AUSTRALASIAN
TAX TEACHERS ASSOCIATION

JOURNAL OF THE AUSTRALASIAN TAX TEACHERS ASSOCIATION

2023

Vol.18 No.1

Edited by

JONATHAN BARRETT AND ROB WHAIT

Postal Address:
JATTA, c/o School of
Taxation and Business Law
University of New South Wales
NSW 2052 Australia

The *Journal of the Australasian Tax Teachers Association* ('JATTA') is a double-blind peer reviewed journal. The Journal is normally published annually, after the Association's annual conference.

The Australasian Tax Teachers Association ('ATTA') is a non-profit organisation established in 1987 with the goal of improving the standard of tax teaching in educational institutions across Australasia. Our members include tax academics, writers, and administrators from Australia and New Zealand. For more information about ATTA refer to our website at https://www.atta.network/.

Please direct your enquiries regarding the Journal to the Editor-in-Chief:

Professor Dale Pinto
Professor of Taxation Law
Curtin Law School
Curtin University
GPO BOX U1987 Perth WA 6845
E: Dale.Pinto@cbs.curtin.edu.au

ISSN: 1832-911X

Volume 18 Number 1 published December 2023

TABLE OF CONTENTS

FOREWORD

ROB WHAIT AND JONATHAN BARRETT

EDITORS

We are delighted to present the 2023 edition of the Journal of the Australasian tax Teachers' Association. It contains articles on a wide variety of topics from multiple jurisdictions including fictitious income in New Zealand, business structures recommended by Australian tax advisers, Australian small business tax literacy and tax education in Indonesia.

We thank all authors for their submissions and for their support of the Association and the Journal. We also thank the anonymous referees who gave up their valuable time to review the articles and provide constructive feedback.

Rob Whait — *University of South Australia*

Jonathan Barrett — *Victoria University of Wellington Te Herenga Waka*

THE INDONESIAN TAX EDUCATION PROGRAM: AN INSTITUTIONAL THEORY PERSPECTIVE

YULIANTI ABBAS, CHRISTINE TJEN AND PANGGAH TRI WICAKSONO*

ABSTRACT

Despite its expanding economy, Indonesia has historically grappled with a low tax ratio. In 2020, the tax-GDP ratio stood at 10.1%, lower than that of its Southeast Asian peers such as Malaysia, Singapore, Thailand, and the Philippines. To improve tax compliance, the Indonesian government has implemented several initiatives, including a national tax education program launched in 2014. A cornerstone of this initiative is the 'Pajak Bertutur (Patur) ['tax enunciates'] program, which organizes one-day events at schools where tax officials teach students about taxation.

To evaluate the Patur program, this study employed Scott's Institutional Theory, which delineates organizations into three pillars: regulative, normative, and cultural-cognitive. Given that the program is publicly funded and requires substantial resources, particularly from the tax authority, it is crucial for the Indonesian government to scrutinize its implementation and potential for improvement.

Through a series of in-depth interviews and focus group discussions with tax officials and teachers, our research reveals that the synchronization of the three organizational elements is pivotal for the promotion of an effective tax education program. Findings suggest that while the Patur program is supported by a robust normative pillar, it is hampered by a lack of regulative pillar, leading to implementation discrepancies. This regulatory deficit, however, may inadvertently allow the program to be more adaptable to the diverse needs of schools, thereby strengthening the cultural-cognitive pillar and increasing overall program effectiveness.

Keywords: tax education, tax awareness, institutional theory

* Department of Accounting, Faculty of Economics and Business, Universitas Indonesia. Corresponding author. Email: Yulianti Abbas at yuli.a@ui.ac.id. Universitas Indonesia provided ethical approval for this research under the reference Nomor: Ket-48/UN2.F10.D11/PBM.00.02/2021.

