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New Business Tax System (Simplified Tax System) Bill 2000

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New Business Tax System (Simplified Tax System) Bill 2000

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17 May 2001

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New Business Tax System (Simplified Tax System) Bill 2000

Date Introduced: 7 December 2000

House: House of Representatives

Portfolio: Treasury

Commencement: Royal Assent apart from items 5 and 14 of Schedule 3 (relating to the transitional arrangements for pre-payments) that commence on 22 September 2002.

Purpose

The purpose of the Bill is to give certain business taxpayers access to a 'Simplified Tax System' (STS) consisting of:

- a cash accounting regime
- a depreciation regime whereby assets costing less than $1000 are written off immediately and most other assets are pooled and depreciated as a single asset, and
- a simplified trading stock regime.

The Bill also removes the 13 month prepayment rule for 'small business' taxpayers and replaces it with a new 12 month prepayment rule.

Background

Ralph Review

The changes proposed in the New Business Tax System (Simplified Tax System) Bill 2000 ('the Bill') flow from the Ralph Review's recommendations which were adopted by the Government in The New Business Tax System.

In its report, *'A Tax System Redesigned'*, the Ralph Review proposed:

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That in order to reduce the compliance costs faced by small businesses, a small business

- with an annual turnover or annual receipts of less than $1 million, exclusive of Goods and Service Tax, and
- which derives less than 5 per cent of its income from a leasing activity,

be able to elect to be taxed under the Simplified Tax System (STS) consisting of:

(a) a cash accounting regime - for recognising business income and day-to-day expenditure as an alternative to an accruals based regime;

(b) a simplified depreciation regime - including a small business depreciation pool for most tangible depreciable assets, as an alternative to an individual asset regime based on effective life; and

(c) a simplified trading stock regime - as an alternative to an annual requirement for stocktaking and stock valuation.[1]

These recommendations for a STS were intended to be a carve out from the proposed new business tax system which would be based upon the concepts of the Tax Value Based Method of computing taxable income - also known as Option 2.[2] The Ralph Review recommended that that the Tax Value Method would form the core principles of the new tax law. Under this method all business taxpayers would be required to compute their taxable income by measuring the movement in the tax values of their assets and liabilities subject to some statutory adjustments. For many small businesses, it has been suggested this could be costly in terms of compliance.[3]

The Ralph Committee therefore made its recommendations for the STS to try to offset some of the additional compliance costs anticipated with the introduction of the Tax Value Based Method.[4]

The Government accepted the recommendations of the Ralph Review in relation to the STS on 21 September 1999. The Treasurer, the Honourable Peter Costello, in his 'The New Business Tax System' Press Release stated that the STS, which would begin from 1 July 2001, would dramatically reduce compliance costs for small businesses and that over 95 per cent of businesses and around 99 per cent of farming businesses would benefit from cash accounting and a simplified depreciation regime.

Exposure Draft Press Release

On 26 October 2000 the Government released an exposure draft of the Bill for the Simplified Tax System for small business. According to the Government changes to the original STS were made after consultation with industry, and therefore the exposure draft differed to the Ralph proposals in several respects. These differences included:

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- allowing businesses with a turnover of less than $1 million access to the STS if they have assets (other than land or buildings) with a written down value of less than $2 million;
- allowing depreciable assets (excluding buildings) with lives of more than 25 years to be pooled and written off at 5 per cent per annum;
- allowing businesses to use ATO guidelines to estimate stock values rather than do a physical stocktake;
- broadening the eligibility rules, for example, to allow for unusual income or changed circumstances, to simplify readmission to the Simplified Tax System and to group only related businesses in determining eligibility; and
- providing scope to include some high turnover/low margin businesses.[5]

After further consultation and adjustment the Government introduced the Bill into the Parliament on 7 December 2000.

New Business Tax System (Simplified Tax System) Bill 2000

The STS as set out in the Bill consists of three main elements. These are:

- a cash accounting regime
- a depreciation regime whereby assets costing less than $1000 are written off immediately and most other assets are pooled and depreciated as a single asset, and
- a simplified trading stock regime.

It should be noted that the STS is a 'package'. In other words businesses cannot choose to use some, but not all, elements. For example, if a business wishes to use the depreciation and trading stock arrangements then cash accounting is mandatory.

The proposed STS applies to assessments for the first income year starting after 30 June 2001 and for later income years.

Commenting on the Bill, the Treasurer stated that after further consultation with small business representatives, the Government had decided to improve certain provisions of the exposure draft STS Bill including:

- simplifying the calculation of trading stock values;
- increasing the depreciating assets threshold from $2 million to $3 million; and
- relaxing the control tests to avoid inadvertent grouping.[6]

Significantly, the Treasurer also acknowledged that the Bill relies on some of the concepts and definitions used in the Uniform Capital Allowances (UCA) system which the Government plans to implement on 1 July 2001. It is of note that to date this Bill has not been introduced into the Parliament.

Deferment of Option 2

The Government has announced its intention to defer implementation of the Tax Value Method in order to allow its further evaluation by the Board of Taxation.[7] Given that the original Ralph recommendations for the STS were aimed at offsetting some of the additional compliance costs anticipated with Option 2[8], it is interest that that the Government still plans to proceed with the STS when the future of Option 2 has now become uncertain.

