IS THE SIMPLIFIED TAX SYSTEM SIMPLE?

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1 Introduction

The paper presents a critical analysis of the operation and impact of the Simplified Tax System (STS) from inception to date. Whilst other researchers have previously analysed STS from a range of policy and practice perspectives, this paper extends on the existing literature in two aspects. Firstly, the paper ‘adds another chapter’ by including in its analysis the changes made to STS in 2005 and 2006. Secondly, the thematic lens of this analysis is primarily ‘simplicity’. This lens is applied to the underlying policy intent, the legislation itself, its application and its impact on taxpayers and tax practitioners. Ultimately there are three key questions that the paper sets out to address, namely: is STS simple?; is STS now more simple than previously?; and how can STS be made more simple?

The paper is presented in nine parts. Following this Introduction, part 2 of the paper provides the background to the introduction of STS and identifies the key features of STS. Each of these key features in then discussed in the parts that follow – issues and developments pertaining to eligibility are examined in part 3; those pertaining to accounting method are examined in part 4; trading stock in part 5; depreciating assets in part 6; prepayments in part 7; and issues and developments in relation to the entrepreneurs’ tax offset are examined in part 8. Part 9 of the paper provides an overall summary of the analysis and draws conclusions to three key questions that were set.

2 Background

The STS was first introduced effective from 1 July 2001 as part of a package of measures to assist small business that was recommended by the Ralph Committee’s Review of Business Taxation. The STS was designed to address the calls from small businesses for recognition of the additional and regressive compliance burden that they faced, and for a simpler and more certain system to be introduced. It was to be an alternative method of determining taxable income available for eligible small businesses that had straightforward financial affairs.

Based on Recommendation 17.1 of the Ralph Committee, it was originally envisaged that STS would apply to small businesses with an annual turnover or annual receipts of less than $1 million, exclusive of Goods and Services Tax (GST) and which derived less than 5 per cent of income from a leasing activity. Eligible small businesses would be able to elect to be taxed under STS which would consist of:

(i) a cash accounting regime – for recognising business income and day-to-day expenditure as an alternative to an accruals-based regime;
(ii) 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
(iii) a simplified trading stock regime – as an alternative to an annual requirement for stocktaking and stock valuation.

Relying primarily on data obtained from a 1993 publication by the Australian Bureau of Statistics (ABS), the Ralph Committee estimated that over 95 per cent of businesses in Australia would be eligible to enter the STS based on the recommended turnover threshold of $1 million.

The Explanatory Memorandum accompanying the New Business Tax System (Simplified Tax System) Bill 2000 reflected the key elements of Recommendation 17.1 of the Ralph Committee. In addition, the Bill included a new 12 month rule for prepayments of deductible expenses by STS and non-business taxpayers.

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3 As reported in various research studies, for example, Evans, C., Ritchie, K., Tran-Nam B. and M. Walpole, 1997, A report into taxpayer costs of compliance, Commonwealth of Australia, Canberra, p. 51.
4 See note 2.
5 The limit on leasing income was intended to prevent businesses participating in STS from being able to transfer the ‘benefits of higher rates of pooled depreciation to lessees outside that system’. Ralph Committee at note 2, p.577.
6 The publication is cited as 1993 on p 576 in the Ralph Committee Report (at note 2), however is cited as being a 1999 publication on p. 88 of the relevant Explanatory Memorandum (at note 7).
8 Recommendation 4.3 of the Ralph Committee, at note 2 p.172.
The Explanatory Memorandum⁹ stated that the main object of the STS was to provide a reduction in the effective tax burden and simplified record keeping and reporting requirements for eligible small businesses. In terms of the reduction of effective tax burden, the only further information provided was that the implementation of the three regimes was intended to reduce the level of documentation that small business taxpayers were required to prepare for taxation purposes and to reduce the related labour and other ongoing costs. That is, it appeared that the reduction in effective tax burden was to be achieved by the reduction of compliance costs, rather than by the provision of any reduction in tax liabilities (other than timing adjustments). The expected financial impact of STS was reported as follows:¹⁰

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These figures were apparently calculated on the basis that only 60% of eligible small businesses were expected to take elect to be taxed under STS.¹¹ This obvious disparity between expected rates for eligibility and uptake of STS was questioned by Dirkis and Bondfield who believed that it was disingenuous and playing on public perceptions. Further, they questioned the wisdom of implementing a system that would benefit only a little over half of those who were considered (by the Ralph Committee) to be in need of assistance.¹² This in turn leads one to question whether or not STS offers real and worthwhile benefits and, more importantly, whether or not was as it ever intended to be successful.

One further area of concern in respect of public perceptions is the issue of compliance costs. Whilst the Ralph Committee¹³ noted the regressive nature of compliance costs and this was, in effect, put forward as a justification for STS, it is reported in the Bills Digest that 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 Method.”¹⁴ That is, there is some doubt as to the motive of STS and the extent to which it was designed to alleviate the compliance cost burden that existed at the time. This confusion is further compounded by the legislation itself with s328-50 ITAA 1997 stating that one of the objects of STS is to reduce tax, in spite of this not being explicitly stated by the Ralph Committee or in the Explanatory Memorandum.