I Introduction

Since 1984, the Directorate General of Taxes ('DGT') in Indonesia has employed a self-assessment system for tax collection based on the principle of voluntary compliance.[1] Under this system, taxpayers are responsible for calculating their own tax liability,[2] which requires a high level of awareness and understanding of tax regulations.[3] The effective functioning of the self-assessment system therefore depends on the taxpayer's knowledge of the tax laws and the role of tax administration in promoting this knowledge through education and support.[4]

The literature underscores the critical role of tax knowledge and education in shaping taxpayer behaviour. Increased tax knowledge is associated with favourable attitudes toward compliance,[5] whereas its absence can engender distrust and aversion toward the tax system.[6] The work of scholars such as Andreoni, Erard, and Feinstein underscores the influence of intrinsic motivation on tax compliance,[7] while Eriksen and Fallan highlight how tax knowledge influences tax awareness and ethical conduct, thereby reducing noncompliance.[8] Similarly, Morgan and Castelyn, as well as Kwok and Yip, have identified taxpayer education as pivotal to comprehending and complying with tax obligations,[9] a sentiment echoed by Abbas and Timothy in the context of Indonesia's small and medium enterprises.[10]

---

1 Andrew Okello, 'Managing Income Tax Compliance Through Self-Assessment' (Working Paper No WP/14/41, International Monetary Fund, March 2014) 11 <https://www.imf.org/external/pubs/ft/wp/2014/wp1441.pdf>.

2 Anis Barieyah Mat Bahari and Lai Ming Ling, 'Introducing Tax Education in Non-Accounting Curriculum in Higher Education: Survey Evidence' (2009) 7(1) *Journal of Financial Reporting and Accounting* 37, 38.

3 Ern Chen Loo, Margaret McKerchar and Ann Hansford, 'An International Comparative Analysis of Self-Assessment: What Lessons Are There for Tax Administrators?' (2005) 20(4) *Australian Tax Forum* 669, 671.

4 Ibid 706-07.

5 Knut Eriksen and Lars Fallan, 'Tax Knowledge and Attitudes Towards Taxation: A Report on a Quasi-Experiment' (1996) 17(3) *Journal of Economic Psychology* 387, 399.

6 Pauline Niemirowski, Steve Baldwin and Alexander J Wearing, 'Tax Related Behaviours, Beliefs, Attitudes and Values and Taxpayer Compliance in Australia' (2003) 6(1) *Journal of Australian Taxation* 132, 163.

7 James Andreoni, Brian Erard and Jonathan Feinstein, 'Tax Compliance' (1998) 36(2) *Journal of Economic Literature* 818, 851.

8 Eriksen and Fallan (n 5) 399.

9 Annette Morgan and Donovan Castelyn, 'Taxation Education in Secondary Schools' (2018) 13(1) *Journal of the Australasian Tax Teachers Association* 307, 311; Betty Yuk Sim Kwok and Rita Wing Yue Yip, 'Is Tax Education Good or Evil for Boosting Tax Compliance? Evidence from Hong Kong' (2018) 32(4) *Asian Economic Journal* 359, 379.

10 Joshua Timothy and Yulianti Abbas, 'Tax Morale, Perception of Justice, Trust in Public Authorities, Tax Knowledge, and Tax Compliance: A Study of Indonesian SMEs' (2021) 19(1) *eJournal of Tax Research* 168, 176.

In response to persistently low tax ratios and compliance levels—evidenced by a tax-to-GDP ratio of 10.1% in 2020,[11] markedly below the average in Asia-Pacific and OECD countries—the DGT launched a tax education initiative in 2014, namely the Tax Awareness Inclusion Program. The Patur program, established in 2017 as the flagship of the initiative, aims to raise tax awareness among students through comprehensive one-day events at educational institutions. During the Patur program, tax authorities visit schools and provide tax-related materials, such as why a government collects taxes, how taxes are being used, and how people contribute to their country by paying taxes. By introducing the concept of taxation to future taxpayers as early as possible, the Indonesian government expects to increase awareness and, in the long run, improve compliance. The program's effectiveness is tentatively supported by research by Abbas, Tjen, and Wicaksono, which found improved tax awareness among students attending the Patur program.[12]

This study first evaluated the legitimacy of the Patur program, using Suchman's definition of legitimacy,[13] and found that while the program aspires to this status, it has not fully achieved a cognitive legitimacy. It then applied Institutional Theory proposed by Scott[14] to explore the institutionalization of the Patur program within schools, positing that such institutionalization is crucial for the sustained legitimacy of the program. This study examined various methods and materials that have been used by Indonesian tax offices in the Patur program. Additionally, this study included a series of focus group discussions and interviews to examine the challenges faced by the Patur program and to gather the perceptions of the participating schools.

