

## Scoping study of small business tax compliance costs - December 2007

### Chapter 4: The nature of small business

#### Defining small business

4.1 There is no standard measure of a 'small business' in Australian legislation. Turnover, numbers of employees, asset values and market share are some of the criteria that have been used to determine whether a business is 'small'. These differences can make it difficult for small businesses to be certain about their responsibilities and entitlements under the various regulatory regimes that guide their business behaviour. It can also increase their compliance costs as they have to make an assessment of whether they come within the various different definitions.

4.2 Until recently the *Income Tax Assessment Act 1997* contained several definitions of 'small business' for the purposes of the income tax law. Since 1 July 2007 a single consistent threshold — turnover under \$2 million — has been applied to determine eligibility for a variety of Australian Government small business tax concessions.<sup>18</sup> Around 1.84 million businesses had turnover under \$2 million in 2006, comprising about 93 per cent of all businesses.<sup>19</sup>

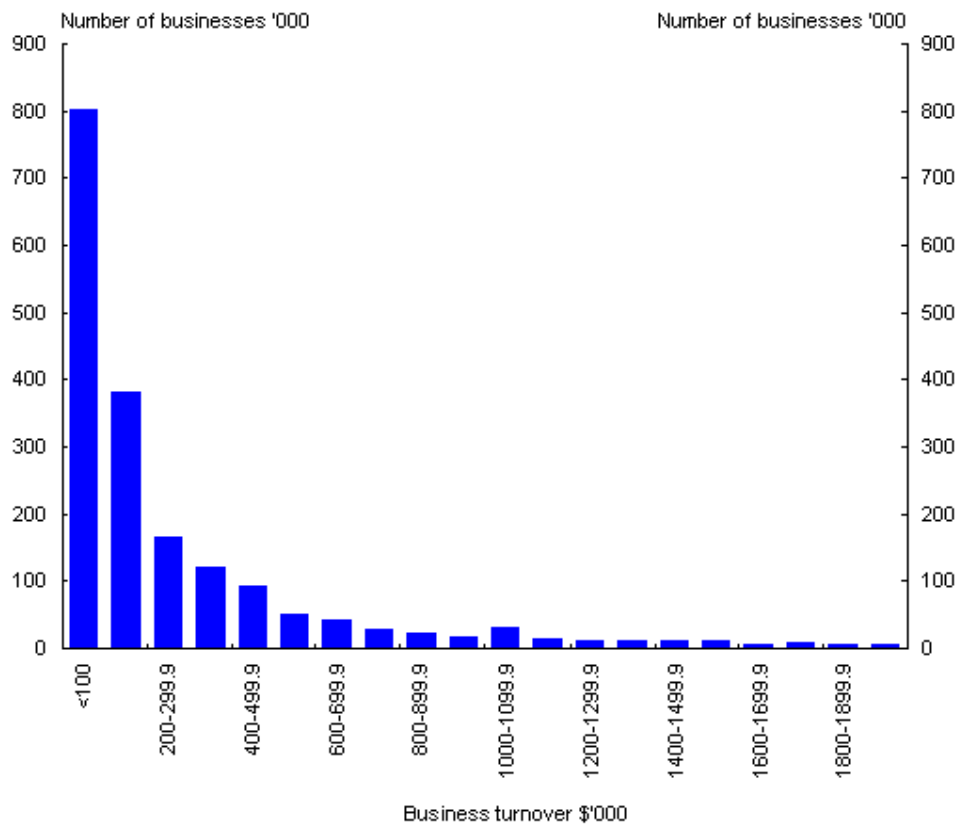
4.3 Various criteria remain elsewhere in legislation. The *Privacy Act 1988* defines a small business as a business with turnover under \$3 million, while parts of the *Corporations Act 2001* and the *Australian Securities and Investments Commission Act 2001* use a measure based on numbers of employees.<sup>20</sup> A list of various definitions of small business in Commonwealth legislation is set out in Appendix 8. Most academic studies use the ABS definition of a small business, which is a non-agricultural business that employs 20 people or less.