Against this background, the various aspects of STS are now examined in more detail including their original design and subsequent changes.

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⁹ At note 7 p.6 (para 1.7).
¹⁰ At note 7 p.4.
¹¹ This is not apparent from the EM, but apparently was the basis of the costings provided by the Ralph Committee. See Dirkis, M. and B. Bondfield, 2004, “The RBT ANTS Bite: Small Business the First Casualty”, Australian Tax Forum, Vol. 19 No. 2, pp.107-158 at p.145.
¹² At note 11.
3 Eligibility

The Ralph Committee envisaged that the STS would require ‘safeguarding provisions’ if its measures were to appropriately target ‘genuine small businesses’. These safeguarding provisions ultimately took the form of three criteria[^15]: the taxpayer had to be carrying on a business in the relevant year[^16]; the taxpayer had to have an ‘STS average turnover’ of less than $1 million, and the business and its affiliates had to have depreciating assets with values totaling less than $3 million at the end of the relevant year.[^17]

There criteria in respect of depreciating assets was non-existent during the transitional period,[^18] with the criteria being first introduced with a $2 million threshold in the draft exposure STS Bill. The threshold was subsequently increased to $3 million when STS was finally legislated.[^19]

If these three conditions are satisfied and the taxpayer wants to enter the STS, the taxpayer must notify the Commissioner of this choice.[^20] Notice is normally given in the tax return for that year, but can also be given subsequently in the case of requests for amendment or the lodgment of a notice of objection.[^21] Once a taxpayer joins the STS, STS continues to apply until the taxpayer is no longer eligible (with eligibility being reassessed each year), or notifies the Commissioner that the STS is to no longer apply (by choice).[^22] If the taxpayer ceases to be eligible to be an STS taxpayer, the taxpayer must notify the Commissioner of the fact in the approved form.[^23]

There are special rules that apply where a taxpayer chooses to exit the STS (rather than is no longer eligible) effectively restricting a re-entry until at least five years after the

[^16]: s328-365(1)(a) ITAA 1997 and based on existing case law.
[^17]: s328-365(1)(c) ITAA 1997. It is noted that the limit on the value of depreciating assets did not apply during the transition to STS (from 21 September 1999 to 30 June 2001). In the exposure draft STS Bill the threshold had been $2 million, though this was subsequently increased after further consultation with small business representatives. The Explanatory Memorandum (at note 7 p.12 para 2.7) indicates that this criteria was deemed necessary to ensure that entities with low turnover in early years of operation but with large investments in capital assets were ineligible to enter STS.
[^18]: The transitional period was from 21 September 1999 to 30 June 2001. During this period small businesses having a 3 year average turnover of less than $1 million could continue (without the need to make any election) to have access to balancing adjustment offsets and accelerated depreciation for plant and equipment.
[^21]: TD 2003/31; s328-435(b) ITAA 1997. Note that in TD2003/30 the Commissioner has taken the view that once notice has been given, the taxpayer cannot subsequently alter the choice for that year.
[^22]: Four public rulings have been necessary on the issue of entering and exiting STS: TD 2003/29; TD 2003/30; TD 2003/31 and ATO ID 2003/38.
[^23]: s328-440(2) ITAA 1997.
income year of exit.\textsuperscript{24} There are also special adjustments that apply on both entry to and exit from STS to avoid double taxation and prevent avoidance.\textsuperscript{25}

This concern about the need for ‘safeguarding provisions’ is somewhat difficult to understand given that the turnover threshold recommended by the Ralph Committee was set at the level at which almost all businesses in Australia would be eligible and able to benefit from STS – which appeared to be the point of the exercise. Nevertheless, the safeguarding provisions were legislated. As can be seen from the above discussion, the rules in respect of entering and exiting STS are themselves not straightforward. Other aspects of eligibility that are clearly important and warrant further discussion are the concepts of ‘average turnover’ and affiliates (or ‘grouped entities’).

3.1 Average Turnover

The requirement for an STS taxpayer to have an average turnover for the relevant year of less than $1 million is at S328-365(1)(b) ITAA 1997.\textsuperscript{26} The STS average turnover is normally calculated using the turnover of the taxpayer and its ‘grouped entities’ in any three of the last four years (excluding input tax credits and decreasing adjustments).

An entity’s STS average turnover can now be calculated either retrospectively or prospectively, all that is required is that eligibility be met by either means.\textsuperscript{27} Under s328-370(1)(a), the STS average turnover in a year is the average of the yearly turnovers in any three of the previous four income years, net of GST and intra-group transactions.\textsuperscript{28} Where a business has not been operated continuously for this period, the taxpayer may make a reasonable estimate.\textsuperscript{29} The same principle applies should the taxpayer calculate average turnover prospectively.\textsuperscript{30}

\textsuperscript{24} S328-440(3) ITAA 1997. Note there are exceptions to this general rule as a result of changes to the STS accounting method effective from 1 July 2005. These are discussed in part 4 of the paper.

\textsuperscript{25} S328-110; S328-115 ITAA 1997. These provisions were deemed necessary because of the specific accounting rules that applied to STS taxpayers until 30 June 2005. Both were repealed by No. 41 of 2005.

