible portion of C _L under self-employment option β ^S =deductible portion of C _K under self-employment option A=PIT allowance W ^{SN} =Y-R ^{SN} =notional labour income component of Y R ^{SN} =notional capital income component of Y m=PIT rate schedule m ^L =PIT rate schedule for labour income (dual system) m ^K =PIT rate for capital income (dual system) t ^{self} =self-employed SSC rate schedule Z=SSC threshold (self-employed) t ^{self/dual} =self-employed SSC rate schedule under dual system Z ^{dual} =SSC threshold (self-employed, under dual system))	Variable definition Y=gross revenue at corporate level W ^I =wage income reported for tax purposes C _K =capital costs (including actual depreciation) β ^I =deductible portion of C _K at corporate level u=CIT rate C _L =costs incurred in providing labour services α ^I =deductible portion of C _L of employee (also owner) A=PIT allowance θ=PIT tax deferral adjustment parameter m=PIT rate schedule m ^L =PIT rate schedule for labour income (dual system) m ^K =PIT rate for capital income (dual system) t ^{ee} /t ^{er} /t ^{self} =employee/employer/self-employed SSC rate schedule X=SSC threshold (employee and employer) Z/Z ^{dual} =SSC threshold (self-employed, dual/non-dual)

Table 1 (cont'd)

Possible Differences in the Statutory Tax Burden on Labour and Capital
(employment versus self-employment versus incorporated business)

Potential sources of differences in tax burden on labour and capital under employment, versus self-employment, versus incorporated business

1. Variable self-employment income compared to employment income, leading to higher tax burden under self-employment, assuming a progressive rate structure (ignoring possible income averaging rules).
2. Preferential treatment of investment income under employment (e.g. where inclusion rate λ is low).
3. More extensive personal tax deductions under self-employment (e.g. where α^S exceeds α^E).
4. Social security contribution under employment differs from that under self-employment (e.g. due to differences between $(t^{ee}+t^{er})$ and t^{self} , partial factoring in of t^{er} , differences in base (W versus Y), different thresholds (X versus Z).
5. Relatively low taxation of capital income with incorporated business where CIT rate u is well below PIT rates), combined with ability to defer PIT on dividends/capital gains.
6. Differences in deductible portion of capital costs under self-employment versus incorporated business (although similar in many systems).
7. Possibility to mischaracterize wage income with incorporated business (reported wage income W^I differs from true W) – tax savings where CIT rate is less than PIT plus SSC rate on labour income.

24. In general, the creation of a business may be less attractive where saving in one's own business means not allocating savings to other assets receiving preferential tax treatment.⁹ For example, the tax system may encourage savings in a principal residence by providing a mortgage interest deduction, while at the same time not taxing individuals on the imputed rent on owner-occupied housing. While preferential tax treatment of a principle residence may operate to encourage home ownership, it may at the same time discourage business start-up and the possible benefits that SME creation might provide (e.g. increased labour demand).

25. Similarly, private pensions may be a relatively attractive savings option. Savers may be attracted to up-front personal tax relief under EET treatment (providing a personal deduction for amounts invested up to some limit, exempt treatment of profits realized at the pension fund level and personal taxation of income withdrawn from the fund), which may be supplemented with other personal tax relief to encourage individuals to save for retirement. Tax preferences may also exist for saving through other institutional investors (e.g. insurance companies).

26. To take another example, placing savings in shares of large mature companies with extensive foreign operations may be attractive to individuals, relative to establishing an SME with only domestic operations, where the tax system provides for low (combined corporate and personal) effective tax rates on foreign source income. Such provisions could include exempt treatment at the corporate level of dividends and capital gains on foreign shares, with low/minimal taxation at source, combined with realization-based capital gains taxation at the shareholder level. Tax advantages to investing in shares of large MNEs may be strengthened with the absence (or limited application) of controlled foreign company rules (i.e. anti-deferral/exemption rules), income conversion possibilities, unrestricted domestic interest deductions for borrowed funds used to finance foreign direct investment, as well as other tax advantages.

27. Similarly, investing in offshore mutual funds or personal holding companies located in tax havens may be attractive to an individual saver, relative to establishing a domestic SME subject to domestic tax, where scope is available to avoid tax on offshore investment (e.g. in the absence of effective domestic anti-abuse rules (e.g. foreign personal holding company rules)).

C. Possible Tax Distortions to Business Incorporation

28. Taxation may distort (discourage or encourage) decisions over business creation in incorporated form where the tax burden on labour and capital income, realized by the owner/worker of an incorporated company, differs from that in employment, taking into account statutory and compliance considerations. Taxation may also distort the choice of legal form in which a business is organized – as an unincorporated business, or as an incorporated (legally separate) business entity.¹⁰ For example, for a self-employed individual, self-employed status may be attractive for tax reasons where a business is making losses and loss offset rules allow business losses to be claimed against personal income. Once the business becomes profitable, incorporation may be attractive if the effective tax rate on corporate profits is relatively low. These and other possible tax distortions to the 'employment versus incorporated business decision' and to the 'incorporated versus unincorporated business decision' are examined briefly below.¹¹ While it may be

⁹ While policies supporting preferential tax treatment of alternative savings vehicles may be judged appropriate when considered in isolation of the SME sector, an unintended outcome of such policies may be significant distortions in the tax system away from the creation (and growth) of SMEs. In principle, cost/benefit assessments of targeted provisions should consider effects on non-targeted activities.

¹⁰ While a number of alternative business forms may be legally possible in a given country for structuring SME ownership and assigning liability, a main distinction for tax purposes is between business forms where only individual income tax applies; and incorporated business forms where income tax applies at the corporate level and separately at the individual shareholder level. The first category generally includes sole proprietorships, and general and limited liability partnerships as well as other flow-through entities (including special flow-through corporations), where taxable income at the entity level is allocated to investors on a pro rata basis. This paper groups the first category (personal tax only) as 'unincorporated business', and the second category (corporate and personal taxation) as 'incorporated business'.

