Attachment I

INTRODUCING A SIMPLIFIED TAX SYSTEM FOR SMALL BUSINESS

The Government will implement a new Simplified Tax System for small business.

The Simplified Tax System will dramatically reduce compliance costs for small businesses.

- Over 95 per cent of businesses and around 99 per cent of farming businesses will benefit from a cash accounting and simplified depreciation regime.

The Simplified Tax System will begin from 1 July 2001.

- The Government will minimise compliance costs for small business of changes to business tax arrangements in 2000-01 by deferring many major changes by an extra year.
- The changes deferred to 1 July 2001 include changes to depreciation arrangements, the taxing of trusts, and other proposals recommended by the Ralph Review.
  - This will allow small business to concentrate in the next year the GST and Pay-As-You-Go tax payment systems.

As an interim measure to the Simplified Tax System, small businesses will continue to be eligible for accelerated depreciation and the balancing charge offset, and will not be subject to the reforms to the prepayment rules.

Those small businesses that are companies will also fully participate in the company tax rate cuts (and those that are not will benefit from the personal tax cuts already legislated) from 1 July 2000.

Key features

The Simplified Tax System will apply to small businesses with a three-year annual average turnover of less than $1 million. Its main features are:

- a cash accounting regime as an alternative to the accruals system including exemption from the reform of the prepayments rules;
- a simplified depreciation regime, including access to a pooling arrangement for assets with effective lives of less than 25 years and immediate write-off for assets costing less than $1,000; and
- a simplified trading stock regime, as an alternative to an annual requirement for stocktaking and stock valuation.

The pooling arrangements operate such that a *de facto* balancing charge offset will apply. When an asset is sold its proceeds will reduce the value of the pool rather than being brought to tax at that time.

For depreciable assets with an effective life of 25 years or more, effective life depreciation under the general capital allowances provisions will apply.

For small business taxpayers that are part of the Simplified Tax System, one of the benefits of accounting on a cash basis is that prepayments for the provision of services or products over a period of less than twelve months, which end in the next income year, are immediately deductible.

If small business taxpayers choose not to enter the Simplified Tax System, they will be subject to the same general capital allowance provisions as other taxpayers, including an effective life regime for depreciable assets.

As an interim measure to the Simplified Tax System, small business will continue to be eligible for accelerated depreciation and the balancing charge offset. Furthermore, small business will continue to immediately deduct plant items costing up to $300.

However, to qualify for accelerated depreciation tax benefits, the plant and equipment may not be used predominantly for leasing or for related activities (other than short-term hire). This means that plant and equipment used in rental properties would not be eligible for accelerated depreciation.

Commencement date

The Simplified Tax System will take effect from 1 July 2001.

Current arrangements

Under current law, small business is generally required to employ an accruals system of tax accounting and to separately depreciate each item of plant and equipment.

Why change is needed

Small businesses incur disproportionately higher costs complying with their obligations under various taxation and other laws.

- Studies have shown that the burden of compliance with taxation laws is regressive and that labour time spent on taxation activities by owners, employees and helpers is the most significant component of tax compliance costs.

- There are substantial opportunity costs associated with this, as time spent on compliance reduces the time available to invest in business growth.

Simplified taxation system for small business

The Simplified Tax System comprises:

- a cash accounting regime as an alternative to an accruals system;
- a simplified depreciation regime, including access to accelerated depreciation for assets with an effective life of less than 25 years and immediate write-off for assets costing less than $1,000; and
- a simplified trading stock regime, as an alternative to an annual requirement for stocktaking and stock valuation.

The benefits available under the simplified depreciation regime are not available for assets with an effective life of 25 years or more.

- Under the simplified depreciation regime, all eligible assets will be pooled and the pool will be depreciated at the declining balance rate of 30 per cent, which is equivalent to a write off on average over 5 years. New acquisitions will be added to the pool and disposal proceeds will be deducted.

If small business taxpayers choose to not enter the Simplified Tax System, they will be subject to the same accruals system and general capital allowance provisions as other taxpayers, including an effective life regime for depreciable assets.

Eligibility

General

To be eligible to enter the Simplified Tax System, a taxpayer must have:

- an average annual turnover for the current income year (measured at the end of the current income year) and the two previous income years of less than $1 million, excluding Goods and Services Tax.

