

Tax Policy for SME Growth and Tax Compliance (Proposal for 2008 WG3 meeting)

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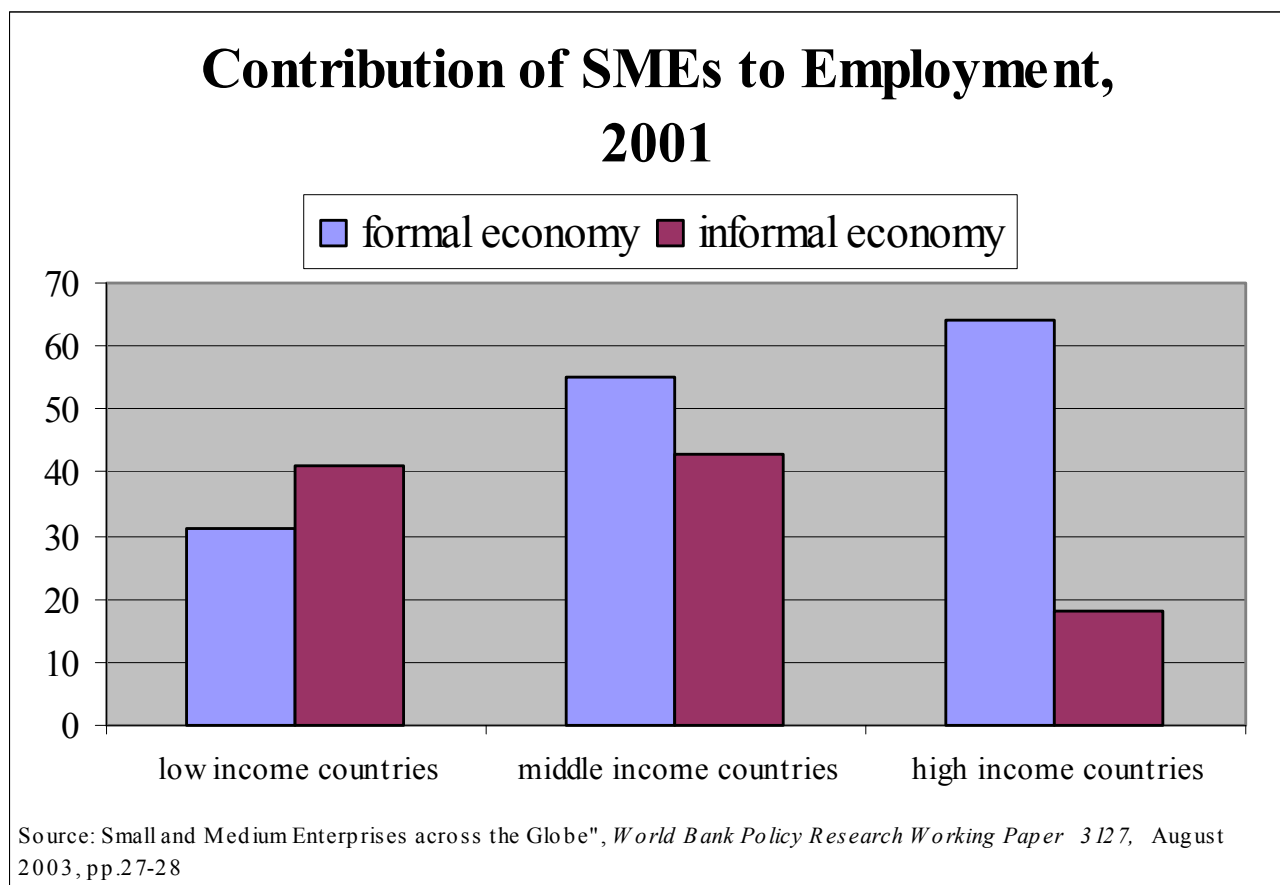
Chair, Working Party No2 (*Tax Policy
Analysis, Tax Statistics and Horizontal
Programmes*) of the OECD Committee
on Fiscal Affairs (CFA)

*Meeting of Working Group 3 (Tax Policy for Investment)
of the MENA-OECD Investment Programme
19-20 June 2007, Cairo*

Discussion points

- Widespread policy interest in SMEs
- Current OECD work on taxation of SMEs
- Analysis of possible tax impediments to:
 - business creation
 - business incorporation
 - external financing of SMEs
 - tax compliance
- Next steps

Policy interest in SME Sector



OECD work on taxation of SMEs

- Preparations for ITD global conference on *Taxation of SMEs*, 17-19 October 2007, Buenos Aires.
 - <http://www.itdweb.org/SMEconference/>
- SME tax questionnaire (OECD and non-OECD).
- Assess tax policy & administration impediments to:
 - SME development and growth
 - SME tax compliance
- Consideration of issues by Working Party No.2 of the OECD CFA (22-24 May 2007, Ottawa).