¹¹ Non-tax factors favouring unincorporated business form may include costs of registering a corporation, complying with corporate law and regulations, or the perception of less 'red-tape'. On the other hand, incorporation may offer limited liability, improved access to financing, and possibly other advantages.

more common for someone to first establish a business in an unincorporated form (and possibly later convert the business into a legally separate incorporated entity), in some cases it may be attractive for non-tax reasons to establish a business in incorporated form (e.g. to limit the liability of the owner to business risks). Tax-related reasons may also lead one to first consider incorporation (e.g. low corporate tax rate). Thus tax considerations to this possibly less common approach are also examined in this section.

29. The previous section B identifies provisions relevant to comparisons of the statutory tax burden on labour and capital income in the case of employment versus self-employment, where main distinctions include: i) the taxation of labour and capital income together as ‘self-employment business income’ under the unincorporated business option (with non-dual taxation), versus separate taxation of labour and capital income under the employment option; ii) possibly different social security contribution rates, thresholds, and incidence under alternative options; iii) the possibility under the employment option of savings in tax preferred instruments (e.g. housing, private pensions, MNEs with foreign assets, offshore mutual funds); and iv) under a dual tax system, taxation of the capital component of self-employed business income at a low separate rate (although possibly higher than the rate applied to returns on other savings (e.g. interest)).

30. A main distinction introduced when considering business incorporation is the scope for double taxation of business profit, first at the corporate level and then at the shareholder level. Double taxation may discourage the conversion of a profitable business to a corporation, depending upon the growth plans of the business and a comparison of tax rates. It may similarly discourage the creation of a business in incorporated form. A related issue introduced by business incorporation is the treatment of capital losses at the shareholder level on SME shares, examined in section F addressing risk-taking, and the inability under incorporated form to claim business losses against other personal income (possibly under self-employment loss rules in some countries). Also important to consider is the scope for owner/workers of incorporated SMEs to mischaracterize labour income as capital income under dual tax systems (and possibly non-dual tax systems) to reduce tax paid. Scope for income shifting may encourage business conversion to, as well as SME creation in, incorporated business form, albeit not in ways intended under tax rules. This consideration is addressed in section G discussing SME tax evasion.

1. Statutory tax burden on labour income

31. In comparing the tax burden on labour income when organizing a business in incorporated versus unincorporated business form, personal income tax and social security contributions would apply in both cases, with possible distortions arising from differences in the treatment of social security contributions of an owner/worker versus a worker than is self-employed (see Table 1).

32. Consider first personal tax on labour income under a non-dual system. With an unincorporated business, personal income tax would be levied on self-employment income, consisting of returns to labour and capital. With an incorporated business, personal tax would be levied on combined labour and capital income paid out separately, with an adjustment in some systems to avoid double taxation of the capital income component (as addressed below). The personal tax burden on a given amount of labour income would generally be the same or similar under the two business forms, assuming the same total amount of labour plus capital income from the business and similar deductions in respect of employment income in both cases. Similarly, under a dual income tax system where labour income is subject to personal income tax separately from capital income, both in the incorporated business case and unincorporated business case, generally the personal income tax burden on labour income would be the same.

33. Thus comparisons of the statutory tax burden on labour income may centre on applicable social security contribution rates, bases, and thresholds. Under a non-dual system, the charge to an entrepreneur would be determined by the rates and thresholds of the self-employed social security contribution (SSC^{self}) assessed on self-employed (combined labour and capital) business income. For an incorporated business, the social security contribution paid by an owner/worker consists in some countries of an employee and an employer component (SSC^{ee} and SSC^{er}) assessed on labour income, which may or may not equal the self-employed social security contribution (SSC^{self}) for a given amount of self-employed income. Differences

would depend on the rates and thresholds of these charges (SSC^{ee} , SSC^{er} and SSC^{self}), and the amount of capital income in self-employed business income.¹²

34. In certain other countries, an owner/worker is subject to the same social security contribution scheme as applies to the self-employed (SSC^{self}), which avoids possible tax distortions where the rates, thresholds and base (combined labour and capital income) are the same in both cases. Where a dual tax system applies and labour and capital income are split, so that contributions of the self-employed can be readily assessed on labour income, the scope for tax distortions is reduced. Indeed, the charges could be the same where the same rates and thresholds apply in both cases.

35. In considering possible differences between unincorporated and incorporated businesses in the tax burden on labour imposed by social security contributions, the question of incidence does not arise, as the incidence question is clear in both cases – that is, social security contributions of an entrepreneur paid in respect of his/her income fall on the SME owner (other than the portion shifted forward onto prices), whether the SME is incorporated or not.¹³

36. As noted in section B, the analysis is complicated where social security contributions bear some relation to social security benefits and therefore are not fully regarded as a tax. In this case, only the portion unrelated to benefits would be factored into tax burden comparisons, at least in principle (with presumably uncertainty on the part of individuals over the linkage between contributions and benefits).

37. A further consideration addressed further in section G, focusing on tax evasion, is that the tax burden on labour income may be artificially reduced where an owner/worker does not fully report as labour income the ‘true’ amount of labour income, either by retaining some fraction of this amount in the company, or distributing some fraction as dividend income (or both).¹⁴ The conversion of labour income into retained profit reduces tax paid where the statutory corporate tax rate is less than the combined personal income tax plus social security contribution rate on labour income.¹⁵ Tax savings are even greater where the firm is in a loss position, so that taxable wage income is converted into tax-free income.