Our analysis, leveraging Scott's framework, revealed that while the Patur program has a robust normative pillar, it is compromised by a deficient regulative pillar, leading to inconsistent implementation. Nevertheless, this regulatory void may inadvertently benefit the program by allowing for adaptability to the diverse environments of different schools, potentially strengthening the program's cultural-cognitive pillar.

II CONCEPTUAL FRAMEWORK

A *Legitimacy Framework*

Organizations need legitimacy to survive.[15] In the institutional theory literature, legitimacy is conceptualized as a generalized perception that an organization's actions are desirable, proper, or appropriate within a socially constructed system of norms,

[11] Organization for Economic Co-operation and Development (OECD), *Revenue Statistics in Asia and the Pacific 2022: Strengthening Tax Revenues in Developing Asia* (Report, 2022) 19 <https://doi.org/10.1787/db29f89a-en>.

[12] Yulianti Abbas, Christine Tjen and Panggah Tri Wicaksono, 'Tax Education and Tax Awareness: A Study on the Pajak Bertutur Indonesian Tax Education Program' (2021) 16(1) *Journal of the Australasian Tax Teachers Association* 198, 210.

[13] Mark C Suchman, 'Managing Legitimacy: Strategic and Institutional Approaches' (1995) 20(3) *Academy of Management Review* 571.

[14] W Richard Scott, *Institutions and Organizations: Ideas, Interests, and Identities* (SAGE Publications, 4th ed, 2014).

[15] Ibid 71; Suchman (n 13) 574.

values, beliefs, and definitions.[16] Prior research suggests that legitimacy can enhance performance and growth[17] and facilitate the development of stronger ties with external stakeholders.[18]

Measuring legitimacy has been a challenge for researchers.[19] Suchman categorizes legitimacy into three types: (1) pragmatic, (2) moral, and (3) cognitive.[20] Pragmatic legitimacy is derived from the organization's ability to meet the immediate, self-interested needs of relevant actors to the extent that such behaviour is attributed to the organization's character.[21] Moral legitimacy encompasses a broader range of considerations in which decisions and actions are evaluated against societal norms and values.[22] Cognitive legitimacy, on the other hand, is based on stakeholders' comprehensibility and internalization of the organization's purpose, meaning, and processes.[23] Assessing the legitimacy of an organization or program is therefore critical in determining its ability to achieve its intended objectives.

B *The Basis of Legitimacy According to Scott's Institutional Theory Framework*

Scott's institutional theory delineates three pillars that collectively support legitimacy: regulative, normative, and cultural-cognitive.[24] These pillars are interdependent, but each contributes uniquely to the achievement of an organization's purpose.[25]

1 *The Regulative Pillar*

The regulative pillar is concerned with the formal rules, laws, and sanctions that govern behaviour.[26] This pillar emphasizes the establishment of explicit, formal rules and the enforcement of compliance through monitoring, sanctions, and incentives.

2 *The Normative Pillar*

In contrast to the coercive approach of the regulative pillar, the normative pillar focuses on social obligations and expectations. It influences behaviour through norms and values that define the goals and objectives of the institution, operating within a shared social framework.[27]

---

[16] Suchman (n 13) 574.

[17] Monica A Zimmerman and Gerald J Zeitz, 'Beyond Survival: Achieving New Venture Growth by Building Legitimacy' (2002) 27(3) *Academy of Management Review* 414, 417.

[18] Ben Jongbloed, Jürgen Enders and Carlo Salerno, 'Higher Education and Its Communities: Interconnections, Interdependencies and a Research Agenda' (2008) 56(3) *Higher Education* 303, 307.

[19] Suchman (n 13) 572.

[20] Ibid 577.

[21] Ibid 578.

[22] Ibid 579.

[23] Ibid 582.

[24] Scott (n 14) 59.

[25] Ibid.

[26] Ibid.

[27] Ibid 64.