Tax impediments to business creation

- Comparison of statutory plus compliance tax burden under self-employment, versus dependent employment.
- Statutory tax burden comparison, factoring in:
 - progressive personal income tax (PIT) rate schedule
 - social security contributions (base, rates, incidence, benefits)
 - treatment of business losses (risk)
 - deductions for expenses in earning income
 - possibilities to evade tax, misreport income, expenses (evasion)
 - preferential treatment of certain savings vehicles
 - other taxes (e.g. inheritance/gift taxes, capital gains tax)

Tax impediments to business creation (cont'd)

- Compliance tax burden comparison, factoring in:
 - costs involved in understanding tax rules, maintaining records, filing tax returns
 - relatively low costs under dependent employment
 - relatively high costs for SMEs (especially new businesses)
 - various approaches to reduce SME compliance cost:
 - presumptive taxes.
 - VAT exemptions
 - compliance and statutory tax burden where business operates 'underground'

Tax distortions to business incorporation

- Comparison of statutory plus compliance tax burden with unincorporated business, versus incorporated business.
- Statutory tax burden comparison, factoring in:
 - double taxation of corporate profit - possibly offset by:
 - integration of corporate and personal income tax
 - earnings retention (financing growth)
 - progressive PIT rate schedule
 - relatively low CIT rate
 - differences in determination of business profit

Tax distortions to business incorporation (cont'd)

- Factors in statutory tax burden comparison (cont'd):
 - scope for owner/worker to mischaracterize labour income as capital income
 - social security contributions (base, rates, incidence, benefits)
 - treatment of business/corporate losses
 - treatment of capital losses on SME shares
 - possibilities to evade PIT/SSC (unincorporated business)
 - other taxes (e.g. inheritance tax)

Tax impediments to SME financing

- Important to address key policy questions:
 - Under what circumstances does ‘market failure’ occur in the allocation of capital to SMEs?
Where are the ‘capital gaps’?
 - What structural features of tax systems are potentially impeding to equity financing of SMEs (i.e. in the absence of market failure)

Tax impediments to SME financing (cont'd)

- Certain structural features of tax systems may impede equity financing of SMEs:
 - classical taxation of distributed profits
 - increased cost of new equity finance (local investors)
 - corporate lock-in effects
 - classical taxation of capital gains
 - increased cost of retained earnings
 - capital gains lock-in effects (share of mature firms)
 - discouraging to venture capital financing

Tax impediments to SME financing (cont'd)

- Other possible structural impediments:
 - full corporate taxation of retained earnings
 - retained earnings key source of finance for SMEs
 - high CIT rate limits available retained earnings
 - preferential SME CIT may encourage SME growth – but only up to some threshold
 - certain advantages with targeting SME investment directly (target growth-oriented SMEs)
 - Preferential taxation of alternative savings allocations:
 - principal residence
 - pension savings
 - offshore mutual funds

Tax impediments to high-risk SMEs

- Important to consider tax treatment of losses.
- Equity investment in innovative, high-growth SMEs typically high-risk.
- Risk-taking by entrepreneurs/investors may be discouraged if tax treatment of profits and losses is asymmetric
- With symmetric treatment, government is equal partner in losses as well as profits

Tax impediments to high-risk SMEs (cont'd)

- Symmetric treatment requires:
 - business losses deductible in full in the year incurred (or the equivalent) if profit taxed in full
 - capital losses deductible in year incurred (or equivalent), at same inclusion rate as gains

Tax impediments to high-risk SMEs (cont'd)

- Policy concerns over symmetric treatment:
 - tax revenue loss (direct plus tax-planning)
 - characterization of consumption expenses as business expenses
 - deferral of tax on capital gains, current relief for losses
- Progressive PIT rate structure discouraging to risk taking

Tax impediments to SME tax compliance

- SME non-compliance (tax evasion) motivated by perception that tax burden is too high and other factors
 - undermines tax system, equity, efficiency, and impedes sustained economic development.
- Seek solutions that reduce compliance burden, increase tax revenue, avoid unintended distortions
- Ensuring tax compliance is difficult for SMEs
 - relatively high compliance burden (stronger incentive to evade)
 - costly to audit SME population

Tax impediments to SME tax compliance (cont'd)

- Tax evasion by SMEs may be curbed by:
 - reducing statutory tax burden on SMEs
 - reducing the compliance burden on SMEs examples:
 - Presumptive taxes
 - VAT exemption thresholds
 - increasing costs/fines for non-compliance
 - increasing probability of detection (audits)
- But such adjustments involve trade-offs.

Tax impediments to SME tax compliance (cont'd)

- Adjustments are not easy or straightforward
 - relaxing reporting requirements for financial accounts, or relaxing auditing requirements (to reduce compliance costs) may also reduce compliance.
 - lower statutory burden may feed perception that tax on *employment* is too high (SME creation to avoid tax)
 - structural features facilitating evasion may be desirable (dual tax)
 - general preference for reducing compliance burden as means to discourage evasion

Next steps

- Preparations for the ITD conference on taxation of SMEs (17-19 October 2007)
 - Finalize summaries of questionnaire responses (OECD and non-OECD countries)
 - Finalize background document for conference
- ITD conference and follow up (incl. preparation of summary report)
- Possible topic for 2008 meeting of Working Group 3 of the MENA-OECD Investment Programme ?