\textsuperscript{26} It was announced in the 2006-2007 Federal Budget that the average turnover threshold would be increased to $2 million and that the calculation of the STS and GST definitions of turnover would be aligned to include input taxed supplies calculated over the same period (http://www.budget.gov.au/2006-07/speech/html/index.htm 29/11/06).

\textsuperscript{27} Note that it was originally proposed to be calculated retrospectively only, which would have been different to the calculation required for GST purposes – see Douglas, R., 2000, “The Simplified Tax System for Small Business – an Overview”, Taxation in Australia, Vol. 35 No. 1, pp. 28-34 at p.32.

\textsuperscript{28} Note that special rules apply to gambling businesses (s328-375(2) ITAA 1997) whereby the actual value of supplies is calculated as 11 times the entity’s ‘global GST amount’ as defined in s126-10 GST Act. That is, the STS rule is designed to align with a similar calculation required for GST purposes. Further, an alternative method of calculation has been made available for fuel retailers because of their high turnover and low profit margin (reg 328-375.01 Income Tax Assessment Regulations 1997). However, increasing the threshold would effectively cater for the latter.

\textsuperscript{29} In TR 2002/11 the Commissioner has indicated that in most cases he will accept the amount shown in the taxpayer’s Business Activity Statement or assessable income when looking backwards; and will accept forward projections where they are ‘reasonable’ and meet certain conditions such as undertaken in good faith and result from a rational and reasoned process of estimation.

\textsuperscript{30} S328-370(4) ITAA 1997.
The provisions for calculating average turnover do appear to be so flexible as to question their necessity. They (and the increase in threshold) give the appearance of supporting inclusiveness. However, they are not simple as evidenced by the length (33 pages) of the relevant public ruling. The provisions in respect of average turnover are undoubtedly further complicated by the concept of ‘grouped entities’.

### 3.2 Grouped entities

S328-380 ITAA 1997 contains the tests by which entities can be considered ‘grouped’ and this test is relevant to both the average turnover test and to the test for the value of depreciable assets in determining eligibility. Basically, entities are grouped where one controls the other, or both are controlled by a third entity.

There are more detailed provisions covering the aspect of ‘control’ specifically in relation to individuals, companies, fixed trusts, non-fixed trusts and partnerships that cover issues including interests in the distribution of income or capital; rights and voting powers. For example, X is held to control Y if X has the right to at least 40% of the voting power in Y where Y is a company.\(^\text{31}\) However, where the level of control is between 40% and 50% the Commissioner has discretion to determine that one entity does not control a second entity if he is satisfied (or thinks it is reasonable to assume) that an unrelated entity actually controls the second entity.\(^\text{32}\)

Where the eligibility criteria is satisfied, entities within the group can each decide individually whether or not to enter the STS, a group decision is not required. Members cannot be excluded from the group in order to satisfy the eligibility criteria.\(^\text{33}\)

The Ralph Committee\(^\text{34}\) had suggested that the model used by the States’ payroll tax legislation or the Capital Gains Tax (CGT) grouping rules may have been appropriate models for the STS grouping provisions. The provisions adopted by STS do closely mirror the CGT small business concessions, but are different to the general grouping rules that exist elsewhere in either income tax or GST law.\(^\text{35}\)

The grouping provisions are not simple\(^\text{36}\) and have come under considerable criticism. For example, Douglas\(^\text{37}\) pointed out that, based on Example 2.6 in the Explanatory

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\(^{31}\) s328-380 (3)(b) ITAA 1997.

\(^{32}\) s328-380(7) ITAA 1997.


\(^{34}\) At note 2, p.576.

\(^{35}\) ATO Fact Sheet (NAT 7169) illustrates the operation of the STS grouping rules (on a simplified basis) by means of a flowchart.

\(^{36}\) TR 2002/6 (38 pages in length) was issued to rule on the STS grouping provisions.

Memorandum, a husband and wife who run two separate businesses but did discuss business matters could find themselves ‘grouped’. Walker argued that the grouping measures could prove complicated where a number of entities are involved or there is cross ownership of entities. Again, given that almost all business in Australia would satisfy the $1 million turnover threshold of STS, the question as to whether this safeguarding provision was necessary, remains. As maintained by Bondfield and Dirkis, any exploitation of the turnover threshold rules (or for that matter, any of the integrity measures) could have been dealt with under Part IVA ITAA 1936 – a much more simple solution.

Further, it was announced in the 2006-07 Budget that the STS average annual turnover would be increased from $1 million to $2 million. This draws even more attention to the question of whether these integrity measures are necessary as the percentage of business outside the proposed threshold would be minute.

4. Cash Accounting

For income tax purposes, it had long been the accepted practice that the meaning of ‘incurred’ (in respect of deductible expenses for cash accounting purposes) was interpreted broadly by the Commissioner to include expenses paid or payable whilst the derivation of income was upon receipt, as established by case law. The Ralph Committee believed that the cash accounting method that had been used for income tax purposes was uncertain and not well founded, hence its recommendation for a modified cash accounting method as was prescribed in Subdiv 328-C ITAA 1997. Under this subdivision, STS taxpayers basically accounted for their ordinary income upon receipt, and accounted for general deductions upon payment.