Grouping provisions

The Ralph Review recommended grouping provisions were necessary to ensure that large businesses do not divide their operations into several smaller units to gain access to the Simplified Tax System. To achieve this, businesses are required to meet a grouping test based on the test under the CGT small business rollover and retirement exemption provisions.

The grouping test for working out the turnover for a small business is the sum of:

- the turnover of the taxpayer;
- the turnover of any entities connected with, or controlled by, the taxpayer; and
- if an associate of the taxpayer is a partner in a partnership not connected with the taxpayer — the associate's share of the partnership's turnover.

Fluctuations in turnover

Some small businesses, and in particular primary producers, may face fluctuations from year-to-year in their turnovers around $1 million.

To ensure that businesses who might enjoy an atypically high turnover in any one year continue to remain in the simplified regime, the turnover test under the Simplified Tax System uses an average of the turnover for the current income year (measured at the end of the current income year) and the turnovers from the two preceding income years.

- If the three-year average turnover is less than $1 million, then the business remains in the Simplified Tax System.

- In circumstances where the average turnover is $1 million or more, these businesses will be required to convert to an accruals system of reporting and future plant items must be depreciated at their effective lives.

Small business with leasing activities

The basic design objective is to exclude businesses with predominant long-term leasing activities from participating in the simplified depreciation regime. These businesses would continue to be eligible for the other benefits of the Simplified Tax System, provided they meet the turnover threshold.

- This is intended to prevent businesses participating in the Simplified Tax System from being able to transfer the tax benefits of the simplified depreciation regime — higher depreciation rates applying to pooled assets and immediate write-off of items costing less than $1,000 — to lessees outside the Simplified Tax System.

However, small business taxpayers leasing assets on a short-term basis will be able to fully participate in the Simplified Tax System. For example:

- a farmer who leases out some equipment on an ad hoc basis; and

- plant, video and formal hire businesses.

Start-up/expanding businesses

An issue not considered in the Ralph Report is that of start-up or expanding businesses.

The principle for determining eligibility is that where investment is expected to result in a turnover in excess of $1 million, accelerated depreciation should not be available merely because the taxpayer is technically a small business taxpayer at the time the asset is first used or is installed ready for use.

- To make an exception for expansions or start-ups would mean that some major investments could qualify for accelerated depreciation because of low turnovers in the early years of the project.

It is, therefore, proposed that where a taxpayer has a reasonable expectation that an investment would result in ongoing annual turnovers in excess of $1 million, simplified depreciation regime benefits should not be available. Where taxpayers make significant investments, they would normally undertake assessments of expected revenues. This would provide a basis for self-assessment.

Re-entering the simplified tax system

Those businesses that either:

- leave the Simplified Tax System; or
- are required to leave the Simplified Tax System because of an increase in their turnover;

may later apply to the Commissioner of Taxation to return to the Simplified Tax System.

A business in the former category will need to make a case on commercial grounds for the reversal; and a business in the latter category will need to demonstrate a substantial change to the nature of their business that would lead to an ongoing reduced level of turnover.

Prepayments

For small business taxpayers that are part of the Simplified Tax System, one of the benefits of accounting on a cash basis is that prepayments for the provision of services or products over a period of less than twelve months, which end in the next income year, are immediately deductible.

Transitional arrangements

The Simplified Tax System begins on 1 July 2001. During the transitional period — from the time of effect to 30 June 2001 — special transitional arrangement will apply.

- The general design principle for the transitional arrangements is that businesses with 3 year average turnovers of less than $1 million will continue to enjoy currently available tax benefits.

Continuation of currently available tax benefits

Small business taxpayers will continue to be eligible for accelerated depreciation for plant and equipment and for the balancing charge offset. Furthermore,

- the reform of the 13-month ‘prepayment’ rule will not apply to small business taxpayers; and
- small business taxpayers will continue to be able to immediately deduct items costing $300 or less until the Simplified Tax System commences on 1 July 2001.

To maximise the opportunity for taxpayers to qualify for these tax benefits during the transition, taxpayers will be small business taxpayers if:

- the average of their turnover in the current income year and the previous two income years is less than $1 million; or
- the average of their turnover in the current income year and the next two income years will be less than $1 million.
  - This is to preclude businesses that have an abnormally low turnover in one year from obtaining access to the small business measures.