4.4 The ATO refers to businesses with turnover of less than \$2 million per annum as 'micro businesses'. Businesses with turnover between \$2 million and \$10 million are generally regarded by the ATO as 'small businesses' although for statistical purposes they are usually included in the 'small and medium enterprises' category, which contains businesses with turnover between \$2 million and \$100 million.<sup>21</sup>

4.5 Chart 4.1 shows that most businesses in Australia are very small in terms of turnover. ABS data indicate that as at June 2006, around 800,000 businesses (around 40 per cent of all businesses, had turnover of less than \$100,000 per year and nearly 1.2 million businesses (around 60 per cent of all businesses) had turnover of less than \$200,000 per year.<sup>22</sup> Chart 4.1 shows that business numbers decrease significantly as turnover rises.

4.6 This means that around 93 per cent of all businesses (1,837,503 in June 2006) fall into the ATO 'micro-business' category, with turnover of less than \$2 million per year. These micro businesses are the core of the small business community.

**Chart 4.1: Numbers of businesses by annual turnover range, June 2006**



(a) Source: ABS cat. no. 8165.0, unpublished data.

### Finding 1

The vast majority of Australian businesses are small businesses. Around 93 per cent of all Australian businesses by number have turnover of less than \$2 million per year.

## Features of small businesses

4.7 Australian small businesses have very diverse characteristics and the sector is very dynamic. Small businesses comprise sole traders, partnerships, trusts and companies and they operate in every industry and in every State and Territory, and are operated by the young to the very old. To the extent that is possible to generalise, according to the ABS the most common small businessperson is a middle-aged man working between 35 and 50 hours per week from home without any staff.<sup>23</sup> Box 4.1 provides a snapshot of the small business sector in 2004, based on ABS data.

### Box 4.1: Features of small businesses in Australia<sup>24</sup>

In June 2004:

- 68.1 per cent of all non-agricultural small business operators were male.
- Of the 1.1 million full-time small business operators, 65.1 per cent worked between 35 and 50 hours per week, while 30.2 per cent worked between 51 and 75 hours per week.
- 59.4 per cent of small business operators were aged between 30 and 50 years, with the proportion of operators over 50 years increasing by 7 per cent since 1995.
- 56.3 per cent of small businesses did not employ staff, while 32.8 per cent employed 1-4 staff and 10.9 per cent employed 5-19 staff.
- 30.2 per cent of small business operators were born overseas.
- 33.5 per cent of small businesses had been in operation between 1 and 5 years, but for employing businesses the majority had been in

- operation for 10 years or more.
- 71.7 per cent of small businesses use computers in their business operations, with 62.3 per cent of these having access to the Internet. 93.0 per cent of businesses employing 5-19 staff used a computer.
- 67.5 per cent of all small businesses were home-based, and were operated by 1,040,000 people, with home-based businesses predominantly (65.5 per cent) operated by males.

## Importance of small business in the economy

4.8 Small businesses account for around 39 per cent of Australia's economic production and employ around 3.7 million people.<sup>25</sup> Over 70 per cent of those employed in the construction sector and over 60 per cent of those employed in the personal and other services sector are employed in small businesses.<sup>26</sup> In addition, small businesses make up around 49 per cent of all exporting businesses (although they contributed only around 1 per cent to the value of total exports).<sup>27</sup>

### Industry distribution

4.9 As Chart 4.2 shows, small businesses operate across all businesses sectors, with the property and business services sector being the dominant sector for small businesses. Just over one-quarter of all businesses are operating in this sector.<sup>28</sup> A significant number of small businesses are also operating in the construction, retail trade and agricultural sectors.