Transitional measures for small business

On 21 September 1999 the Government made significant changes to the rules for depreciation of business assets. Amongst other things it removed accelerated depreciation for business assets and replaced it with an effective life of plant system. It also removed balancing adjustment offsetting for disposal of certain plant. At the same time the Government passed a number of transitional measures which provided concessions for certain small businesses until the introduction of the proposed STS on 1 July 2001.[9] Under these transitional arrangements small business taxpayers continue to have access to balancing adjustment offsetting and accelerated depreciation for plant and equipment[10] including immediate deductions for items costing $300 or less.[11] Small business taxpayers are also excluded from the changes to the 13-month ‘prepayment’ rule[12]. Eligibility to these transitional concessions is not governed by any election by the taxpayer but is dependant on the business having a 3 year average turnover of less than $1 million.

While it is beyond the scope of this Digest to consider these transitional measures reference to them will be made for comparative purposes.

Main Provisions

Schedule 1—Simplified tax system (STS)

It is significant that the Bill relies heavily on a new uniform capital allowances regime [ie a proposed new Division 40] being enacted prior to 1 July 2001. To date proposed Division 40 is released only as an exposure draft[13]. As many of the fundamental

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definitions used in this Bill are only defined in that draft, the reader should be aware that it is difficult to provide a full analysis of the Bill in this Digest.

Item 1 inserts **new Division 328** into the *Income Tax Assessment Act 1997* (1997 Act). The Division deals with the Simplified Tax System (STS) for small business. **Proposed section 328-50** outline the object of this Division.

Eligibility criteria for STS taxpayers — Proposed Subdivision 328-F

The tests for determining whether a taxpayer is eligible to be an STS taxpayer are contained in **proposed Subdivision 328-F**.

Under **proposed subsection 328-365(1)** an entity is eligible to be an STS taxpayer for an income year if it:

- carries on a business during the year
- has an 'STS average turnover' of less than $1 million, and
- the business and its affiliates have depreciating assets with values totalling less than $3 million at the end of that year.

If an entity satisfies these criteria then it can choose to become an STS taxpayer according to **proposed section 328-435**.

Criteria 1 — Carrying on a business

The first test for determining whether a taxpayer is 'carrying on a business' is according to the normal rules of the 1997 Act and the criteria developed by the courts. As these rules are already in place this Digest does not provide a discussion of them. However it is of note that for STS purposes 'carrying on a business' also includes closing down a business **(proposed subsection 328-365(3))**.

Criteria 2 — An STS average turnover of less than $1 million

The second eligibility criteria is that the small business has 'STS average turnover' for that year of less that $1 million. **Proposed section 328-370** sets out the method of calculating the STS average turnover. An entity's 'STS average turnover' for an income year is generally calculated using the average of the entity's `STS group turnovers' of any 3 of the preceding 4 years.

According to the Explanatory Memorandum this method of averaging 3 out of 4 years removes the impact of fluctuations in stock prices or crops resulting in the taxpayer becoming ineligible for STS. Entities that may have had an unusually high turnover in any one of the preceding 4 years have the option to disregard the group turnover of that particular year when calculating their STS average turnover.[14]

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If an entity fails this basic test then **proposed subsection 328-370(3)** provides an alternative of calculating STS average turnover by taking the average of actual turnover for the current year plus a reasonable estimate of the turnover for the following 2 years.

Where the entity or taxpayer carried on a business for only part of the current year then it may use a reasonable estimate of its 'STS group turnover' for the part of the year when they did not carry on a business **(proposed subsection 328-370(4)).**

The Explanatory Memorandum states that in determining 'a reasonable estimate of turnover', an entity would normally take into account considerations such as:

- any orders placed and/or forward contracts entered into;
- the amount that could have been generated in turnover for a full income year based on a pro-rating of the turnover for the part of a year provided this is typical of the turnover in a full year;
- the type of business activity undertaken, considering the nature and type of turnover of similar businesses in that industry; and
- the current size and investment in the activity.[15]

Given that the Explanatory Memorandum also states that the 'generic penalties regime in Division 284 of Schedule 1 to the *Taxation Administration Act 1953* will apply to any estimate that proves not to have been reasonable,'[16] it has been suggested that guidance about what is a reasonable estimate should be placed in the body of the Bill rather than the explanatory materials.[17]

STS group turnover and grouped entities

Crucial to the definition of "STS average turnover" is the definition of 'STS group turnover'. STS group turnover is defined to be the sum of the value of the business supplies[18] made by the entity itself and by the entities it is grouped with. Transactions within the group and between the entity and the group are excluded from turnover **(proposed section 328-375).**

Grouping rules are an anti avoidance measure contained in the Bill to prevent taxpayers from segregating their business into a series of small businesses in order to gain access to the STS.[19]

An entity's turnover will be grouped with that of another entity where:

- either entity controls the other
- both entities are controlled by the same third entity, or
- the entities are STS affiliates of each other **(proposed section 328-380)**.

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An STS affiliate of a taxpayer is defined as an entity who could reasonably be expected to act in accordance with the taxpayer's wishes, or in concert with the taxpayer, in relation to the affairs of the taxpayer's business **(proposed subsection 328-365(4)).** The Explanatory Memorandum provides guidance on the method of determining an STS affiliate.[20]

Essentially, an entity would be regarded as controlling another entity where that entity either alone or together with its STS affiliates owns, (or have the right to own) interests that will give it at least 40 per cent of income or capital distributions of that other entity or the right to exercise or control the exercise of at least 40 per cent of the voting power in the other entity **(proposed subsection 328-380(3))**. This section applies to individuals, companies and fixed trusts. Partnerships are subject to similar grouping rules according to **proposed subsections 328-380(5) and (6).**

Under **proposed subsection 328-380(7)** the Commissioner has the discretion to determine that control does not exist where the interest is more than 40 per cent but less than 50 per cent, provided it can be shown that another entity actually has control.