38. The alternative income shifting approach of characterizing labour income as dividend income reduces tax where the combined corporate and personal income tax rate on dividend income is less than the personal income tax plus social security contribution tax on labour income.¹⁶ This is the case under most

¹² For a self-employed social security contribution of a given amount (SSC^{self}), the rate of tax on self-employed business income (determined by SSC^{self} divided by total self-employed business income) determines the rate of tax on labour income. Where the contribution amount SSC^{self} is not proportional to self-employment income (due to a tiered rate structure, thresholds), the contribution rate depends on the level of self-employment income and thus on the capital income amount.

¹³ As noted previously, under the employment option, the incidence of the employer social security contribution in general is unclear.

¹⁴ In principle, an owner/worker should report as labour income a wage/salary amount that would be paid to an arm’s length employee for the same amount and type of labour input as provided by the owner/worker. The true amount of labour income is underreported where some portion of this income amount is characterized as retained profit, or as dividend income.

¹⁵ Under the retention method of income shifting, earnings may be realized in the hands of the shareholder (e.g. to finance consumption), with tax savings compared to the alternative of receiving wages, where the shares are sold, if the combined statutory corporate tax rate and personal capital gains tax rate is less than the combined personal income tax plus social security contribution tax rate on labour income. This will typically be the case in dual tax systems, as well as non-dual tax systems where the statutory corporate tax rate is relatively low and personal capital tax does not apply or capital gains are only partially included in the capital gains tax base.

¹⁶ The combined corporate and personal tax rate on dividend income takes into account integration provisions. Under a dual income tax with full imputation system, the combined rate equals the low flat personal tax rate on capital income (with a full offset for corporate income tax). In some dual systems, this flat rate equals the statutory corporate tax rate.

dual income tax systems, where the effective tax rate on dividend income is generally well below the effective tax rate on labour income. Similarly, under non-dual tax systems, characterizing labour income as dividend income may provide tax relief (albeit less relief than under a dual income tax) where social security contributions are levied on labour income only (not capital income), as is the typical case.

39. Income shifting may be particularly attractive where labour income is taxed at progressive rates while capital income is taxed at a low flat rate, and the entrepreneur works hard to earn substantial but possibly variable income. In other words, the tax savings are larger, and thus potential income shifting incentives stronger, the higher is the effective tax rate on labour income relative to that on capital income (with a progressive rate structure tending to result in higher taxation for variable (as opposed to relatively constant) income).

40. Tax evasion including income shifting techniques noted above lower the statutory tax burden on labour for an owner/worker of an SME, relative to the tax burden of labour faced as an employee where personal income tax and social security contributions are withheld at source. Tax relief from evasion could be expected to encourage some individuals to create an SME for tax (alongside possibly other) reasons. Similarly, for salaried employees who file their tax returns individually, greater scope may be possible to evade tax on labour income through creating an SME and under-reporting labour income. However, while policy makers may be keen to support SME creation, they generally would not wish to accommodate SME creation through these channels, given the damaging effects to a tax system that tax avoidance creates. Moreover, where SME creation is motivated by tax avoidance reasons, rather than business reasons, it is less likely that the SME is growth-oriented. As noted previously, policy interest in providing tax relief to SMEs may centre on this latter group.

2. *Statutory tax burden on capital income*

41. A central consideration linked to the creation of a business in incorporated form is the scope for double taxation of business profit. In most countries, corporate profit is subject to corporate income tax.¹⁷ When distributed, after-tax profit is taxed again, subject to personal income tax or final withholding tax on dividend income. Retained after-tax profit may give rise to taxable capital gains on shares in the hands of individual shareholders, implying double taxation. In general, double taxation of corporate profit tends to discourage business incorporation at the time of the formation of a business, and along a development path. Given this, tax systems may have in place mechanisms to alleviate double taxation. At the same time, the possible tax distortion against incorporated business form where some degree of double taxation applies (under classical tax treatment or under an integrated system where relief is partial rather than full) may be expected to differ depending on the growth strategy (including investment and payout policy) of the firm.

42. The overall statutory tax burden on income from capital in an incorporated company depends on the effective corporate income tax rate, effective personal tax rates on dividends and capital gains, and the growth plans of an SME. For a growth-oriented SME, where the bulk of earnings are to be retained in a company to finance growth over an extended period so that future personal taxation of after-corporate-tax profits can be deferred for a long period and possibly avoided, the focus of an investor may be on the corporate tax burden alone.¹⁸

¹⁷ It may be noted that in some non-OECD countries (e.g. Estonia), corporate profits are not subject to corporate income tax. However, distributed corporate profits are subject to a dividend withholding tax.

¹⁸ Where business plans involve the retention of corporate profit to finance investment in business assets over a growth period, future dividend taxation may be discouraging to the injection of (new) equity capital, but not to the retention of earnings 'trapped' in the firm. Where dividend tax is avoided (e.g. through the eventual sale of a business), but capital gains on shares are subject to tax, personal taxation may only partially factor in with deferral of capital gains tax under a realization based system (possibly with rollover relief).

43. The effective corporate tax rate depends on tax depreciation rules and other main base provisions which in many countries mirror tax base provisions for unincorporated businesses.¹⁹ The effective corporate rate also depends critically on the statutory corporate tax rate applied to the base, which in many systems is below (in some cases well below) the top personal tax rate on ordinary income (e.g. interest) and self-employment income.²⁰ In contrast, with dual tax systems, the statutory corporate tax rate and the personal tax rate on capital income (e.g. interest) and on the capital component of self-employed business income may be comparable (low and in some cases equal), implying no distortion to business form operating through this channel.