### Finding 2

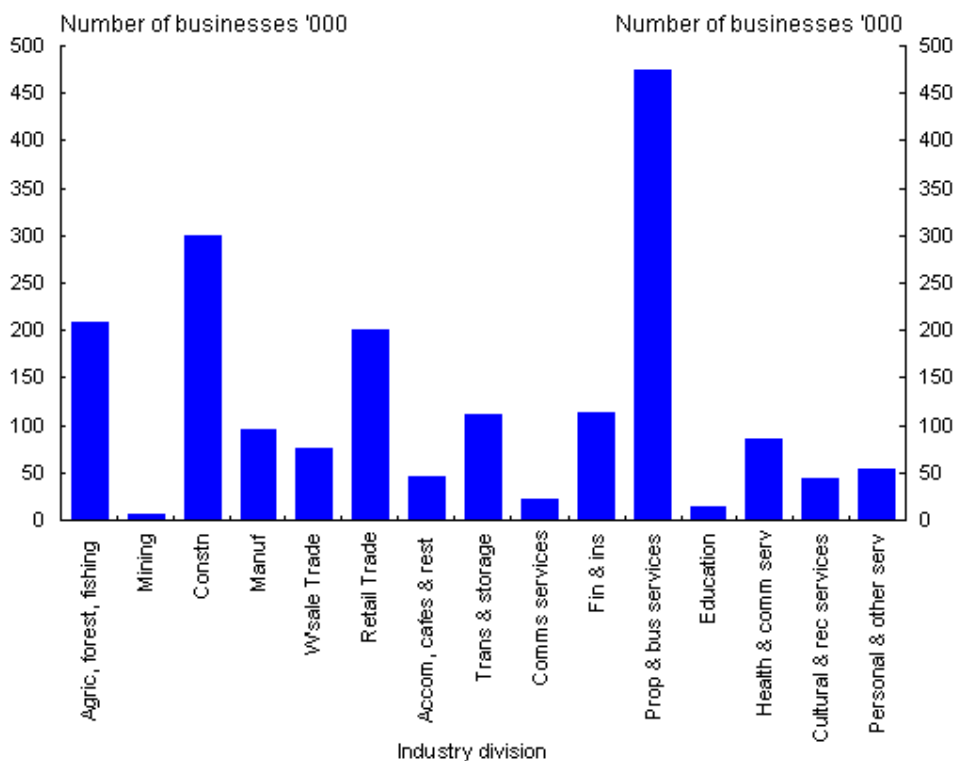
Small businesses are very important to the Australian economy. They produce around 39 per cent of Australia's industry value added and employ almost half the non-agricultural workforce. Most are engaged in the property and business services, agriculture, construction and retail sectors.

### Business structures and numbers of employees

4.10 Table 4.1 shows Australian small businesses as at June 2006 categorised by their business structure and the number of staff they employ. Around one-third of all businesses are sole proprietorships, with a significant number employing no staff. Just under another third use a company structure, with the around half of these businesses employing between one and four staff.

4.11 Overall around 60 per cent of all small businesses do not employ any staff. Many of these small businesses are self-employed people who have in a sense bought themselves a job by establishing their own business. Their perceptions of tax compliance costs tend to differ somewhat from those who consider themselves as 'business people', as they tend to have an expectation that their tax compliance costs should be no greater than those of an employee.

**Chart 4.2: Private sector small businesses by Industry Division (ANZSIC classification)**



Source: ABS cat. No. 8165.0 *Counts of Australian Businesses, including Entries and Exits, June 2003 to June 2006*, unpublished data. Industry sectors with an insignificant number of businesses have been omitted from this chart.

**Table 4.1: Small business structures and numbers of employees**<sup>29</sup>

	Non employing	1-4 employees	5-19 employees	Total small businesses	As a proportion of small businesses (per cent)
Sole proprietorships	500,876	76,495	19,672	597,043	33.2
Partnerships	267,630	75,410	35,338	378,378	21.0
Companies	180,636	245,729	98,858	525,223	29.2
Trusts	172,658	81,089	44,033	297,780	16.6
Total	1,121,800	478,723	197,901	1,798,424	100

Source: ABS cat. no. 8165.0.