Grouping rules for non-fixed trusts

The grouping rules for non-fixed trusts are contained in **proposed subsection 328-380(4)**. The Explanatory Memorandum states that the tests of control in **proposed subsection 328-380(3)** are not appropriate for non-fixed trusts because a beneficiary may not have any entitlement to a distribution of income or capital until certain events occur. For example, a beneficiary of a discretionary trust does not have any entitlement until the trustee actually exercises a discretion to distribute to particular beneficiaries.[21]

An entity will be deemed to control a non-fixed trust if the entity together with its STS affiliates:

- has received a distribution of more than $100 000 in any of the last four years
- controls the trustee, or the trustee is accustomed to follow their direction
- is able to appoint or remove the trustee
- can obtain the beneficial enjoyment of either the income or capital of the trust, or
- can control the application of the income or capital of the trust.

The effect of this provision is that the controller of a trust will have the trust's income grouped with theirs, but potential beneficiaries and beneficiaries who have received a distribution of less than $100 000 will not be grouped.

It has been suggested that the rules do not address the situation where a distribution was to terminate a membership interest. In this case, a beneficiary may have received a distribution of more than $100 000 in the past, but the purpose was to sever their

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connection with the trust. It is argued that this payment, which severed the connection, meant that they continue to be grouped with the trust for the next four income years.[22]

Regulations may alter the calculation of STS group turnover

Proposed subsection 328-375(4) states that regulations can be made to provide a different calculation of STS group turnover. Significantly, the regulations cannot have the affect of increasing the amount of an entity's group turnover calculation. This subsection is a response to concerns that there may be other supplies (like gambling supplies[23]) which generate an unusually high turnover.

Criteria 3 — Depreciating assets worth less than $3 million

The third eligibility criteria under **proposed subsection 328-365(1)** is that the small business and its affiliates must have depreciating assets worth less than $3 million. The value of a depreciating asset for an income year, means basically the cost of the asset less any amounts representing decline in value that have been deducted or are deductible against it. In establishing whether the value of a taxpayer's depreciating assets total less than $3 million the closing balance of each pool of depreciating assets[24] will need to be added to the value of any depreciating assets not subject to pooling **(proposed subsection 328-365(2)**).

The Government's rationale for the $3 million cap on depreciating assets is to ensure that entities with low turnover in early years of operation but with major investments in capital assets would not qualify for STS (and in particular have access to accelerated deprecation). It is felt that accelerated depreciation which was abolished for non STS taxpayers from 21 September 1999, should not be available merely because a taxpayer is technically a small business taxpayer at the time the asset is first used or is installed ready for use.[25]

It is of interest that the eligibility test used in the transitional arrangements[26] does not include this cap on depreciation assets. Businesses that satisfy the current turnover test in the transitional arrangements will therefore need to review their eligibility before 1 July 2001 to ensure that the value of their depreciating assets is less than $3 million.

Entering and leaving the STS

To be an "STS taxpayer" for an income year an entity must:

- satisfy the eligibility criteria as set out in the Bill, and
- notify the Taxation Commissioner of its intention to become an STS taxpayer (**proposed section 328-435).**

In other words a taxpayer must satisfy the threshold tests and must elect to join STS. If a small business taxpayer chooses not to enter the STS it will be subject to the same rules as

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other businesses, including the general capital allowance provisions. Under **proposed subsection 328-440(1)** a business will continue to be an "STS taxpayer" unless it elects to leave STS or is required to leave STS because it is no longer eligible. If a taxpayer is no longer eligible then it must notify the Commissioner of that fact **(proposed subsection 328-440(2)).**

The Ralph Review had originally proposed that those businesses that either leave STS or are required to leave the STS because of an increase in their turnover, may later apply to the Commissioner of Taxation to return to the STS. Where a business voluntarily opted out of STS the Ralph Review proposed that the entity be required to make a case on commercial grounds for re-entry. Where the departure from STS was due to a business exceeding the turnover threshold, that business would be required to demonstrate to the Commissioner that a substantial change in the nature of their business has occurred which would lead to an ongoing reduced level of turnover.[27]

The Ralph approach has been rejected in the Bill. Under **proposed subsection 328-440(3)** if an STS taxpayer chooses to opt out of STS then it must wait at least 5 years to rejoin. Where a taxpayer is excluded because it exceeds the turnover threshold, then a business can rejoin the STS when it satisfies the eligibility test (**proposed section 328-440, note)** It has been suggested that the five year exclusion test for businesses electing out of STS is unduly harsh and needs the addition of a Commissioner's discretion to allow some flexibility to deal small businesses who make mistakes or receive poor advice.[28]

A small business always loses the benefits of the STS in the subsequent year to the income year in which the limit is exceeded. This differs to the transitional measures where the loss of the small business classification occurs in the year in which the turnover threshold is exceeded.[29] This is seen as a welcome amendment by professional and industry organisations who argued for the position in the Bill on the basis that it would lead to greater certainty in business planning.[30]

Accounting Method for STS taxpayers — Proposed Subdivision 328-C

Small businesses that elect to use STS are required to account for their income and expenditure on a cash basis. Thus under **proposed paragraph 328-105(1)(a)** ordinary income is only derived by a STS taxpayer under section 6-5 of the 1997 Act when it is received or deemed to be received.[31] Similarly under **proposed paragraph 328-105(1)(b)** an amount is only deductible under section 8-1 (general deductions), section 25-5 (tax-related expenses) or section 25-10 (repairs) when it is paid.