3 *The Cultural-cognitive Pillar*

The cultural-cognitive pillar includes shared conceptions and internalized norms derived from the external organizational culture.[28] This pillar encompasses the internalization of collective beliefs and adherence to roles that organizational members often take for granted as part of their social reality.[29]

4 *Application of Scott's Institutional Theory in Educational Research*

Scott's institutional theory has been applied to various studies within educational research to elucidate factors that influence program effectiveness. Casto and Sipple's examination of the implementation of Universal Pre-Kindergarten ('UPK') in rural New York school districts found varying degrees of application, with local and normative influences outweighing over non-local and regulative ones.[30] Linnér and colleagues' comparative analysis of health and physical education ('HPE') practices in Sweden, Norway, and New Zealand highlighted societal differences in social justice pedagogies, suggesting that they are shaped by their respective institutional systems of governing.[31] These applications of Scott's framework suggest that the regulative, normative, and cultural-cognitive pillars distinctly influence the success of educational programs.

C *Development of Research Questions*

Based on Scott's institutional theory and existing literature, this study evaluated the extent to which the Patur program has achieved legitimacy and the influence of the cognitive, normative, and regulative structures on this legitimacy. The distinct variables representing the three pillars were examined and are presented in Figure 1.

---

[28] Ibid 67.

[29] Ibid 67.

[30] Hope G Casto and John W Sipple, 'Who and What Influences School Leaders' Decisions: An Institutional Analysis of the Implementation of Universal Prekindergarten' (2011) 25(1) *Educational Policy* 134, 162-163.

[31] Susanne Linnér, Lena Larsson, Göran Gerdin, Rod Philpot, Katarina Schenker, Knut Westlie, Kjersti Mordal Moen and Wayne Smith, 'The Enactment of Social Justice in HPE Practice: How Context(s) Comes to Matter' (2022) 27(3) *Sport, Education and Society* 228, 231.

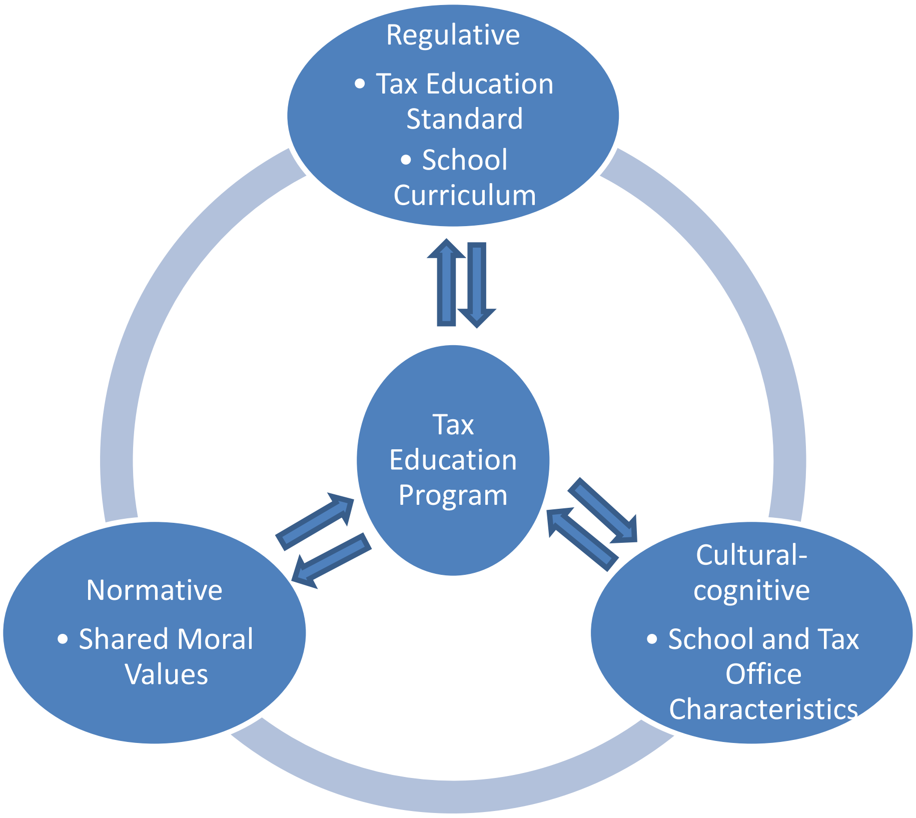


Figure 1: Scott's Three Pillars of the Indonesian Tax Education Program

The research questions ('RQs') addressed in this study are as follows:

RQ1: What state of legitimacy is the Patur program currently in?