44. Where instead SME development plans involve early dividend payout (or earnings realization through the sale of shares) and personal taxation applies, a key consideration is whether corporate and personal taxation of business income is integrated, and the degree to which double taxation is mitigated. Common integration provisions applying at the personal shareholder level include imputation credits giving partial (or full) credit for corporate tax paid on distributed income (less common for EU countries, given recent ECJ rulings requiring that such credits be extended to foreign EU shareholders), fixed dividend credits determined independently of corporate level tax, and partial inclusion of dividend income in the personal tax base. In general, the greater the degree of integration, the less pronounced would be the tax impediment to incorporation linked to the taxation of income from capital.

45. As regards the taxation of capital gains on the fraction of earnings retained in a company, double taxation is obviously avoided where capital gains tax is not imposed on gains on domestic shares. Where it is, partial relief from double taxation may be provided under a realization-based system that taxes gains when shares are sold, rather than as gains accrue, but this relief tends to be limited where an investor's plans include disposition of shares relatively early on after investment. In some systems, relief is provided by partial inclusion of capital gains, possibly with a holding period requirement, while in others double taxation is avoided by allowing shareholders to 'step-up' (increase) the basis of shares by their pro rata share of retained earnings.

46. For SMEs that are not growth-oriented, if integration relief avoids double taxation by fully offsetting corporate level tax, and the effective corporate and personal tax rate on corporate profit equals the personal tax rate on ordinary income, then in general tax distortions associated with classical treatment would not arise. Where integration is less than full, the tax system may discourage the creation of business in incorporated form.

47. Finally, as with the decision over establishing an unincorporated business, setting up an incorporated business may be discouraged where saving in one's own business means not allocating savings to other assets receiving preferential tax treatment. The more abundant and the richer the set of tax preferences attracting capital to other savings vehicles (e.g. principal residence, private pensions, MNEs, offshore funds), the more pronounced would be tax distortions discouraging SME creation.

¹⁹ Departures could include a dividend paid deduction (offsetting basic corporate income tax) as a mechanism to integrate corporate and shareholder-level taxation of incorporated business income and thereby avoid double taxation. However, integration measures, where in place, are typically found at the shareholder level (helping to maintain the role of corporate tax as a withholding device).

²⁰ A comparison with the personal income tax (PIT) rate on interest income is relevant where an individual compares the combined corporate plus personal tax rate on profit derived from an incorporated business, with the personal tax rate on interest income on savings invested in ordinary bonds under the employment option. Where profits are retained in a corporation and possible shareholder level tax is avoided, current taxation of corporate profits is limited to corporate income tax.

D. Tax Compliance Cost Considerations

48. In addition to comparisons of the statutory tax burden and implied tax liability, comparisons of the burden associated with complying with the tax system may be an important – and possibly a more important – tax consideration in the decision over whether to become self-employed. For many employees, personal income tax and social security contribution calculations are carried out by employers, with tax withheld at source, saving employees the time/cost associated with self-assessment, record keeping and tax payment. For other employees, these costs are met individually. However, the time/cost in completing and submitting tax returns may be low for an employee (although possibly more complicated with complex savings arrangements) relative to the compliance costs facing a self-employed individual, or the owner/worker of an incorporated company, which may grow as the complexity of the business operation expands.

49. Compliance costs 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. For example, in most countries, businesses must contend with a VAT system (unless the business falls under a VAT exemption threshold) not faced by an employee. Business income tax also introduces complexities not relevant to an employee that pays tax only on labour income and non-business investment income. Complexities may multiply where more than one level of government is involved in levying and/or administering a tax and rules and procedures are not well co-ordinated. Given differences across countries in the number and types of taxes on business, the complexity of the rules, and the levels of government involved, it is not surprising that compliance burden assessment is very much country specific and difficult to compare.

50. Compliance costs are difficult to measure (making difficult a comparison of the total tax burden), but certain comprehensive studies may be found. Recent studies of business compliance costs in the U.S. include Blumenthal and Slemrod (1992), Hall (1995), Slemrod (1996), and Slemrod and Venkatesh (2002). Studies by Ariff, Loh and Talib (1994), Ariff, Loh and Ismail (1997) and Chan, Cheung and Ariff (1999) consider business compliance costs in Hong Kong, Malaysia and Singapore. Pope (1995) and Sandford and Hasseldine (1992) study business compliance costs in Australia and New Zealand. 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. Another interesting finding is that tax-planning accounts for a larger proportion of total compliance cost for large firms.

51. 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 burden is high relative to large companies and relative to the tax compliance burden for payroll employees. This suggests that if the statutory tax burden on a given amount of labour and capital income is roughly the same for an employee as for a self-employed individual, then the higher compliance burden for the latter would mean that the tax system is non-neutral, tending to discourage SME creation.

52. Where this is the case, policy makers wishing greater neutrality might consider steps to lower the compliance burden on SMEs, lower the statutory tax burden on SMEs, and/or reduce the tax preferences for non-business assets. Depending on how the statutory tax burden on SMEs is lowered, this approach could be an attractive option (e.g. taken together with steps to reduce compliance costs directly) where tax impediments relating to basic statutory tax provisions are identified. To take an example, the introduction of an investment tax credit targeted at unincorporated SMEs may offset the discouraging effects of a relatively high marginal personal income tax plus employer social security contribution rate applied to self-employed business income, while at the same time reduce taxpayer resistance to a high compliance tax burden.

53. Addressing a high compliance tax burden directly may however be the most efficient action to take, particularly when there are reductions that could be realized at relatively low cost to government (e.g. streamlining of tax procedures, more clearly drafted legislation, more efficient tax administration, easier to

understand/more accessible tax information, better co-ordination of policy and administration at different levels of government, opportunities for electronic filing of tax returns, integrated payment systems).