This modified cash account system used in the STS mirrored the cash accounting system used for GST purposes. However, for GST purposes, businesses with a turnover of $500,000 or more are required to use accrual accounting. Further, it became apparent that small business taxpayers who needed to monitor debtors and creditors preferred accrual accounting. Clearly, the requirement to keep two accounting systems, or hybrid systems, could not lead to reduced record keeping or compliance costs.

The take up rate of STS remained low in its early years and was reported to be only 14% for the year ended 30 June 2002. The prescribed modified accounting system was commonly cited as a deterrent to eligible small businesses and the issue of compliance

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39 At note 11.
40 See TR 97/7.
41 At note 2, p. 579.
29/11/06.
costs remained a major concern for taxpayers. In response, Subdiv 328-C ITAA 1997 was repealed in October 2005 effective from 1 July 2005. Taxpayers entering STS from 1 July 2005 are required to use the appropriate method of accounting based on the nature of their business and the relevant case law. The correct method of accounting is that which gives a correct reflex of income. For example, a taxpayer trading in goods would be expected to use accrual accounting, whilst a sole trader providing services (such as an accountant) would be expected to use cash accounting. That is, the accounting method to be used for income tax purposes by new entrants to STS is the same method that would have otherwise applied.

The repeal of Subdiv 328-C is clearly an improvement in terms of the simplicity of STS policy, legislation, its application and impact on taxpayers and tax practitioners. Common sense prevailed. One of the consequences of this change was to introduce transitional provisions to suspend the re-entry rule for five years from 1 July 2005 for taxpayers who exited the STS for the 2004-05 and prior years (the assumption being that they exited because the cash accounting method was no longer appropriate).

5. Depreciating assets

In general, the assets of STS taxpayers fall into one of three categories as prescribed in Subdiv 328-D ITAA 1997. The first category are those depreciating assets acquired for a taxable purpose and costing less than $1,000, which can be written off immediately and claimed as a deduction in the year in which the asset is first used, or installed ready for use. Non STS business taxpayers under Div 40 ITAA 1997 have no threshold for write-off purposes but instead must rely upon calculations based on effective life. Thus the immediate write-off afforded of lower-cost assets afforded by STS is comparatively attractive although it is a timing issue rather than a tax saving per se.

The second category of depreciating assets includes those costing more than $1,000 and with an effective life of less than 25 years. These are pooled in a general STS pool and depreciated at the diminishing value rate of 30%. The third category of depreciating assets are those costing more than $1,000 and with an effective life of 25 years. These

43 See response by Mr Dutton, Minister for Revenue and Assistant Treasurer, to Question 3121, House of Representatives, Tuesday 31 October 2006.
44 The exception to this principle is that taxpayers who entered STS before the 2005-06 income year can choose to continue using cash accounting (328-115 Income Tax (Transitional Provisions) Act 1997).
45 s28-115 ITAA 1997.
46 s328-180 ITAA 1997.
47 Though not necessarily all that generous. By way of comparison, the US code allows for small businesses to immediately write off assets costing up to $100,000. See McKerchar, M., Ingraham, L. and S. Karlinsky, 2005, “Tax complexity and small business: a comparison of the perceptions of tax agents in the United States and Australia” Journal of Australian Taxation, Vol. 8 No. 2., pp.289-327.
48 s328-185(2); s328-190(1)(a) ITAA 1997. Note that the comparative attractiveness of this rate compared to that otherwise available under Div 40 ITAA 1997 will decline given that the diminishing value uplift factor has increased from 150% to 200% of the prime cost rate for post 9 May 2006 assets (s40-72 ITAA 1997).
assets are pooled in a long life STS pool and depreciated at the DV rate of 5%.\(^{49}\) To eliminate pool tails, where the value of either pool falls to $1,000 or less, the balance of that pool is written off immediately.\(^{50}\)

There are some exceptions to these general principles. For example, certain depreciating assets used to carry on a business of primary production can be claimed either under the STS provisions or under Subdiv 40-F (water facilities or horticultural plants) or Subdiv 40-G (landcare, connection of electricity or telephone lines) as appropriate.\(^{51}\) Note that where a STS taxpayer exits the system, any pooled assets remained pooled and the STS rates for pooled assets continue to apply to those assets.\(^{52}\) New assets then acquired cannot be allocated to these pools but would need to be depreciated under the provisions of Div 40. From a record keeping perspective, this need to maintain two distinct capital allowances systems would be a deterrent for a STS taxpayer considering an exit strategy.

Non STS taxpayers would normally calculate the capital allowance (or depreciation) of each asset individually and prima facie, this appears to require more record keeping and effort on the part of the taxpayer than simply keeping track of two pools. However, given that over 90% of business taxpayers are using the services of tax agents who would in turn be almost universally using software packages,\(^{53}\) the calculations themselves (either under Div 40 or STS) require little effort. It may also be considered that having each item listed individually on a depreciation schedule does in itself form an asset register that in itself is a useful tool in managing the business and its tax affairs.