## Age of operators

4.12 Small business operators reflect the national trend of an ageing population. In June 2004, 31 per cent of all operators were older than 50 years, compared with 23 per cent of all operators in February 1995. The proportion of male operators aged more than 50 years increased from 25 per cent to 32 per cent and female operators from 19 per cent to 29 per cent over the same period.<sup>30</sup>

## Age of businesses

4.13 Business failure rates are not as high as is commonly believed. Research undertaken by the Productivity Commission in 2000 indicated that around two-thirds of businesses survive the first five years of operation, and that the majority of businesses that cease operation do not close because of 'failure' but for reasons unrelated to their financial position. The research showed that

only around 2 per cent of businesses cease operations each year because the owners, while solvent, cannot secure a sufficient return, and only 0.5 per cent of businesses cease operation each year due to insolvency.<sup>31</sup>

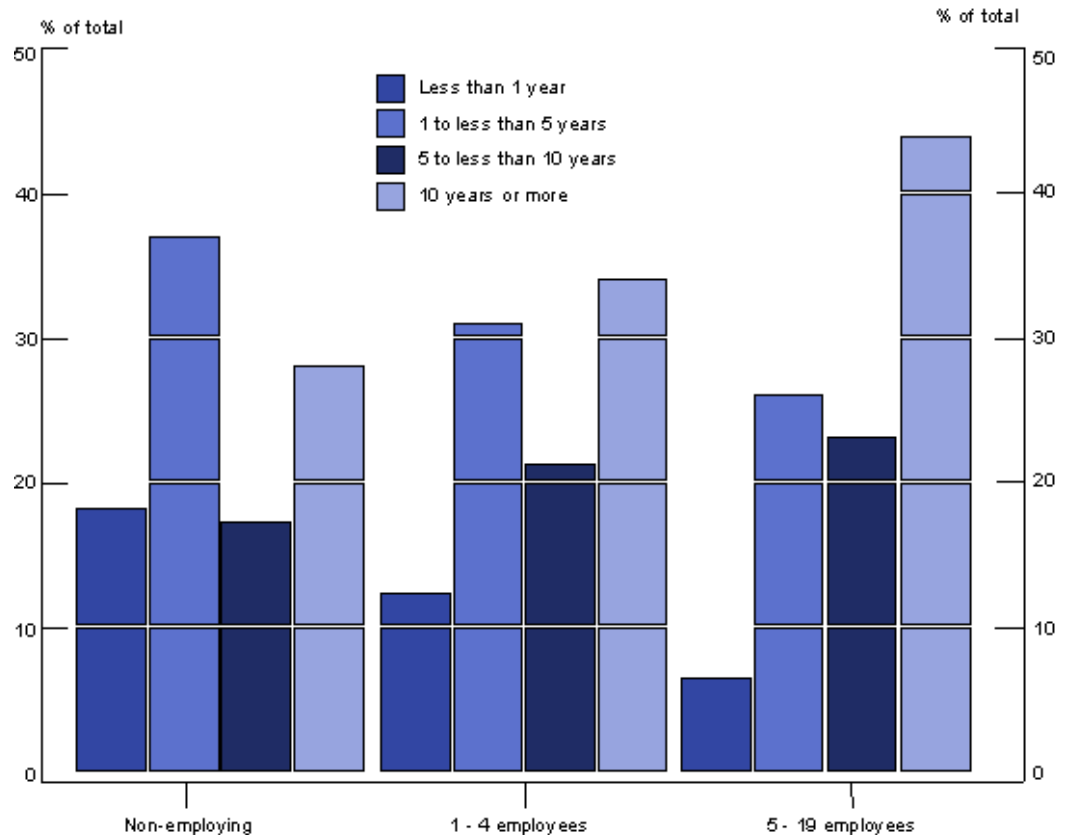
4.14 More recent data from the ABS give a higher figure for business closures, with 15.3 per cent of small businesses that employed fewer than 20 staff ceasing operations in 2005-06. The corresponding entry rate for new businesses in 2005-06 was 16.7 per cent.<sup>32</sup> The ATO estimates that around 10 per cent of micro-businesses are new to business each year, and many of these businesses may have limited experience with the business tax system.<sup>33</sup>

4.15 The first few years in the life of a small business are the most risky, and over the short to medium term, business survival is very much dependent on the age of the business. The longer a business survives, the greater its chances of continuing survival.