The practical effect is that items such as work in progress will be taxable only when cash is received, debtors at the end of the year will no longer be brought to account as income and amounts owing to creditors at year end in respect of expenditure will no longer be deductible.[32]

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Significantly other specific income and deduction provisions in the 1997 Act continue to apply to STS taxpayers **(proposed subsection 328-105(2)).** In terms of income, the effect is that if another provision of the Act specifically defers or brings forward the taxing point for a particular type of ordinary income, the timing rule in that specific provision overrides the 'received' rule for STS taxpayers. The example given in the Bill is Subdivision 385-G of the deferral of profits from second wool clips received in the current income year until the following income year.

In terms of deductions, an example of a specific deduction timing rule that overrides the paid rule is the prepayment rules. Thus, an STS taxpayer who has paid for a two year magazine subscription will be subject to the prepayment rules. Another example is the cost of upgrading the mains electricity supply for a primary producer which is spread over 10 years as a specific deduction under Subdivision 387-E.

Capital allowances for STS taxpayers — Proposed Subdivision 328-D

Proposed Subdivision 328-D sets out the capital allowances for STS taxpayers. The term ‘capital allowances’ refers to the deductions provided in the income tax law for certain kinds of capital expenditure.

Under **proposed Subdivision 328-D** the cost of a depreciable asset can be written off in three ways: immediately or through two pool arrangements (either a ‘general STS pool’ or a ‘long life STS pool'). **Proposed Subdivision 328-D** only applies to STS taxpayers and only where the asset was used during or before that income year **(proposed subsection 328-175(1)).**

It is of note that a number of fundamental definitions used in relation to capital allowances for STS taxpayers are missing from the Bill. The Explanatory Memorandum states that this Subdivision is dependent on the new uniform capital allowances regime (ie proposed Division 40) being enacted prior to 1 July 2001. To date proposed Division 40 is released only as an exposure draft[33], and many of the terms used in this Bill are only defined that exposure draft. These include depreciating asset,[34] effective life,[35] asset's cost,[36] balancing adjustment event,[37] taxable purpose[38] and adjustable value.[39] It would seem important for Parliament to have the opportunity to scrutinise these key definitions alongside the provisions of the Bill.

Low cost assets

Under **proposed section 328-180** STS taxpayers are able to claim an outright deduction for low cost depreciating assets. The Bill does not define a low cost asset[40] but according to the Explanatory Memorandum it is a depreciating asset whose total cost is less than $1000 at the end of the income year in which the taxpayer starts to use it for a taxable purpose.[41]

Note that this immediate deduction for low cost assets is not available for business assets acquired by taxpayers before joining the STS. Those items however can be added to a pool

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and if the pool has assets totally less than $1000 then it will be written off immediately in the same manner as low cost assets **(proposed section 328-210).**

Pooling of assets

Proposed section 328-185 deals with pooling. There are two kinds of pools namely:

- a 'general STS pool' containing depreciating assets with effective lives of less than 25 years, and
- a 'long life STS pool' containing depreciating assets with effective lives of 25 years or more.[42]

Upon entry into STS all assets (other than low cost assets and excluded assets) are automatically assigned to a pool **(proposed subsection 328-185(3))**. However, where a long life STS pool asset was first used before 1 July 2001 an STS taxpayer can choose to have the item depreciated under proposed Division 40[43] of the 1997 Act **(proposed subsection 328-185(5))**. This election and the allocation to a pool are irreversible **(proposed subsections 328-185 (6) and (7)).** Assets acquired during the year are allocated to the pool at the end on the year **(proposed subsection 328-185(4)).**

Proposed subsection 328-190(1) sets out the formula for calculating a deduction for each pool. The formula is:

Opening pool balance × Pool rate, where the pool rate is 30 per cent for a general STS pool or 5 per cent for a long life STS pool.

However, where the assets are acquired during the income year, the rate to be applied is 15 per cent or 2.5 per cent respectively. Note that these rates apply to depreciating assets irrespective of when during the year they were acquired.[44] Such a rule avoids the need to apportion the asset's business use over its first income-producing year.

The 'opening pool balance' is determined under **proposed section 328-195** as the sum of the business use components of all the depreciating assets that are allocated to the pool under **proposed subsection 328-185(3)**. For subsequent years, the 'opening pool balance' is the prior year's closing balance adjusted by any change in the business use of assets in the current year as required under **proposed section 328-225**.

The 'closing pool balance' is determined under **proposed section 328-200**. Effectively it is the opening pool balance plus any adjusted values of new assets less the value of any assets disposed of and deductions for new and existing assets.

Estimating business and private use of depreciating assets

STS taxpayers must estimate how much they will use a depreciating asset for the purposes of producing assessable income **(proposed subsections 328-205(1) and (2))**. For

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example, if a taxpayer estimates that the asset is to be used solely for the purposes of producing assessable income the estimate of taxable use is 100 per cent. The Explanatory Memorandum points out that such an adjustment is required even if the private use is minor.[45]

To determine the 'taxable purpose proportion' of the asset's adjustable value, the original estimate is multiplied by the asset's adjustable value **(proposed subsection 328-205(3))**.

The estimate must be made in the income year the taxpayer first enters the STS and its cost is to be adjusted before it is added to the pool. If there is a change in the business use percentage while the asset is held of more than ten per cent, its value in the pool must be adjusted according to **proposed section 328-225**.