RQ2: What are the specific processes and practices within the regulative (eg, rules, laws, or structures governing behaviour), normative (eg, the shared system of norms, expectations, and values), and cultural-cognitive (eg, the commonly held beliefs and frameworks that constitute social reality and meaning-making) pillars of the Patur program that contribute to its current legitimacy?

III Research Methodology

To answer the research objectives, we conducted a qualitative exploratory study through in-depth interviews and focus group discussions ('FGDs'). To obtain detailed information about the Patur program, we conducted in-depth interviews at the DGT central office, specifically with officials working in the Public Relations Directorate. Subsequently, we conducted focus group discussions with tax officials and high school officials and teachers to explore the implementation of the program. All in-depth interviews and FGDs were conducted virtually using Zoom video conferencing, as it was not possible to conduct face-to-face interviews and FGDs because of the COVID-19 pandemic. The scope of this study was the Jakarta region for its convenience, so the tax offices and schools were also selected from this region.

Before proceeding to FGDs with tax officials and school officials or teachers, we conducted interviews with five DGT officials. Three of them were responsible for creating and managing the Patur program in its early years, and the other two participants are the ones currently managing the program. Interviews with the DGT central office mainly explored information regarding the background of the Patur program and its concept, the expected results, and the perception regarding the implementation of the program. The interviews are used to assess the legitimacy of the Patur program from the perspectives of the regulators.

To gain a deeper insight into the implementation of the program, we conducted two FGDs with tax office officials. First, we obtained the list of tax offices that have organized the Patur program for high schools in Jakarta for the years 2018, 2019, and 2020. From this list, we selected officials from 10 potential tax offices to be invited for each FGD, resulting in a total of 20 tax offices. In selecting the tax offices to be invited to the FGD, we applied the following criteria:

a. Tax offices had conducted Patur at least twice. This should allow us to explore the implementation of the Patur program from different years.
b. In each FGD, we selected tax offices that allowed us to include six different regional tax offices of the DGT in Jakarta. This was to anticipate the possibility that tax offices in the same region might have similar materials and methods in conducting the Patur program.

In the first FGD, there were nine participants from six tax offices, as some tax offices sent more than one person to the FGD. In the second FGD, there were 14 participants from nine tax offices. All the participants were tax officials who are responsible for managing the program. These FGDs mainly focused on exploring the implementation of the Patur program. This included the expected results, the materials and methods used in the program, and their suggestions for improving the program.

We also conducted two FGDs with participants from high schools in Jakarta to explore the schools' perceptions regarding the Patur program. We gained access to participants from high schools through the DGT central office. Using the list of high schools that participated in the Patur program in 2018, 2019, and 2020, we selected 10 potential schools from which participants would be invited to each FGD, for a total of 20 schools. We used the following criteria to select the schools:

a. Schools have participated in Patur for at least once, but we have given priority to those that have participated at least twice. Tax offices tend to select different schools each year, so many schools may have participated only once.
b. Similar to the selection of tax offices, for each FGD, we selected schools that allowed us to include six different DGT regional tax offices in Jakarta.
c. In each FGD, we invited different types of schools, as different as possible, to allow us to explore the possible variation in the implementation of the Patur program because of the differences. Where possible, we included public high school, private high school, and vocational school in each FGD, by considering the distribution of schools from the list that we obtained from the DGT.

There were five participants from four schools in the first FGD and nine participants from six schools in the second FGD. All participants were school officials or teachers directly responsible for implementing the program. The FGDs discussed topics comprising participants' expectations of the Patur program, their overall experience after attending the program (including the materials and methods used in the program), and their suggestions for improving the program in the foreseeable future. Data from the DGT tax offices and schools would be used to assess the Patur program based on Scott's institutional theory.