54. In recognition of the relatively high tax compliance burden imposed on SMEs by a given set of tax rules and procedures, a number of countries allow SMEs to be taxed (or opt to be taxed) under a simplified tax structure (presumptive taxation), keep less detailed financial accounts, or file tax payments less frequently to reduce compliance costs. Such measures may not only reduce the compliance burden, but also the amount of tax paid. On either count, such an approach may encourage small business creation. VAT exemption thresholds, which exempt certain businesses from paying VAT, reduce both the tax burden on SMEs and their compliance burden. (The SME tax survey aims to gather national estimates of the revenue losses of various measures including VAT exemptions).

55. However, difficult trade-offs are confronted under different simplifying regimes. A key issue, for example, in VAT systems with exemption thresholds, is the appropriate (most efficient) threshold level. Reducing the compliance burden on SMEs with turnover below a threshold level would be expected to encourage the creation of SMEs by addressing the impediments of a high compliance burden. However, where the compliance burden increases significantly once a threshold level of income is exceeded, an unintended effect of such a measure would be discouraging SME growth beyond that point. Graduating a compliance tax burden is obviously more difficult than graduating a statutory tax burden, and likely to pose significant complexity, thus rubbing against the central intention of simplification measures. Thus a step increase in compliance costs tends to be the norm where thresholds are met, raising difficult questions over how to get the threshold level 'right'.

E. Possible Tax Impediments to SME Financing

56. Sections B and C review possible tax distortions to the labour and capital investment decisions of potential entrepreneurs. With this focus, consideration is given to the tax treatment of labour and capital income of an employee versus business owner/worker. This section considers possible taxation impediments to attracting external financing, including local equity investors, international or institutional investors, and venture capitalists. A number of tax considerations relevant to an entrepreneur's decision of whether to commit own funds to his/her business carry over and apply in the case of external finance. However, certain considerations raised below are particular to other potential investor groups, subject for example to different tax rules.

1. Classical shareholder taxation of distributed profit

57. For new business start-ups, particularly innovative firms whose main assets include intangible capital that may be difficult to value (due to limited secondary markets trading similar intangibles), equity capital tends to be a particularly important potential source of funds. Banks may be reluctant to lend where there is limited collateral to secure a loan, and where investment is not expected to generate revenues for a number of years. Given this, possible tax distortions to equity finance (e.g. linked to the double taxation of corporate profits) may be particularly problematic to the financing of SMEs.

a) increased cost of new equity finance

58. Under classical tax treatment of dividend income, distributed profits are subject to corporate and shareholder tax, implying double taxation of distributed profit. This stands in contrast to interest on debt finance, which is deductible (not subject to tax) at source. Double taxation of dividends is impeding to SMEs where it increases the required rate of return on (that is, the cost of) new equity finance. This result is more likely for SMEs where domestic investors are the most important potential marginal providers of finance (unlike MNEs with access to international capital markets where shareholder-level tax may not factor in).

b) corporate lock-in effects

59. In addition to increasing the cost of equity finance raised from local investors, double taxation of dividends may impede SME financing to the extent that it encourages mature (established) companies to retain rather than distribute profits in order to avoid dividend taxation, and where individual shareholders (e.g. local investors) are more inclined to invest in SME shares than mature companies. While certain theories including the ‘new view’ of dividend taxation suggest that dividend taxation (where held fixed at a given rate) should not affect the timing of dividend payments, it may be that in practice shareholders of mature companies are more likely to agree to dividend retention in order to defer dividend taxation. Where this is the case, the pool of financial capital available to SMEs may be reduced.

60. As noted in section C, double taxation of dividends may be avoided by various means, with the more common integration mechanisms (e.g. partial inclusion of dividend income) operating at the shareholder level. In general, the greater the degree of integration relief, the less pronounced would be the possible financing impediment linked to the cost of new equity and corporate lock-in.

2. Classical shareholder taxation of capital gains

61. Double taxation of corporate profits may also pose a significant impediment to the financing of SMEs. This argument applies not only in the case of distributed profits of SMEs, but also in the case of retained earnings giving rise to capital gains. This potential source of double taxation is particularly relevant and important to growth-oriented businesses where a significant percentage of corporate profits is retained, giving rise to capital gains. Double taxation of profits of mature firms may also be problematic for SME financing.

a) increased cost of retained earnings

62. When after-corporate tax profits are retained, the market value of equity shares increases by the amount of the retention. Thus taxation of capital gains on shares represents double taxation of corporate profits (just as shareholder level taxation of distributed profits represents double taxation). While some relief from double taxation is available through the taxation of capital gains on a realization (rather than accrual) basis, the taxation of capital gains under a classical tax system may operate to increase the cost of (required rate of return on) retained earnings as a source of funds.

63. As in the case of dividend taxation, the impeding effect of capital gains taxation is more likely where domestic shareholders are the marginal providers of finance, which may be the typical case for SMEs.

b) capital gains lock-in effects

64. A classical tax system that taxes capital gains of individuals (including gains on shares in mature companies) on a realization basis creates ‘capital gains lock-in’ incentives – that is, incentives to hold onto assets producing capital gains.²¹ Lock-in incentives tend to impede an efficient allocation of savings, including an efficient allocation of capital to certain start-up businesses requiring external equity capital.

²¹ Taxing capital gains as they accrue (rather than when they are realized at the time of asset sale) is difficult on a number of counts. Valuation problems may be met in assessing current market values of assets giving rise to capital gains. Taxing accrued but unrealized capital gains may also introduce liquidity problems for taxpayers with insufficient cash-flow to cover the tax burden. Moreover, providing investors with the cash value of accrued losses in excess of accrued gains required for symmetric treatment of accrued gains/losses may be viewed as problematic.