Disposal of a depreciating asset

A 'balancing adjustment event' occurs when an STS taxpayer disposes of or sells a depreciating asset. When a pooled asset is sold the business use percentage of the sale is subtracted from the pool**.** Where an asset's business use estimate has been adjusted the taxpayer must use an average of the asset's current and previous business use estimates to work out the business use percentage of the sale proceeds **(proposed subsection 328-205(4)).**

Primary producers

There are special arrangements for primary producers who are also STS taxpayers. Primary producers who currently have assets subject to concessional depreciation under Subdivision 40-G of the 1997 Act will be able to choose either that form of depreciation, or calculate deductions under the STS pooling scheme **(proposed subsection 328-175(2))**. This election must be made for each depreciating asset and once the election has been made, it cannot be changed **(proposed subsection 328-175(3)).**

Exclusions to the capital allowances arrangements for STS taxpayers

Certain assets are excluded from the depreciation scheme for STS taxpayers.

Buildings are excluded from the pooling arrangements unless the building would qualify for deduction under the primary production provisions in proposed Division 40. Such a building can be pooled according to the STS or alternatively, the taxpayer can choose to claim deductions for the building under the primary production provisions in proposed Division 40 **(subsection 328-175(5)).**

Proposed subsection 328-175(6) denies any deduction for depreciating assets 'predominantly let' on a depreciating asset lease. According to the Explanatory Memorandum 'predominantly' means more than 50 per cent of the time.

A depreciating asset lease is an agreement or renewal of an agreement, under which a right to use a depreciating asset is granted. It will not include a short-term hire agreement or a

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hire purchase agreement **(Schedule 2, item 13, subsection 995-1(1)).** A short-term hire agreement is an agreement for the intermittent hire of an asset on an hourly, daily, weekly or monthly basis. It will not include reasonably continuous hiring or hiring totalling longer than a few months **(Schedule 2, item 18, subsection 995-1(1)**).

The Government's rationale for this exclusion is that concessional STS treatment could be transferred to non-STS taxpayers if STS taxpayers received pool deductions for depreciating assets they lease to others.[46]

Proposed subsection 328-175(7) excludes from deduction assets allocated to 'low value pools' before entering the STS and assets allocated to 'software development pools'. STS taxpayers must continue to use the rules in proposed Subdivision 40-E for assets allocated to a low value pool prior to entering the STS. However, low cost assets acquired after entering the STS will be subject to the STS low cost asset rules in **proposed section 328-180.** In contrast assets allocated to a software development pool both before and after becoming an STS taxpayer are excluded from the depreciation arrangements of the STS. They remain subject to the rules in proposed Division 40[47] **(proposed subsection 328-175(8)**).

Where a business ceases to qualify or opts out of STS, the STS pools will be frozen as a single item attracting depreciation of 30 per cent or 5 per cent until written off **(proposed subsection 328-220(1)).** All subsequently acquired assets will be subject to normal effective life provisions and cannot be allocated to a pool until again becoming an STS taxpayer **(proposed subsection 328-220(2)).** In addition, once a depreciating asset has been allocated to a pool, it cannot be reallocated on the basis of effective life (**subsection 328-185(7**). For example, a depreciating asset in a long life STS pool cannot be allocated to the general STS pool if its effective life falls below 25 years, even if the taxpayer subsequently re-enters the STS.

Trading stock — Proposed Subdivision 328-E

Division 70 of the 1997 Act contains the current arrangements for dealing with trading stock[48] for income tax purposes. Under this Division each item of trading stock on hand at the end of the income year must be valued at either cost, replacement price or market selling value. The difference between the value of trading stock on hand at the start and at the end of the income year must be brought to account under section 70-35 of the 1997 Act as either assessable income or a deduction. **Proposed Subdivision 328-E** of the Bill modifies the trading stock rules in Division 70 of the 1997 Act for STS taxpayers.

Under **proposed section 328-285** where the difference between the value of trading stock on hand at the start of an income year and the 'reasonably estimated' value at the end of the year is $5000 or less, an STS taxpayer is not required to value each item of trading stock on hand at the end of the income year and account for any change in the value of trading stock on hand for income tax purposes. Note however that STS taxpayers may still choose

to account for changes in the value of trading stock in any income year **(proposed subsection 328-285(2))**[49].

Where the difference between the value of trading stock on hand at the start and end of an income year is greater than $5000 then an STS taxpayer must value each item of trading stock on hand at the end of the year; and account for the change in value on a cash basis.

What constitutes a 'reasonable estimate' is described very broadly in the Explanatory Memorandum as:

> […] an approximation of the value by the taxpayer that is reasonable in all of the circumstances. For example, some taxpayers may maintain a constant level of stock each year and will know the value of stock on hand, while others with fluctuating stock levels may keep comprehensive stock records from which the estimate can be derived. Therefore, a reasonable estimate will depend on the circumstances of the taxpayer.[50]

Where a STS taxpayer fails the **proposed subsection 328-285(1)** test, or elects to account annually, **proposed section 328-290** requires the taxpayer to value each item in accordance with section 70-45 of the 1997 Act and take into account the value of all trading stock in accordance with section 70-35, in working out assessable income and deductions. Note 2 confirms that where the cash value of all trading stock at the end of the income year is:

more than the cash value of all trading stock at the start of that year, the difference is included in assessable income; and

less than the cash value of all trading stock at the start of that year; the difference is an allowable deduction.