### 5.1 Acquisitions

In the year of acquiring or improving an asset (at a cost of more than $1,000) which is to be allocated to a pool, the assets attract a pool deduction of half of the standard rate that applies to that pool in the year of the addition.\(^{54}\) An exception is in the case of the first year of entering STS where then opening value of the pool is held to reflect the closing value of the assets held immediately prior to entry (adjusted to exclude any non-business percentages).\(^{55}\) That is, acquiring an asset on 1 July will attract a lesser deduction under STS than under the Div 40 provisions. Under STS a timing gain could be made in the year of acquisition on the claim for depreciation for assets, say, purchased in June. Conversely, a timing loss in the year of acquisition would occur for assets purchased in

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\(^{49}\) s328-185(2)(b); s328-190(1)(b) ITAA 1997. Note that the Ralph Committee did not originally propose a long life pool. Instead, these assets were to be depreciated on an effective life, per-item basis. The long life pool was established as a result of representations from industry and professional associations. Buildings cannot be added to the long life pool unless they also qualify for primary production deduction: see Douglas at note 37 p.323.

\(^{50}\) s328-210(2)(3) ITAA 1997.

\(^{51}\) s328-175(3) ITAA 1997.

\(^{52}\) s328-220(1) ITAA 1997. Under s328-185(7) once an asset is allocated to a pool it cannot be reallocated.


\(^{54}\) s328-185(5) ITAA 1997. Note that the Ralph Committee in Recommendation 17.3 had envisaged a pro-rata of depreciation on a quarterly basis. On this basis the 50% rule is more simple.

\(^{55}\) s328-195(1) ITAA 1997.
July. Timing losses and gains may or may not advantage a taxpayer depending on their circumstances.

Assets that have a part private use have their taxable purpose proportion adjusted at the time of entering the pool.\textsuperscript{56} That is, if an asset cost $10,000 and its private usage was estimated at 20%, then only $8,000 would be allocated to the pool. Effectively this taxable purpose proportion for every asset needs to be re-estimated in each subsequent year (up to three years after the year of income in which the asset was allocated to the STS general pool, or up to 20 years in the case of the long life STS pool). Where the private/business usage changes by more than 10%, an adjustment is made to the opening pool value.\textsuperscript{57} This means a STS taxpayer would still need to keep track of individual assets in the pool and their current business/private usage. That is, the single asset or pool that the Ralph Committee envisaged is simply not possible unless no disposals or acquisitions ever take place and business usage remains constant.

5.2 Disposals

The disposal of an asset which has fallen into one of the three STS asset categories does require adjustments to be made. Where an asset costing less than $1,000 had been subject to an immediate write off and subsequently sold, the business use proportion of the proceeds of the sale is required to be returned as assessable income.\textsuperscript{58} In the case of the disposal of a pooled asset, the business use proportion of the proceeds of sale (its ‘termination value’) must be subtracted from the pool balance at the end of the year of disposal.\textsuperscript{59} Where the disposal results in the pool having a negative balance, then this amount is included as assessable income in that year and the pool balance becomes zero.\textsuperscript{60} Where the disposal results in the pool having a positive or nil balance, no further adjustment is required and the pool balance is carried forward. In contrast, a loss on the disposal of an asset (under Div 40) could generate a more immediate tax relief than would the adjustment of the value of the pool as under STS.

By way of illustration of the operation of an STS pool, below is an extract of a series of examples from the Explanatory Memorandum.\textsuperscript{61} It would be difficult to conclude on the basis of these examples that the calculations required for depreciating pooled are simple!

Example 5.2: Determining the taxable purpose proportion of the adjustable value of STS assets
Eugene is an STS taxpayer from the 2001–2002 income year. He owns 2 assets which are used in his print shop business. He has a van. It has an effective life of 8 years and the adjustable value is $25,000. Eugene estimates he uses the van 70% of the time for the purpose of producing assessable income. This means the taxable purpose proportion of the van’s adjustable value is $17,500 (70% of $25,000).

\textsuperscript{56} s328-205(1); s328-225 ITAA 1997.
\textsuperscript{57} s328-225 ITAA 1997. The calculation of the adjustment as required at (3) and (4) is not simple.
\textsuperscript{58} s328-215(4) ITAA 1997.
\textsuperscript{59} s328-215(2) ITAA 1997.
\textsuperscript{60} s s328-215(2); s328-215(3) ITAA 1997.
\textsuperscript{61} Explanatory Memorandum at note 7, pp55-63.
The other asset is a printing press. It has an effective life of 2 years and the adjustable value is $5,000. The press is used solely for the purpose of producing assessable income. Eugene expects this rate of usage to continue. This means the taxable purpose proportion of the press’ adjustable value is $5,000 (100% of $5,000).

As the effective life of each asset is less than 25 years, they are both allocated to the general STS pool. The STS general pool’s opening balance for the 2001−2002 income year is:

\[ \text{Opening Balance} = \text{van} \text{ taxable purpose proportion} + \text{press taxable purpose proportion} \]

\[ = 17,500 + 5,000 \]

\[ = 22,500 \]

**Pool deductions**

5.43 A taxpayer in the STS will calculate the annual deduction for pooled depreciating assets by multiplying the opening balance of the pool by the pool’s deduction rate \[\text{Schedule 1, item 1, subsection 328–190(1)}\]. (Note that if the pool has a low value for an income year, an amount can be claimed under section 328–210 instead of calculating the annual pool deduction.)