65. Under a realization-based capital gains tax system, taxation of capital gains is deferred until the year in which the asset producing capital gains is disposed of. Deferring capital gains taxation tends to lower the effective tax rate on capital gains. Deferred taxation thus creates ‘lock-in’ effects distorting decisions over asset sales – that is, tax driven incentives to hold onto assets with accumulated unrealized (untaxed) gains to benefit from tax deferral, rather than sell and unlock capital for investments – including investments in promising SMEs – that would be selected absent tax considerations. Lock-in effects tied to deferred taxation of capital gains may thus lead to sub-optimally diversified portfolios (and misallocated productive capital, implying reduced national income in certain cases).

66. SMEs may benefit from ‘patient capital’ encouraged by realization-based taxation of capital gains lock-in effects, to the extent that investors are encouraged to hold onto shares of an existing SME to benefit from capital gains tax deferral. However, this benefit does not apply to new SME business start-ups, which have yet to raise external equity financing. To the extent that individuals are encouraged to hold onto shares of mature firms or other assets generating capital gains, on account of lock-in incentives, SME financing may be frustrated. This outcome would tend to be inefficient if a new business idea could lead to a profitable business enterprise, but does not go forward due to this tax distortion.

c) limited venture capital financing

67. The development and commercialization of certain new ideas and products, particularly those of innovative, knowledge-based SMEs that are relatively high-risk, offer little collateral to secure a bank loan, and involve a long-term development plan, requires equity investment and active management of venture capitalists. For venture capitalists, whose typical investment strategy involves the sale of a significant equity interest in an SME that the venture capitalist has helped grow (e.g. at the time of an initial public offering), the taxation of capital gains is a key consideration. Where venture capital financing is required, onerous shareholder capital gains tax rules including the treatment of capital losses (addressed in section F), may be a serious impediment to the creation of innovative, high-growth potential SMEs.

3. Full corporate taxation of retained earnings

68. Where access to bank loans is limited, for example due to lack of sufficient collateral, and new equity capital is also limited or otherwise costly, for example due to shareholder-level taxation, corporate retained earnings may be a critically important source of funding for the development of SMEs. Where this is the case, a relatively high basic statutory corporate tax rate may be seen as disadvantageous to SMEs by constraining the amount of after-corporate tax profit available for investment. For this reason, countries may be encouraged to apply a reduced corporate tax rate to SMEs, possibly up to some taxable income threshold.

69. As noted previously, certain approaches to reducing the tax compliance burden on SMEs may have the unintentional effect of inhibiting SME growth. SME growth may also be inhibited by measures that reduce the statutory tax burden on SMEs, depending on the design features. For example, depending on exactly how the corporate tax rate on SMEs is reduced, SME growth may be encouraged, but possibly only up to some business level. One may consider, for example, a tiered statutory corporate tax rate structure.²² Introducing in an upper-tier bracket a claw-back to tax relief provided by a lower-tier bracket

²² An alternative to introducing a tiered rate structure is to maintain a basic statutory corporate tax rate while introducing a small business deduction – that is, a deduction targeted at SMEs which lowers the effective tax rate on SME profit over some range. Canada provides an example of this approach. Under an earlier design, Canadian controlled private companies were provided with a tax deduction equal to 16 percent of the first \$200,000 (CDN) of active business income earned in Canada. The deduction lowered the effective federal tax rate on this band of income from 28 to 12 per cent. However, as the effective federal tax rate at the margin jumped from 12 to 28 per cent once taxable income grew above the \$200,000 threshold, SMEs faced a large discreet jump in their effective tax at this point, discouraging certain SMEs from growing further. This effect

may discourage growth beyond the point where the claw-back becomes operative. Even without a claw-back, a significant jump in the corporate tax rate at some taxable income level may discourage firms from growing beyond that point. Perhaps a graduated rate approach that is most conducive to growth is one that ratchets up the statutory tax rate through multiple increments over a fairly broad income range. Such an approach would tend to be more costly in terms of foregone tax revenue for a given taxable income amount. But should the more generous tax treatment create significant new SME growth, an overall revenue increase might result.

70. However, in considering the implications of a small business corporate tax rate, it is important to recognize that a reduced SME tax rate provides tax relief to not only growth-oriented SMEs, but also SMEs that for one or more reasons do not plan on expanding beyond a given size – for example, a business with a very limited consumer base. An alternative pro-growth strategy (if desired) may be to target tax relief to the level of investment undertaken by SMEs. Examples would include accelerated depreciation, a special investment allowance or investment tax credit for SMEs. This form of subsidy operates to increase the purchasing power, of a given amount of retained earnings, in the acquisition of productive capital (conducive to economic growth). This stands in contrast to the reduced SME tax rate approach that increases the amount of after-tax profit available for investment, but is available regardless of the level of new investment. At the same time, tying tax relief to investment expenditure (as opposed to increasing the amount of after-tax earnings available for retention) subsidizes investment without regard to the source of finance. However, like a reduced SME tax rate approach, tax relief tied to the level of investment may only be claimed if the SME is profitable (unless the relief (e.g. investment tax credit) is non-wastable). For loss-making companies, unused depreciation allowance carryover provisions, as well as business loss and capital loss carryover provisions are centrally important (see section F).

4. *Preferential tax treatment of alternative investments*

71. As noted in sections B and C, the tax system may discourage an entrepreneur from creating an SME where returns on savings allocated to other assets are subject to less onerous taxation. Certain possible tax preferred savings alternatives are noted (principal residence, private pension savings, equity shares of MNEs with tax-preferred foreign earnings, units of offshore mutual funds). These same tax considerations may likewise discourage potential external providers of equity finance from investing in the equity shares of a domestic SME, with returns subject to ordinary tax treatment.