Schedule 2 — Consequential amendments

Schedule 2 makes consequential amendments to the 1997 Act relating to the STS. In particular it adds to section 995-1 definitions of 'depreciating asset lease', 'long life STS pool', 'opening pool balance', 'short-term hire agreement', 'STS affiliate', 'STS average turnover', 'STS group turnover', 'STS taxpayer' and 'taxable purpose proportion'.[51]

Schedule 3 — Deducting prepayments

Pre-payments for the provision of services

Where expenditure qualifies for deduction under section 8-1 of the 1997 Act, the deduction is generally allowable in full in the year the expenditure is incurred. However

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there are special rules that affect the timing of deductions for expenditure incurred in advance of the provision of services.

In particular section 82KZM of the *Income Tax Assessment Act 1936* (1936 Act) requires prepaid expenditure which would otherwise be immediately deductible under section 8-1 to be deductible over the period during which the services are to be provided up to a maximum of 10 years.

13-month rule

The exception is the 13-month rule. A prepayment for services to be done within 13 months of the date of the expenditure is deductible in the year in which it is incurred providing it is:

- made by a small business taxpayer, or
- it is non-business expenditure.

12-month rule

Items 2-4 of **Schedule 3** of the Bill amend paragraphs 82KZM(1)(b) and (ba) and subparagraphs 82KZM(1)(aa)(i) and (ii) of the 1936 Act to repeal and replace this 13 month pre-payment rule with a new 12 month rule. The new 12-month rule will allow immediate deduction for prepayments where the payment is incurred for a period of service not exceeding 12 months and the period of service ends in the next income year. The 12 month rule will apply only to STS taxpayers and to individual taxpayers incurring deductible non-business expenditure.

Prepaid business expenditure incurred by small business taxpayers and prepaid non-business expenditure incurred by non-individual taxpayers will be apportioned over the eligible service period unless the taxpayer enters the STS **(items 6-8, paragraphs 82KZMA(2)(a) and (b) and subsection 82KZMA(3))**.

Concluding Comments

The Government claims that over 95 per cent of businesses and around 99 per cent of farming businesses will be able to take advantage of the STS.[52] Some commentators dispute these claims.

For example Chris Evans and Jacqui McManus note that:[53]

> . . . the basis of the Ralph assumption appears to be ABS data relating to the 1993 year, supplemented by ATO data. However data collected by the ATAX compliance costs research team for the 1997-98 year suggests that less than 90 per cent of all businesses have a turnover of $1 million or less.

> Moreover, neither the Ralph Review figures nor those derived from the ATAX research take into account two significant factors that will considerably reduce the number of small business taxpayers able to access the STS.
>
> In the first place, the statistics do not reflect the fact that many of the businesses that are apparently potentially within the STS are not active businesses. At any time there are a considerable number of businesses that are dormant, or which are purely trustee businesses, which are not likely to benefit from the measures available in the STS. And secondly, the operation of the proposed grouping provisions will serve to eliminate many other potential beneficiaries of a simplified tax system.

The TIA in their submission to Government on the Exposure Draft of the STS Bill has expressed concern about the rules relating to non-fixed trusts. TIA suggests that the definition of non-fixed trusts combined with the grouping rules work to exclude from the STS small businesses conducted through discretionary trusts with wide classes of potential beneficiaries or objects.[54]

The $1 million threshold

The $1 million threshold has been the focus of much lobbying effort and is seen as excluding many small businesses from the benefits of the STS. Small business representatives[55] have pointed out that a turnover threshold discriminates against high volume, low gross margin businesses such as service stations and liquor outlets.[56] They cite the following example:

> A petrol station, selling petrol at 95.9 cents per litre with a mark-up of two cents per litre will not qualify for STS as the small business in earning a gross profit as little as $20,855 will have passed the $1 million turnover threshold.[57]

The Explanatory Memorandum suggests that **proposed subsection 328-375(4)** which enables the Government to make regulations to provide a different method of calculating STS group turnover will enable the Government to further consider these type of cases and make any necessary adjustments where required. Michael Dirkis from the TIA suggests that this provision does not hold out any real relief for such businesses, as despite the efforts of the TIA and other business and professional groups, the Government has to date refused to entertain any changes citing large revenue cost.[58]

It can also be argued that businesses with turnovers close to $1 million or with abnormal 'capital' asset sales in a year, face additional compliance costs ensuring that they do in fact meet the complex set of eligibility rules for the STS.

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Capital allowances

Despite the Government's claims that the Bill will simplify the capital allowance arrangements for STS taxpayers, it has been argued that some of these depreciating provisions are quite complex given that the target audience is small business. The TIA suggests that the appropriateness of STS will depend on the depreciation rates on key assets and will vary from one taxpayer to another. It is possible that for small business taxpayers with a high number of depreciable assets costing more than $1000 or assets which have effective lives shorter than the pool lives, then STS is not the appropriate choice.[59]

Trading stock arrangements

The Government expects that the new trading stock arrangements will remove the requirement for an annual stocktake and stock valuation for most STS taxpayers.[60] Some commentators disagrees. Cooper argues that a $5000 absolute stock figure or allowable annual movement, is a relatively small percentage of turnover for a business with a turnover exceeding say $100 000 and therefore this concession will have only relatively limited application.[61]

It could also be argued that in order to make a 'reasonable estimate' of whether the cost of trading stock has changed by more than $5000 an STS taxpayer may be required to undertake a stock take. Robert Douglas, formerly Director of Taxation from the National Farmers' Federation, suggests that the examples in both the legislation and the Explanatory Memorandum show that 'reliable' and 'accurate' record keeping and inventory systems are going to be essential in using the simplified inventory system.[62]

Cash Accounting

The Government's Explanatory Memorandum states that:

- cash accounting minimises compliance costs for STS taxpayers because, for tax purposes, they will not be required to recognise sales for which payment has not been *received*. On the deductions side, they will not be required to recognise expenses that they have not *paid*.