4.16 In addition, businesses that employ staff tend to survive longer than non-employing businesses. For example, of the businesses that began operation in 2003-04, only 50 per cent of non-employing businesses were still operating in June 2006, compared with 80 per cent of employing businesses.<sup>34</sup> ABS data show that the majority of non-employing businesses at June 2004 had been in operation for one to less than five years. However, the majority of businesses employing one to 19 employees had been in operation for 10 years or more.<sup>35</sup>

4.17 Chart 4.3 shows the relationship between the length of operation of Australian small businesses and the number of employees in 2004.

**Chart 4.3: Proportion of businesses, by employment size group and length of operation, June 2004**



Source: ABS cat. no. 8127.0, summary.

Small business and taxation

**Business structures and taxation**

4.18 As Table 4.1 shows, just over 50 per cent of small businesses in Australia are sole traders or partnerships and many micro-businesses are content to continue to use these more simple business structures. These business operators pay income tax at their own personal marginal tax rates. This will have tax advantages for these business proprietors as long as their average personal income tax rate is below the company income tax rate.<sup>36</sup>

4.19 However, as business opportunities expand, some proprietors find that there are advantages in incorporation, despite the increased compliance requirements that it may bring. Becoming an incorporated enterprise may reduce the risks to the owners of running a business by providing limited liability to all shareholders, subject to personal guarantees that are often required. In addition, some businesses find that a company structure is advantageous, or sometimes necessary, when seeking to enter into business contracts. Nevertheless, for many businesses it is the difference between the company tax rate and their personal marginal tax rate that drives the decision to incorporate. At the time of making that decision to incorporate they may not be fully aware of the possible consequences of incorporation to their tax compliance costs.

### Taxes paid by small businesses

4.20 Small business involvement in the tax system often extends beyond the payment of income tax. Depending on their nature and size, small businesses are also likely to pay GST and complete a BAS. ATO data show that while most small businesses prepare their own BAS (often with the assistance of bookkeepers), 95 per cent have their income tax returns prepared by tax agents, indicating the significant role of tax agents in small business tax compliance. If a small business employs staff, its involvement in the tax system will be even more complex and may involve the payment of pay-as-you-go (withholding) (PAYG (W)), FBT, superannuation, and state payroll tax.

### Micro-businesses

4.21 Table 4.2 provides ATO data which break down the number of taxpaying micro-businesses by type of business structure and the extent to which they are liable for income tax, GST and FBT.

4.22 While unincorporated businesses are liable for very little FBT, they are liable for a significant amount of GST. Businesses with turnover over \$75,000 are required to register for GST<sup>37</sup>, and smaller businesses can register if they wish to claim input tax credits, but then have to comply with additional reporting requirements. The relatively high number of businesses that register voluntarily potentially reflects the importance of input tax credits to them or their perception that their customers may prefer to deal with GST registered businesses.

**Table 4.2: Micro-businesses: Taxpaying profile, 2004-05**

	Taxpayers and \$ tax liability					
	Income tax		GST		FBT	
	No. of entities	\$m	No. of entities	\$m	No. of entities	\$m
Individuals	1,532,079	16,034	924,524	1,071	214	1
Partnerships	368,200	0 <sup>38</sup>	320,708	1,525	452	2
Trusts	215,431	0 <sup>39</sup>	188,550	1,755	3,565	22
Companies	689,915	6,227	573,228	3,607	18,036	122
Total	2,805,625	22,261	2,007,010	7,958	22,267	147

Source: ATO. Based on tax returns processed to 18 May 2007 for entities that have lodged their 2004-05 income tax return. Data is rounded to the nearest \$ million. The GST turnover threshold was \$50,000 in 2004-05.