**Example 5.3: Calculating the annual pool deduction for an STS pool**

Eugene calculates the deduction for the general STS pool by multiplying its opening pool balance by the general STS pool rate of 30%:

\[ 22,500 \times 30\% = 6,750 \]

This results in a deduction of $6,750 for the pool for the year.

**Example 5.4: Treatment of assets that are first used, or installed ready for use, during an STS income year**

In the 2001−2002 income year, Eugene acquires and begins to use a new millennium press in place of the old press. The millennium press costs $20,000. The press has an effective life of less than 25 years. Eugene estimates it will be used only for business purposes, so the taxable purpose proportion of the adjustable value of the millennium press is $20,000 (100% of $20,000).

In the first year the millennium press is used to produce assessable income, the deduction is 15% of the taxable purpose proportion of the asset’s adjustable value:

\[ 20,000 \times 0.15 = 3,000 \]

Eugene claims $3,000 in respect of the millennium press in the 2001−2002 income year. (The press is then allocated to the general STS pool in the 2001−2002 closing pool balance calculation).

**Example 5.5: Calculating the taxable purpose proportion of assets disposed of during the year**

During the 2001−2002 income year Eugene sells his old press for $2,000. The taxable purpose proportion of the asset’s termination value is $2,000 (because Eugene’s business use estimate is 100%).

**Example 5.6: Calculating the closing pool balance**

Eugene calculates the general STS pool’s 2001−2002 closing pool balance in the following order:

1. Eugene must add the taxable purpose proportion of the adjustable value of the millennium press (acquired during 2001−2002) to the pool’s 2001−2002 opening balance: $22,500 + $20,000 (100% business purpose estimate for the millennium press) = $42,500 (Eugene has incurred no cost addition amounts).

2. Eugene then subtracts from $42,500 the following amounts:
   \$2,000 (termination value of old press — see Example 5.5)
   \$6,750 (pool deduction — see Example 5.3)
$3,000 (15% deduction for the millennium press Eugene began to hold in 2001–2002 — see Example 5.4)
= $30,750

3. Therefore, the final closing pool balance for Eugene’s general STS pool in 2001–2002 is $30,750. The opening pool balance for Eugene’s 2002–2003 general STS pool will be $30,750.

**Example 5.7: Change in an asset’s taxable purpose proportion**

In September 2002 Eugene estimates that the taxable purpose proportion of his van increases from 70% to 85%. Before Eugene can calculate the 2002–2003 deduction for the general STS pool, Eugene must adjust the 2002–2003 opening pool balance to reflect the van’s new business use estimate. The closing pool balance for 2001–2002 is $30,750. This is the opening pool balance for 2002–2003. The adjustment that is required to be made is:

reduction factor x asset value x (present year estimate − last estimate)

Eugene was depreciating the van prior to entering the STS. The ‘reduction factor’ is therefore:

\[(1 − rate)^n\]

Excluding this year (2002–2003), a deduction was allowed for the van under this Subdivision in the 2001–2002 income year. Therefore n = 1 and the reduction factor is:

\[(1 − 0.3)^1 = 0.70\]

The ‘asset value’ of the van is $25,000 (its adjustable value when Eugene’s print shop joined the STS). The present year estimate less the last estimate is:

\[0.15(0.85 − 0.70)\]

As a result the calculation is:

\[0.70 \times 25,000 \times 0.15 = 2,625\]

The 2002–2003 opening pool balance of Eugene’s general STS pool needs to be increased by this amount. Thus, the adjusted opening pool balance is:


Once Eugene’s 2002–2003 general STS opening pool balance has been adjusted, the 2002–2003 pool deduction can be calculated. The deduction is:

\[30\% \times 33,375 = 10,013\]

As Eugene has not acquired or disposed of any assets during 2002–2003, the closing balance calculation is as follows:

\[33,375 (2002–2003 adjusted opening pool balance) − 10,013 (general STS pool deduction: 30\% \times 33,375) = 23,362\]

The opening pool balance for Eugene’s 2003–2004 general STS pool will also be $23,362.
6. Trading stock

Subdiv 328-E ITAA 1997 contains a simplified system of accounting for trading stock for STS taxpayers whereby they are only required to account for changes in their trading stock on hand at the end of the year if the difference between opening stock and their reasonable estimate of closing stock exceeds $5,000.62

However, where the increase in trading stock exceeds $5,000, Subdiv 70-C ITAA 1997 would apply and an adjustment would be need to be made to taxable income. This is illustrated in the following example.63

<table>
<thead>
<tr>
<th></th>
<th>Actual opening stock $</th>
<th>Actual (estimated) closing stock $</th>
<th>No STS concession Income(+) / deduction(–) $</th>
<th>With STS concession</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Opening (deemed) stock $</td>
</tr>
<tr>
<td>Year 1</td>
<td>40,000</td>
<td>43,000</td>
<td>+3,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>43,000</td>
<td>46,000</td>
<td>+3,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>46,000</td>
<td>49,000</td>
<td>+3,000</td>
<td>46,000</td>
</tr>
</tbody>
</table>

To be able to determine the extent to which the value of trading stock has changed, the taxpayer is required to make a reasonable estimate – reasonable, given all the circumstances.64 Critics have pointed out that examples in both the Explanatory Memorandum and legislation illustrate that reliable and accurate record keeping system would be a requirement.65 There appears to be little scope for improved simplicity or a reduction in compliance costs in respect of trading stock.