- in many instances the cash accounting method allows STS taxpayers with ordinary income from sales and day to day business expenses to work out their taxable income using their cashbook and bank statements. This method provides for greater alignment with the cash basis of accounting used for GST, and

- the effect of cash accounting enables small businesses to relate their tax liability with inflow of business funds.[63]

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Douglas, suggests these claims are overstated and argues that many small businesses already use cash accounting for income tax and management purposes and further that those small businesses that currently choose to use accrual accounting for management purposes could find a small increase in compliance costs as cash accounting is mandatory with the STS.[64]

Ken Traill, consultant to the Institute of Chartered Accountants in Australia ('ICAA'), argues that many small businesses today already use accounting software packages in the market to prepare their accounts and tax returns and thus already use the accruals basis. The ICAA have conducted a survey of members in small practices (ie less than three partners) indicating that 76 per cent of respondents' clients use some form of accrual accounting, 54 per cent use full accrual accounting, while 22 per cent use a modified from covering just trading stock and sales or some other part accrual basis. The ICAA 's criticism of the STS is that it is an all-or nothing system. It is not possible to adopt only those elements of the package that suit the particular circumstances of a business and then reject the rest. Consequently those businesses wanting to use an accruals basis for their accounts and tax returns will not be able to use the depreciation and stock-take elements of the STS. Accordingly the ICAA recommends that the three elements of the package be separated to permit small businesses to elect to use the depreciation pooling method while also using the accruals basis of accounting.[65]

Financial impact

The Bill will have a significant cost to revenue and presumably small business will be the major beneficiary. The financial impact of the STS is set out in the Explanatory Memorandum in the following table[66]:

2001-2002	2002-2003	2003-2004	2004-2005
– $280m	– $547m	– $236m	– $337m

The financial impact of the new 12-month rule for prepayments is expected to be:

2000-2001	2001-2002	2002-2003	2003-2004	2004-2005
– $20m	– $20m	–	–	–

Presumably these measures were originally planned to complement the revenue beneficial measures of the Ralph Review such as the entity taxation[67] and Option 2 reforms which have since been either abandoned or deferred.

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1 July 2001 timeframe?

While the Government has recently abandoned its entity taxation measures and has deferred implementation of the Tax Value Method for business, it still plans to implement the STS by 1 July 2001. In order to meet this tight deadline Parliament will have a considerable task to satisfy itself that the STS meets the objective of reducing compliance costs for most small businesses. This task will be more difficult in the absence of key concepts and definitions regarding the STS yet to be introduced into the Parliament.

Endnotes

1 Review of Business Taxation, *A Tax System Redesigned: More Certain, Equitable and Durable,* July 1999, p. 575.

2 The original start date of 1 July 2001 for Option 2 has been deferred.

3 Ken Traill, 'The Simplified Tax System: Is it Really Simple?', *Charter*, v. 71, March 2000, p. 32.

4 ibid.

5 Treasurer, 'Simplified Tax System - Release of Exposure Draft Legislation', *Press Release*, No. 101, 22 October 2000.

6 Treasurer, 'Simplified Tax System for Small Business' Press Release, No. 110, 7 December 2000.

7 Treasurer, *Press Release: Business Tax Reform: Implementation Timetable* 22 March 2001.

8 See above at p. 2.

9 A fuller discussion of these measures can be found in Bills Digest No 85, 1999-2000, 'A New Business Tax System (Capital Allowances) Bill 1999'.

10 These measures were implemented in the *New Business Tax System (Capital Allowances) Act 1999.*

11 Section 42-125 of the 1997 Act.

12 Section 82KZMA(2)(b) of the 1936 Act.

13 Treasurer, ‚Uniform Capital Allowance System: Release of Exposure Draft Legislation', *Press Release,* No. 114, 18 December 2000.

14 *Explanatory Memorandum,* para 2.11.

15 ibid, para 2.18.

16 ibid, para 2.19.

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17 Michael Dirkis, *'Simplified Tax System: or STS Exposed: A Simplified Tax System for Small Business or a Tax System for Simple Businesses?'* Overview Seminar, Taxation Institute of Australia, p. 17.

18 The "value of business supplies" an entity makes during an income year is defined in subsection 960-345(2) (via section 995-1) of the 1997 Act as the sum of the values of all the taxable supplies the entity made during the year in the ordinary course of carrying on a business[18] and the prices of the other supplies made in the ordinary course of carrying on the business. The calculation excludes the GST payable on the taxable supplies and the definition would exclude from turnover the sale of assets not acquired or used for trading purposes, rental receipts and interest.

19 Grouping rules was a recommendation of the Ralph Review.

20 *Explanatory Memorandum,* para 2.39.

21 ibid, para 2.42.

22 Robert Douglas, The Simplified Tax System for Small Business: an Update, *Taxation in Australia,* v. 35, no. 6, Dec/Jan 2001, p. 323.

23 The Bill contains special provisions for calculating the value of gambling supplies **(proposed subsection 328-375(2))** in order to provide that the amount included in the calculation of STS group turnover is simply the difference between the total amount wagered and total monetary prizes paid out.