IV FINDINGS AND DISCUSSIONS

A *Legitimacy of the Patur Program*

The Patur program initiative is a cornerstone of the DGT's efforts to incorporate tax awareness into the educational curriculum. Launched in 2017, the Patur marked the commencement of the tax awareness inclusion program and has since become an annual fixture to promote this educational cause. An interviewee from the DGT described the structure of the initiative:

> In the implementation of the tax awareness inclusion program, we have three pillars. The first pillar is cooperation and policy; the second is education; and the third is campaign. […] No matter how good the program is, if there is no campaign, I don't think the public will know [about it]. Also, [if there is] no campaign, [there] will be no synergy among the stakeholders. […] One of the campaigns is the "Patur" program.

The Patur program is strategically designed to impart tax-related knowledge to students at an early stage. The ethos behind the Patur program is to nurture the younger generation by instilling in them the importance of understanding taxation. An official articulated the DGT's ambition for the Patur program to leave a lasting impression, even though it unfolds over a short period of time:

> The concept of the Patur program is that we come to the schools simultaneously, give the students an hour of information about taxes, but we use a delivery [of information] that is understandable for each level of education. So, the way we deliver the information will be different for students in elementary schools, middle schools, high schools, and universities. […] We hope that this one hour will be memorable for the students. […] They are the golden generation for whom we can provide good values.

The DGT envisions that the Patur program, along with the integration of tax awareness into the educational syllabus, will increase students' awareness of taxes and shapes them into conscientious future taxpayers who are willing to fulfill their fiscal obligations:

> We hope that there will be an increase in tax awareness among future taxpayers, who are students, […] so that they can be more aware of taxes in the future. Subsequently, they will be able to voluntarily register as taxpayers, pay and report their taxes, and fulfill other aspects of tax compliance.

As previously defined, legitimacy is perceived as the recognition of an entity's actions are consistent with the societal norms, values, and definitions prevalent in its operational milieu. From this standpoint, the Patur is designed not only to provide tax awareness, but also to achieve cognitive legitimacy by ensuring that both tax offices and schools understand and support the program's rationale and objectives. Nonetheless, the measurement of the Patur program's legitimacy remains indeterminate. Interviews with the DGT officials revealed a gap in the evaluation of the program's outcomes since its inception: 'It seems that, as far as I know, there has never been an outcome [result] of Patur, in fact, we are very grateful if the university can help with the evaluation.'

Therefore, it is crucial to identify the elements that contribute to the perceived legitimacy of the Patur program.

1 The Indonesian Patur Program Based on Scott's Institutional Pillar

(a) The Regulative Pillar

(i) Indonesian Tax Education Standard

The regulative pillar focuses on rules, laws, or structures that are relevant to the program. In relation to the tax education program in Indonesia, the DGT issued Circular Letter No 52 Year 2020 on 30 December 2020, regarding the Tax Awareness Inclusion Program ('TAIP') through Education (SE-52). SE-52 is intended as a guideline for the DGT to increase the tax awareness through TAIP. In addition, SE-52 aims to provide uniformity in the understanding and implementation of TAIP. As regulated in SE-52, there are several stages of TAIP implementation process consisting of preparation stage, implementation stage and evaluation stage. However, this regulation is very general and broad with regard to the implementation of TAIP.

The Patur program is part of the TAIP in the form of a campaign program to increase students' tax awareness. Although there is no specific regulation regarding the teaching materials and delivery methods of the Patur program, the DGT has identified tax-related values or themes that need to be taught in each level of education. These values become the basis of the creation of the teaching materials. The values remain the same each year, although the content may need to be modified. One of the participants from the DGT's central office explained:

> For the materials, since the first Patur in 2017, we have determined a limit of topics that are most appropriate for each level of education. […] When we make the materials each year, we use the themes as basis. […] There may be a slight modification of the materials each year, but we definitely start from that initial concept for each level of education.

For example, the value to be conveyed to high school students is 'taxes are the backbone of the country'. Therefore, the materials created for high school students should support this value. The main content of the materials for high school students consists of:

a. The definition of tax, including types of taxes, who is responsible for paying taxes, and how the country collects taxes;
b. Tax as the backbone of government revenue, explaining the place of taxes in the state budget ('APBN');
c. The role of taxed in the development of the country.