However, unlike the pooling provisions, the trading stock provisions are not mandatory for STS taxpayers. Further, given the repeal of Subdiv 328-C ITAA 1997 the trading stock provisions may be more simple than previously, particularly where small business taxpayers prefer to use accrual accounting consistently for income tax purposes.

7. Prepayments

Before the introduction of STS, a 13 month rule applied to the deductibility of prepayments by ‘small business taxpayers’ as defined by s 960-335 ITAA 1997. With

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62 The intention based on the Exposure Draft was that trading stock would be accounted for on a cash basis though this was relaxed as a result of wider consultation: see Bondfield, B, 2002, “If there is an art to taxation the simplified tax system is a dark art”, *Australian Tax Forum*, Vol. 17 No. 3, pp.313-360 at p.356.

63 Adapted from Atax study materials prepared by Professor Chris Evans.

64 Explanatory Memorandum, at note 7, p. 73. The ATO has articulated its expectations on a reasonable estimate in its publication “The Simplified tax System – A guide for tax agents and small business at note 33.

65 See Douglas at note 37.
the introduction of STS, the 13 month prepayment rule was replaced by a new 12 month rule, but was only available to those small business taxpayers who were eligible and elected to be taxed under the STS. This may have implications for the timing of tax liability for small business taxpayers, but it is not relevant to the goal of having a more simple tax system for business or reducing compliance costs. If anything it is a financial inducement of sorts (given that it is a timing issue) to business to enter the STS.

8. Entrepreneurs’ Tax Offset

In the few years that have elapsed since the introduction of STS, it became more and more apparent that more inducements were needed if the uptake rate was to increase substantially. Compliance costs for small business remained on the political agenda, which is not surprising given that most of the STS measures discussed thus far appear to be anything but simple.

The Entrepreneurs’ Tax Offset (ETO) was announced by the Government in the 2004 election policy statement Promoting an Enterprise Culture. The offset was ‘designed to foster the entrepreneurial spirit of small businesses’. The Explanatory Memorandum goes on to explain that offset was not intended to reduce small business compliance costs as ‘this aim was achieved by providing eligible small businesses with simpler depreciation rules than under the uniform capital allowances regime, a cash basis for recognising income and deductible expenses (see Chapter 2 for changes to this component), and simple trading stock rules.”

The ETO is available from 1 July 2005 to STS taxpayers with a turnover of less than $50,000. The offset is a maximum of 25 per cent of the tax applicable to net business income and will reduce by the rate of 21 per cent per $1,000 of turnover over $50,000, expiring at $75,000. Few would describe this mixing of bases as simple and its application has to date required two ATO interpretative decisions.

The Minister for Revenue and Assistant Treasurer has recently reported that more than 600,000 taxpayers have elected into the STS (equivalent to approximately 25-30%) at the end of the 2005 year and that an increase in the take up rate was expected when 2006

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66 s82KZM(1) ITAA 1997.
67 The Treasurer has asked the Board of Taxation to undertake a scoping study of small business compliance costs and to report back in late 2006. See http://www.taxboard.gov.au/content/tax_compliance_costs.asp 29/11/06.
69 Ibid, Chapter 1. It is a somewhat contradictory assertion to follow as Chapter 2 of the same EM explains why the requirement to use cash accounting is being repealed at the same time.
70 Subdiv 61-J ITAA 1997.
71 ID 2006/227 (ETO and personal services income – partnership); ID 2006/228 (ETO and personal services income – company).
72 The Compliance Plan 2005-06 (http://www.ato.gov.au/corporate/content.asp?doc=/content/53764.htm) indicated that there were 2.3 million micro-businesses – i.e. those businesses with a turnover of less than $2m. The Plan from the previous year indicated that 80% of micro businesses have a turnover of less than 200,000. This would indicate that between 25% and 30% of eligible small business had entered the STS up until the 2005 year.
income tax returns are lodged based on the repeal of Subdiv 328-C.\textsuperscript{73} He also maintained that the STS had reduced compliance costs from the outset and that the Government had continued to respond to community feedback and has modified the system to increase both its accessibility and its benefits.

Another aspect of change to STS that was announced in the 2004 Federal Budget was the reduction of the review period of assessments issued to STS taxpayers from 4 yrs to 2 years.\textsuperscript{74} Of all the STS measures, this one does appear to reduce the record keeping requirements and compliance costs of small business – though a counter argument could be that the only saving is in record retention. Clearly, having a shorter period of review would be attractive to taxpayers seeking greater certainty (if not simplicity) in their tax affairs.