5. *Negative experience with tax preferences to encourage SME financing*

72. Depending on their design, special tax preferences to assist SMEs may distort the allocation of capital in unintended ways, including tax-induced impediments to SME financing. To take an example, certain countries have introduced personal income tax deductions and tax credits for investments in shares of qualifying venture capital funds. In some cases, the tax relief has been extremely generous (e.g. over 80 per cent of the cost of qualifying shares subsidized by tax relief), leading to “too much money chasing too few deals” and below average rates of return at the fund level (which are accepted given the generous tax subsidy). Such an outcome is problematic to the extent that it impedes the placement of capital in more productive uses (e.g. SMEs that do not meet targeting criteria imposed on qualifying funds), places non-qualifying funds at a competitive disadvantage relative to qualifying funds (thereby limiting access to the pool of venture capital expertise). Moreover, disappointing average performance of firms receiving tax-assisted venture capital funds (e.g. linked to an over-supply of funds) may ultimately discourage interest in venture capital financing, at least for a number of years.

was later dampened with the introduction of provisions that tapered the small business deduction, allowing the effective tax rate to rise gradually rather than in one discrete adjustment.

73. Certain other examples may be cited of shareholder-level (as well as SME-level) tax preferences to encourage SME financing where it is not clear that the benefits of tax relief outweigh the costs. Given the inability of early-stage companies that are in a loss position for one or more years to immediately claim tax deductions and credits, some systems provide taxable individual investors with special tax deductions or credits in respect of investments in shares of qualifying incorporated SMEs. A key issue is the extent to which such tax relief is passed onto SMEs (reflected in SME share prices). To the extent that flow-through provisions are judged to be inefficient, policy interest may be placed instead in targeting SMEs more directly by targeting tax relief directly to SMEs.

F. Possible Tax Impediments to High-Risk SMEs

74. The discussion in the paper up to this point has concentrated on possible tax distortions to SME creation and development with a focus on the tax treatment of profits of SMEs. Also critically important is the tax treatment of losses incurred by investors in SMEs, in particular investors in early-stage SMEs where losses may be expected for one or more years following the creation of a business.

75. In general, risk-taking – that is, investing where the rate of return is uncertain, falling above the rate of return on a safe asset (e.g. a government bond) in ‘good’ years, while falling below the safe rate of return in ‘bad’ years and possibly negative – may be discouraged by the tax system if the tax treatment of profits and losses is asymmetric.²³ In general, symmetric treatment requires that business losses can be deducted at the same effective rate as business profits are taxed, for only then is the government an equal partner in the investment, sharing equally in profits and losses. For incorporated SMEs, symmetry also requires that capital losses on SME shares can be deducted at the same effective rate as gains on SME shares can be taxed.

76. In systems that tax business profits in full in the year earned, symmetric treatment of business losses requires that losses can be deducted in full in the year incurred, or equivalently (in present value terms) can be carried forward indefinitely, with interest, until claimed. Symmetry also requires that the deduction is taken against a tax base subject to the same statutory tax rate as taxable profit. Options for the immediate deduction of current year business losses could include allowing the losses to be deducted against prior year business profits (a tax adjustment for prior years). Another option for self-employment business losses is to allow those losses to be deducted against other personal taxable income.

77. Policy-makers may be understandably reluctant to provide symmetric treatment of business profit and losses, not only because of the implied revenue loss from business loss deductions (assuming no behavioural response), but also because of a concern that this treatment could encourage SME tax-planning. For example, self-employed individuals could be encouraged by full loss offsetting to mischaracterize expenses incurred for personal consumption purposes as business expenses, and thus obtain a tax subsidy for personal consumption.

78. Where a business is in incorporated form, relevant loss considerations include the treatment of corporate losses, as well as the treatment at shareholder level of capital losses on shares in a loss-making company. As with unincorporated business income, symmetric treatment of corporate profits and losses to avoid possible tax impediments to risk-taking generally would require that corporate losses can be deducted (at the same rate as taxable profit) in the year incurred, or carried forward indefinitely with interest. Immediate claiming of a corporate loss could include a carry-back to offset corporate taxable profit in prior years. Where a corporation undertakes a range of business activities, allowing losses on one activity to offset profits on another furthers symmetric treatment.

²³ Depending on risk preferences, symmetric treatment of gains and losses may *increase* the level of risk-taking (i.e. increase the percentage of capital placed in assets generating uncertain returns) relative to the no tax case. While this outcome is debatable, in practice risk-taking in SMEs may be expected to be discouraged where the tax system treats SME profits and losses asymmetrically.

79. Losses at the corporate level result in capital losses at the shareholder level (just as corporate profits are reflected in shareholder capital gains). Symmetric loss offsetting requires that capital losses on corporate shares be treated symmetrically with capital gains on shares.²⁴ This implies current year tax relief (or the equivalent) for realized capital losses (symmetric with current taxation of realized capital gains), with allowable capital losses determined by the same inclusion rate used to assess taxable capital gains. Current year (or current year-equivalent) tax relief could include allowing capital losses to be deducted against other investment or ordinary personal income, as well as an indefinite carryforward with interest of unused capital losses.

80. Policy-makers may be reluctant to provide fully symmetric treatment of corporate profits and losses because of the direct revenue loss, and concerns of tax-planning in the owner/worker SME case. As owners of an incorporated SME in general have some scope to mischaracterize personal consumption expenses as corporate expenses, some limits may be expected on corporate loss claims. Also, under a realization based capital gains tax system with full loss offset, investors could be expected to sell shares producing losses (to obtain current relief for such losses), while deferring sales of shares producing gains in order to defer capital gains tax.²⁵ Lengthy carry-forward (and possibly carry-back) provisions may be viewed as sufficient to enable scope for the claiming of losses, albeit typically without an interest adjustment.

81. At the same time however, the possible effects of asymmetric treatment of corporate profits and losses, and capital gains and losses on SME shares, may encourage policy-makers to consider whether the trade-off could be adjusted through more liberal treatment of losses, with revenue losses possibly covered by more restrictive rules governing allowable business deductions (i.e. the denial of certain deductions that tend to have a consumption (and not pure business expense) element).