4.23 The ATO's 2006-07 Compliance Program data indicate that micro-businesses pay around 11 per cent of total Australian Government tax collected, including 13 per cent of all income tax from companies and 25 per cent of all GST. Micro-businesses also contribute an additional 7 per cent of net ATO collections through amounts withheld from payments to employees.

4.24 The ATO notes that, as a group, micro-businesses generally have limited time, knowledge and resources to manage their tax affairs. When difficulties arise in tax compliance, they are generally in the areas of: registering in the tax system; record keeping; lodging on time; reporting information (including compliance with the tax and superannuation laws); and paying tax on time. For 2005-06, 67 per cent of total debt outstanding to the ATO was owed by micro-businesses.<sup>40</sup>

### **Businesses with turnover between \$2 million and \$5 million**

4.25 Businesses with turnover between \$2 and \$5 million tend to operate at a slightly higher level of organisation and sophistication than micro-businesses. According to the ABS, in June 2006 there were around 50,000 businesses with turnover of between \$2 million and \$5 million that employed less than 20 people.<sup>41</sup>

4.26 Table 4.3 shows that a much smaller proportion of this group are liable for taxation as individuals and a greater proportion are incorporated compared with micro-businesses.

**Table 4.3: Small businesses with turnover between \$2 million and \$5 million: Taxpaying profile, 2004-05**

	Taxpayers and \$ tax liability					
	Income tax		GST		FBT	
	No. of entities	\$m	No. of entities	\$m	No. of entities	\$m
Individuals	2,698	367	2,273	-117	28	0
Partnerships	4,919	0 <sup>42</sup>	4,683	102	288	3
Trusts	11,710	0 <sup>43</sup>	11,283	815	1,832	20
Companies	31,237	2 564	30,929	2 108	7,284	98
Total	50,564	2 931	49,168	2 908	9,432	121

Source: ATO: Based on tax returns processed to 18 May 2007 for entities that have lodged their 2004-05 income tax return. Data is rounded to the nearest \$ million.

### **The not-for-profit sector**

4.27 There are around 700,000 'not-for-profit' organisations in Australia. Participants in the not-for-profit sector are not established for 'business' outcomes and they do not generally come within definitions of small business. However, tax compliance cost issues for the not-for-profit sector are considered briefly as part of this study.

4.28 The not-for-profit sector includes charities, deductible gift recipients, public benevolent institutions and other organisations, which can use a variety of legal structures. The principal characteristic that distinguishes not-for-profit organisations from other organisations is that they cannot distribute their gains or profits to their members, owners or managers. Their objectives are community outcomes, generally altruistic.

4.29 Small not-for-profit organisations can face similar compliance costs to those of small businesses in respect of some taxes. They may also have complex compliance issues in accessing tax concessions available to them.

4.30 While very few not-for-profits are required to lodge income tax returns, depending on their particular circumstances they may be required to:

- lodge a monthly or quarterly BAS;
- lodge annual FBT returns (the provision of fringe benefits by not-for-profit organisations to their employees is quite prevalent as a result of the capped rebates or exemptions available to many of them); and
- maintain particular records to evidence concessional tax compliance requirements, for example, in relation to non-commercial activities and GST free supplies.

4.31 Another key challenge for small not-for-profit organisations is a lack of resources to manage their tax compliance obligations properly. Most rely on volunteers or a small number of employees for their administration activities and these volunteers may not have all of the skills necessary to deal with taxation issues. Perhaps more often than is the case for profit making businesses, they may also lack the financial resources to engage tax professionals. Allowance is not always made (or fully made) for these administrative costs in the funding provided for not-for-profit activities.

### **Finding 3**

While not-for-profit organisations are not generally established for business purposes, in some respects they may experience similar compliance issues to small businesses.

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<sup>18</sup> For details, see Minister for Revenue and Assistant Treasurer and Minister for Small Business and Tourism joint press release 2007/079, 'Benefits for Small Business take effect from 1 July 2007'.