9. Conclusions

At the outset three questions were posed: is STS simple?; is STS now more simple than previously?; and how can STS be made more simple? It is argued, on the basis of the evidence presented herein, that the STS is not simple. Its eligibility criteria and its mandatory provisions in relation to depreciating assets are undoubtedly and unnecessarily complex. The policy itself, at least as recommended by the Ralph Committee, appears relatively straightforward if not always consistent and well-directed. On one hand STS is sold as being able to benefit almost all small business taxpayers, and on the other hand, the legislators have gone to great lengths to exclude anyone who may be setting out to ‘exploit’ its provisions.

It is difficult to see what the real advantages of STS are for taxpayers in terms of reducing the overall effective tax burden in real dollar terms of tax savings (other than the timing of tax liability and now the ETO), or in a reduction in compliance costs. Whilst the immediate write-off of assets costing less than $1,000 may be attractive to some (a token offering at best), it may not always be attractive enough to warrant the pooling of all other assets and the inability to access the increased diminishing value rates available under Div 40 from 1 July 2006.

The STS has been labeled as a system within a system, one that has been developed without sufficient debate or research and has relied on perception management.\textsuperscript{75} It is not surprising that it appears to have missed its mark – mainly because its policy goals are neither clear nor consistent, thus making it virtually impossible to develop well aligned and effective strategies. While research has found that there is not one single cause of tax law complexity, there is sufficient evidence about the various causes and their impacts to demonstrate that the more simple and straightforward the policy, the greater the likelihood of being able to develop law that can be readily applied efficiently,

\textsuperscript{73} At note 43.
\textsuperscript{74} s170(1) ITAA 1936 amended by Tax Laws Amendment (Improvements to Self Assessment) Act (No. 2) 2005.
\textsuperscript{75} See Bondfield at note 62.
consistently and with certainty.\textsuperscript{76} In doing so, both compliance and administrative costs could potentially be minimised.

One aspect of STS that does give rise to substantial compliance costs is the need to taxpayers to consider their position on an annual basis. Are they eligible for STS, do they remain in or elect out? In making this decision taxpayers would be expected to consult with their tax advisors (and incur the related monetary cost of seeking the advice) to determine whether or not they are better off in or out of STS, particularly given that the STS continues to change. In fact it may be more simple to remain outside the STS. Once in and where assets are pooled, it is certainly more complex to opt out and have to maintain both types (STS and Div 40) of depreciation systems.

Is the STS more simple now than before? Increasing the thresholds for average turnover and depreciating assets do not represent a change to the level of simplification; not does the introduction of ETO. Allowing STS taxpayers to determine the more appropriate accounting method is a more straightforward approach, but whether it is more simple or not depends on the nature of the small business taxpayer’s existing accounting practices. Certainly this change makes the policy and legislation more simple, but its impact on taxpayers (in terms of the take up rate of STS) and practitioners suffering what Bondfield\textsuperscript{77} described as ‘change fatigue’ remains to be seen. Indeed, the Explanatory Memorandum for the removal of Subdiv 328-C indicates that the impact of its removal on compliance costs was ‘minimal’.

How can the STS be made more simple? There does appear to be scope to simplify (by possible removal of the bulk) of the turnover and grouping provisions. This would simplify the policy, the legislation itself and its application. Even so, these would do little if anything to reduce compliance costs for small business taxpayers.

More appropriate changes would be the lifting of the immediate write-off threshold for assets and the removal of the need to pool assets at all (i.e. Div 40 to apply). This would reduce the compliance costs of STS taxpayers who wish to opt out, and possible the compliance costs of those who want to opt in (in that they would not have to change their accounting systems). In spite of the Minister’s assertions that compliance costs have reduced since the outset of STS, the evidence is not apparent. There is a reference made by the Minister to the ATO contacting an unspecified number of accountants to understand why they were not recommending STS to their clients, but otherwise whether or not STS has reduced compliance costs, and if so, to what extent, remains unclear.\textsuperscript{78}

However, these changes though would only allow the STS – the system with a system – to continue to evolve by trial and error and political whim. This manner of change, together with unclear policy objectives and the apparent lack of understanding of the causes of small business compliance costs, are unlikely to produce a more simplified tax system.

\textsuperscript{76} See McKerchar et al at note 1 for a more detailed discussion and model on improving tax simplification.
\textsuperscript{77} Ibid at p.341.
\textsuperscript{78} At note 43.
Finally, the STS is part of a wider raft of tax legislation and there are many other considerations for small business (including GST, capital gains tax, CGT concessions and superannuation) that most likely have a part to play in decision making by taxpayers and in tax advising by practitioners but are beyond the scope of this paper. From the perspective of taxpayers and tax practitioners, it is not just keeping abreast of changes, but trying to anticipate them, that is giving rise to increased compliance costs and fatigue. Public perceptions are important, particularly in a tax system that relies heavily on voluntary compliance. But there comes the time where perceptions no longer respond to rhetoric or mixed messages and real reform is needed. This will require rigorous research, vision, commitment and clear messages from policymakers if small business is to have a more simple tax system.