In addition, the materials also include illustrations or examples that are closely related to students' daily activities to make the materials easier to understand. The teaching materials for the Patur program have been prepared by the DGT central office. The tax offices are required to deliver the materials to the students according to the guidelines provided by the DGT central office, as one of the participants from the tax offices shared:

> Actually, we were given guidelines on how to implement the Patur program in schools. The materials were also available to us. They were prepared by P2Humas (Public Relation Directorate). […] However, this did not exclude the possibility of developing materials provided by the DGT head office.

The guidelines provide keywords to be delivered by the tax offices in the Patur program, as well as suggested methods for delivering the materials. However, the guidelines provide only general guidance, so tax offices can modify the materials and methods if necessary, as long as the modification is still related to the objective of raising students' tax awareness. Some examples of modifications that tax offices have made in the Patur program include:

a. Adding more illustrations or examples that are related to the materials, so the materials could be easier to understand by students.
b. Adding local knowledge that is related to the region where the school is located.
c. Preparing slightly different materials for students in vocational high schools because they may have different plans after graduation. Students in vocational high schools may be more likely to find jobs, while students in regular high schools may be more likely to pursue higher education after finishing graduation.
d. Translating materials into the local language in which the materials are delivered. This is done when the tax offices see that it could provide a better understanding to the students.

Since the guidelines from the DGT central office only provides general guidance, the main challenges they face are related to the methods they use to deliver the materials to the students. First, they need to prepare methods that are fun, so that they can keep the students focused throughout the event. This will depend on the creativity of the tax offices to determine the methods that best suit the students they will be facing. Second, since the instructors are tax officials, they mostly do not have professional experience in teaching young people (students). Third, the methods may depend on the infrastructure available in the school, such as computers, internet connection, and availability of rooms to hold the event. The infrastructure between regions and between schools may vary across Indonesia, so tax offices may need to adapt the methods to the infrastructure available to them.

Our findings on the regulative pillar indicate that the Patur program is supported by Indonesian regulations on tax education. However, the regulations are very general and do not provide guidance on how to operationalize the program. The DGT central office provides directions and guidelines on how tax offices should implement the Patur program, but they are not formally regulated. Thus, our results indicate the absence of government regulations and directions on the Patur program, which implies the absence of a strong regulative pillar.

(b) School Curriculum

Continuing our examination of the regulative pillars, we have investigated the integration of tax education into the school curriculum. Our focus was on determining the extent to which tax education is formally integrated, whether as a separate subject or within other academic courses.

Feedback from the FGDs indicates that tax education is not compartmentalized as a separate subject within the curriculum. Instead, taxation is intermittently addressed in the context of economics and civic education classes: 'Yes, it was taught in the economics class. There is more emphasis on how they know the importance of taxes. In Civic Education, students also learn about the awareness of citizens to pay taxes.'

The marginal presence of tax education within established subjects may prove insufficient. Teachers have noted, through FGDs, that students, particularly those specializing in the sciences, have a limited comprehension and awareness of tax-related issues. Therefore, the Patur program initiative is instrumental in reinforcing tax awareness from an early stage and supporting the efforts of educators to demystify tax concepts for students:

> Of course, it's very useful for our students in general and especially for students majoring in financial accounting. [….] So indeed, various additional information from the activities of the Patur program will really help our students to understand the subject of taxation in a broader sense.

The insight gained from the FGDs conducted underscored that taxation is not universally taught across the different types of high schools. This finding is consistent with our previous observations that the Patur program operates without a robust regulatory foundation or explicit operational guidelines at the educational institution level, further reflecting the program's nebulous presence within the regulative structure.

(b) Normative Pillar

The normative pillar is critical to the effectiveness of the Patur program and depends on the mutual recognition of the importance of tax education by both tax offices and educational institutions. Interviews and FGDs revealed that these stakeholders agree on the need for the Patur program to promote tax awareness among students. The Patur program provides a basic understanding of tax concepts—what taxes are, their purposes, and their role in national development. Tax authorities and schoolteachers and officials agree that early awareness could pave the way for students to become conscientious taxpayers in adulthood. One teacher outlined the sentiment as follows:

> In my opinion, high school students need tax education. In addition to tax being a part of economics subject in high schools, the Patur program could help students understand what taxes are, what they are for, and to raise their awareness of the importance of paying taxes when they become taxpayers.