<sup>19</sup> ABS cat. no. 8165.0 *Counts of Australian Businesses, including Entries and Exits, June 2003 to June 2006*.

<sup>20</sup> *Privacy Act 1988* — business where annual turnover is \$3 million or less; *Corporations Act 2001* (re financial services and markets) and *Australian Securities and Investments Commission Act 2001*: if a manufacturing business — 100 people, otherwise, 20 people.

<sup>21</sup> See for example the ATO 2006-07 Compliance Report. In the Business Perceptions surveys prepared regularly by Eureka Strategic Research for the ATO, the additional classification of 'very micro businesses' is used to describe those with turnover under \$50,000.

<sup>22</sup> ABS cat. no. 8165.0 *Counts of Australian Businesses, including Entries and Exits, June 2003 to June 2006*.

<sup>23</sup> ABS Media release 2005/56 'Small business operators ageing: ABS', 28 April 2005.

<sup>24</sup> ABS cat. no. 8127.0 *Characteristics of Small Business, Australia*. The definition of small businesses used by the ABS in this survey does not include agricultural businesses.

<sup>25</sup> ABS cat. no. 8155.0 *Australian Industry 2004-05*. Economic production is measured by Industry Value Added, which is a measure of the contribution by businesses to gross domestic product.

<sup>26</sup> ABS cat. no. 8155.0 Table 2.1 pp 20 and 30.

<sup>27</sup> ABS cat. no. 5368.0.55.006 *Number and Characteristics of Australian Exporters, 2005-06*.

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- <sup>28</sup> The property and business services industry division includes businesses engaged in renting and leasing assets, scientific research, architectural, surveying and engineering services, computer consultancy and maintenance and data processing, legal services, accounting services, marketing and advertising, business management, employment services, security and cleaning.
- <sup>29</sup> Data includes businesses with turnover less than \$2 million and employment of less than 20 people.
- <sup>30</sup> ABS Media release 2005/56 April 28 2005.
- <sup>31</sup> Productivity Commission, 2000, *Business Failure and Change: An Australian Perspective* Staff Research Paper at <http://www.pc.gov.au/research/staffresearch/bfacaap>.
- <sup>32</sup> ABS cat. no. 8165.0, *Counts of Australian Businesses, including Entries and Exits*, table 10, p 14.
- <sup>33</sup> ATO *Compliance Program 2006-07* p 15.
- <sup>34</sup> ABS cat. no. 8165.0, *Counts of Australian Businesses, including Entries and Exits, June 2003 to June 2006* media release 26/2007, 26 February 2007.
- <sup>35</sup> ABS cat. no. 8127.0 *Characteristics of Small Business Australia (Re-issue) 2004*, summary.
- <sup>36</sup> Australia has a progressive income tax system with marginal tax rates stepping higher as incomes rise. A taxpayer's marginal rate is the rate of tax that applies to the highest dollar they earn, whereas their average tax rate is the total amount of tax they pay, divided by their taxable income. Company income tax is applied at a flat rate of 30 per cent.
- <sup>37</sup> The threshold was increased to \$75,000 from 1 July 2007. Between 1 July 2000 and 30 June 2007 the GST registration threshold was \$50,000.
- <sup>38</sup> Partnerships do not pay tax. Profits or losses are distributed to the partners who account for the distribution or loss in their tax returns. Similarly trusts are not entities for income tax purposes and the trustee (often a company) or the beneficiaries pay tax on any net taxable income.
- <sup>39</sup> See previous footnote.
- <sup>40</sup> Australian Taxation Office *2006-07 Compliance Program* publication NAT 7769-08.06, p 15.
- <sup>41</sup> ABS cat. no. 8165.0, June 2006, unpublished data.
- <sup>42</sup> Partnerships do not pay tax. Profits or losses are distributed to the partners who account for the distribution or loss in their tax returns. Similarly trusts are not entities for income tax purposes and the trustee (often a company) or the beneficiaries pay tax on any net taxable income.
- <sup>43</sup> See previous footnote.

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