82. A steeply progressive personal tax rate schedule may also be identified as discouraging to risk-taking, relative to that under a more flat schedule, by taxing away a relatively large share of returns in good states when profits are high. The discouraging effects of progressive tax rates may be most pronounced where tax deductions in respect of start-up costs are taken against limited taxable income in early years (implying limited tax relief in respect of these deductions taken against low marginal rates) and where the ability to claim loss relief under this rate structure significantly restricted.

G. SME Tax Evasion

83. As noted in the introduction, SME tax evasion, driven generally by a perception that the tax burden (statutory plus compliance burden) is too high, poses a number of problems to tax systems, raising difficult questions over how tax policies and tax administration may influence tax compliance incentives and behaviour. Policy-makers and tax administrators are tasked with finding solutions that limit tax evasion, while also limiting revenue shortfalls and unintended distortions to other decision margins.

84. Compliance requirements range from ensuring that businesses report taxable income accurately and in full, and claim only deductions that are allowed to them, to ensuring that they file tax returns and operate in the formal rather than the 'underground' economy. Non-compliance (tax evasion) undermines the functioning of the tax system in a number of ways, raising equity and efficiency concerns including

²⁴ As noted in section D, personal taxation of capital gains on shares implies double taxation of retained profits, taxed first at the corporate level (with capital gains equal to after-corporate tax retained profit). On a symmetric basis, personal tax relief for capital losses on shares implies a double deduction for corporate losses deducted first at the corporate level (with capital losses equal to the after-corporate tax loss).

²⁵ While such tax-planning can occur in the absence of full loss offset (i.e. limiting sales of shares with capital gains to amounts necessary to fully absorb current capital losses, while deferring the realization of other gains), the scope for tax-planning would be greater with full loss offset (i.e. no need to sell shares with gains to absorb capital losses).

those where revenue shortfalls require increased reliance on other taxes or reduced public expenditures. Where tax evasion is left unchallenged, voluntary compliance with the tax system overall tends to erode, as evasion in one or more areas contributes to a view that the tax system is systematically unfair.

85. Ensuring a high degree of tax compliance tends to be particularly difficult in the case of SMEs. This is both because their compliance tax burden is relatively high – that is, the cost of complying with a given set of tax rules/regulations is generally higher for SMEs as a percentage of turnover or profit – and because of difficulties in ensuring compliance through tax audits, given the large number of SMEs in the economy (relative to the number of large taxpayers).²⁶ Amongst SMEs, unincorporated SMEs without audited financial accounts may be expected to have the highest rate of non-compliance.

86. In theory, a taxpayer's incentive to comply with a tax system depends on an assessment of the relative benefits and costs of complying versus not complying (as well as perceptions of the state of public governance, the level of efficiency in the expenditure of public funds, individual risk preferences, and possibly other factors outside the scope of this paper). Benefits of evading tax through underreporting or artificially reporting taxable income, or misrepresenting expenses, include a lower tax burden. Benefits of evasion through operating in the underground economy include avoiding completely the statutory burden and compliance burden imposed by the tax system (with the exception of VAT). Individuals may also perceive that tax avoidance where undetected can increase the competitive position of firms where some amount of tax savings are passed onto lower prices implying increased demand. The potential costs of non-compliance include the payment of fines incurred where a tax audit reveals non-compliance, non-recoverable VAT paid on business inputs,²⁷ and possibly a reputation cost (associated with tax-cheating) which may reduce output demand.

87. The preceding suggests that SME tax evasion may be curbed by reducing the statutory tax burden on SMEs, reducing the compliance tax burden on SMEs, increasing fines for non-compliance, and/or increasing the probability of detection (e.g. through increased audit). . Some combination of the first two approaches is identified in section D as possibly necessary to counter the relatively high compliance tax burden facing SMEs, where neutral tax treatment or possibly more favourable tax treatment is sought.

88. But such adjustments typically are not easy or straightforward. For example, a lowering of the statutory tax burden on SMEs may mean not only revenue loss – it may also feed a perception that the tax burden from *employment* is too high and may encourage the creation of self-employed business as a means to evade tax, particularly if the chance of detection is viewed as limited (suggesting the need to increase the perceived costs of evasion, if/when lowering the statutory tax burden SMEs).

89. Also, certain structural features of a tax system may facilitate tax evasion, although be desirable for other reasons. For example, tax evasion is facilitated under dual income tax systems where capital income is taxed at a low flat rate, while labour income is taxed at progressive rates. Under this structure, owner/workers of an incorporated closely-held SME may realize tax savings by income shifting through mischaracterizing labour income as capital income. Income shifting incentives of this type may arise as well under a non-dual system where social security contributions are levied only on labour income.

90. As noted previously, a reduction in tax compliance costs may be achieved through a number of channels. While certain adjustments may seem possible in principle (e.g. improving coordination across levels of taxing authorities), they may be difficult to achieve in practice. Also, deciding on the details of

²⁶ The compliance tax burden on SMEs may be high relative to that for large companies not only because of a more limited ability to defray a fixed compliance cost (with a smaller sales/income base), but also because the unit cost of professional tax services (per hour) may be higher for SMEs that rely on outside tax professionals rather than in-house professionals employed by large companies.

²⁷ Those outside the tax net that do not report VAT must bear the cost of VAT paid on business inputs. This follows because once outside the VAT system, VAT paid on inputs may not be credited against VAT charged on outputs

certain simplifying approaches (e.g. establishing an appropriate VAT exemption threshold) may not be straightforward. To take another example, presumptive tax regimes may not only reduce compliance costs but also tax liabilities, so care would need to be taken to ensure that large unintended distortions are not introduced.

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