24 See p. 12 of the Digest for a discussion of pooling.

25 It is of interest that the Ralph Review did not consider the issue of start-up businesses and the Government's initial proposal was 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. Taxpayers making significant investments would be expected to undertake their own assessments of expected revenues. This proposal was criticised as being difficult to implement, as there is no indication of how many years in advance the projection should span in order to reasonably expect an ongoing turnover in excess of $1 million. The Government responded in the Exposure Draft of the STS Bill with a $2 million cap on depreciating assets. This figure has been increased to $3 million in this Bill.

26 See p. 3 of the Digest for a discussion of the transitional arrangements.

27 Review of Business Taxation, *A Tax System Redesigned: More Certain, Equitable and Durable,* July 1999, p. 575.

28 Taxation Institute of Australia, Letter to the Hon. Peter Costello, *Op cit,* para 28.

29 Section 960-335 of the 1997 Act. See p. 3 of the Digest for a discussion of the transitional arrangements for small business.

30 Robert Douglas, 'The Simplified Tax System for Small Businesses: an Overview', *Taxation in Australia,* v. 35, no 1, July 2000, p. 30.

31 Ordinary income is income under ordinary concepts such as revenue from sales of goods, or services, professional fees and commissions.

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32 Michael Dirkis, *Op cit,* p. 31.

33 Treasurer, ‚Uniform Capital Allowance System: Release of Exposure Draft Legislation', *Press Release,* No. 114, 18 December 2000.

34 A 'depreciating asset' is an asset with a limited effective life and which can reasonably be expected to decline in value over the period it is used (*Explanatory Memorandum,* para 5.20).

35 The 'effective life' of an asset is determined at the time the asset is first used, or installed ready for use, for any purpose (*Explanatory Memorandum,* para 5.20).

36 An asset's 'cost' will usually be the amount(s) the taxpayer has paid to hold the asset (net of GST credits). An asset's cost consists of 2 elements - the amount(s) you initially pay to hold the asset (the first element) and the amount(s) you are taken to have paid after you start to hold the asset (the second element, *(Explanatory Memorandum,* para 5.20).

37 A 'balancing adjustment event' occurs when a taxpayer ceases to hold a depreciating asset. For example, a balancing adjustment event occurs where the asset is disposed of, lost or destroyed (*Explanatory Memorandum,* para 5.20).

38 A 'taxable purpose' is the purpose of producing assessable income (*Explanatory Memorandum,* para 5.20).

39 An asset's 'adjustable value' is its cost less any amounts that the taxpayer has deducted, or could have deducted, for its decline in value since the asset was first used, or installed ready for use, for any purpose. Assets already held by the taxpayer on entering the STS are included in an STS pool at their adjustable value (*Explanatory Memorandum,* para 5.20).

40 The asterisk next to the term 'low cost asset' indicates that it is defined. Presumably this is to be defined in the capital allowances legislation yet to be introduced into the Parliament.

41 *Explanatory Memorandum*, para 5.31.

42 Under the original Ralph proposals, depreciating assets with a life of more than 25 years (long-life assets) were to be depreciated on an effective life, per-item basis. Following representations from industry and professional associations, a separate pool is to be established for long-life assets.

43 The Bill introducing Division 40 is still to be introduced into the Parliament.

44 It was originally proposed that assets acquired during a year would be subject to pro-rata depreciation depending on which quarter of a year they were acquired.

45 *Explanatory Memorandum,* para 5.38.

46 *Explanatory Memorandum,* para 5.24.

47 The Bill introducing Division 40 is still to be introduced into the Parliament.

48 Trading stock is defined in section 60-10 of the 1997 Act to include:

- anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of a business; and
- livestock.

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49 The Explanatory Memorandum suggests that taxpayers may prefer to adjust their assessable income in smaller annual increments rather than in one larger amount when the change in value of trading stock exceeds $5000 (para 6.12).

50 *Explanatory Memorandum,* para 6.14.

51 These definitions are all discussed above under Schedule 1.

52 Treasurer, ' The New Business Tax System', *Press Release*, 21 September 1999, Attachment 1 Introducing a Simplified Tax System for Small Business.

53 Quoted by Michael Dirkis, *Op Cit* who also quotes Robert Douglas, *Op Cit,* and Ken Traill, *Op Cit.*

54 Taxation Institute of Australia, Letter to the Hon. Peter Costello, *Exposure Draft: New Business Tax System (Simplified Tax System) Bill 2000*, 17 November 2000, para 11.

55 For example the Taxation Institute of Australia, *Op Cit,* p. 26.

56 For example Michael Dirkis, *Op Cit,* p. 26.

57 ibid.

58 Michael Douglas, Robert Douglas, 'The Simplified Tax System for Small Businesses: an Overview', *Taxation in Australia,* v. 35, no 1, July 2000, p. 30.

59 Michael Dirkis, *Op cit,* p. 47.

60 ibid, para 6.13.

61 Quoted in Michael Dirkis, *Op cit,* p. 51.

62 Robert Douglas, The Simplified Tax System for Small Business: an Update, *Taxation in Australia,* v. 35, no. 6, Dec/Jan 2001, p. 324.

63 *Explanatory Memorandum, paras* 4.11–4.13.

64 Michael Douglas, Robert Douglas, 'The Simplified Tax System for Small Businesses: an Overview', *Taxation in Australia,* v. 35, no 1, July 2000, p. 32.

65 Ken Traill, *Op cit,* p. 32.

66 page 4.

67 The Government has recently announced its intention to withdraw the 'Exposure Draft: New Business Tax System (Entity Taxation) Bill 2000' and not to proceed with the reform of entity taxation. Treasurer 'Entity Taxation', *Press Release*, 27 February 2001.

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