This sentiment is echoed in the context of vocational education, where immediate employment upon graduation is common. One vocational school educator explained:

> I teach in a vocational high school, and our students will work in the industry, according to their competency, after they graduate. When they work for an organization, they will have to pay taxes. Therefore, the Patur program is very important especially for us in the vocational high school so that our students could know more about taxes.

Participants advocated for the Patur program to extend beyond economics and civics to provide comprehensive tax education. This includes insight into personal tax obligations and an appreciation of the role of taxes in funding public services and national prosperity. Teachers emphasized the importance of understanding the benefits of tax contributions and the allocation of tax revenues for Indonesia's advancement.

Complementing the teacher's perspective, tax offices incorporate familiar cultural values such as ‘*gotong royong*’—the communal spirit of cooperation inherent in Indonesian culture—when teaching tax principles, thereby simplifying the concepts for students:

> We could start by explaining problems that students usually face in their daily lives. […] We then incorporate how ‘gotong royong’ can be used to solve their problems. Then, we

> connect it by explaining that paying taxes is a form of 'gotong royong' that can be used to develop the country.

This cultural alignment facilitates students' understanding of tax responsibility as a shared social duty. Our analysis confirms that the harmonized viewpoints between educators and tax officials form a robust normative pillar for the Patur program, highlighting its recognized value in tax education.

(c) Cultural-cognitive Pillar

The cultural-cognitive pillar encompasses the shared beliefs and behaviours that become second nature within an organization. For the goals of the Patur program to be ingrained in both tax and school officials, it is essential to tailor the program to the distinct characteristics of each entity. Although the DGT provides broad guidelines, tax offices are empowered to tailor these to their specific circumstances, reflecting a diverse application of teaching methodologies.

Based on our interviews, participants from the tax offices see that modifications are sometimes necessary to adapt to the conditions they encounter, either internal factors within the tax office or external factors from the schools and their environment. Internally, tax offices may have varying budgets and staffing that affect their capacity to execute the Patur program. Limited resources may limit the number of schools reached each year, necessitating a rotational approach to school selection for maximum impact. Additionally, the teaching proficiency of tax officials can have significant impact on program delivery. Externally, the diversity of the target audience is also a factor. For example, students in vocational high schools who are slated to enter workforce immediately can benefit from tailored tax education that aligns with their industry-focused education. One tax official shared:

> In our region, we have vocational high schools, not the regular high schools. Therefore, we will adapt the materials to the students in vocational schools. We think that it will be more interesting if the materials are adapted to our audience. If we are teaching students in vocational schools specializing in culinary arts, for example, it will be interesting to also explain how taxes relate to the culinary industry.

Moreover, regional differences necessitate an adaptive approach. Local socio-economic contexts and language can influence the method and content of tax education, ensuring relatability and comprehension. Participants illustrated the importance of this local adaptability as follows:

> We added some information related to the region where our office is located. The concept of taxation we explained is general and can be used nationally. However, since we see many small and medium enterprises (SMEs) in our region, we add some tax materials related to them.

> If we talk in Bahasa Indonesia, it might be more difficult for them to understand. They are more familiar with their local language than Bahasa Indonesia. […] This can also become a suggestion [for other tax offices] to translate their materials into the local language if [people in] their area [of operation] use the language [more].

The results emphasize the pivotal role of the cultural-cognitive pillar in the implementation of the Patur program. Our results show how cultural-cognitive elements influence the effectiveness of the Patur program. The ability of tax offices to identify materials and methods that are appropriate to their internal and external environments becomes pivotal in the implementation of the program. This highlights the commitment of tax offices to provide tax education to students. Thus, our results indicate a strong need for a cultural-cognitive pillar in the Patur program. The willingness of tax offices to customize strategies reflects a shared commitment to effective tax education. However, the lack of standardized practices may potentially undermine the long-term effectiveness of the program.

V CONCLUSION

The Patur program, a cornerstone of Indonesian tax education for young students, has been in operation for five years. Given Indonesia's position as one of the countries with the lowest tax ratios in the Australasian region, it is crucial to examine the effectiveness of such initiatives. The lessons learned from this study are valuable not only for the Indonesian government but also for other countries seeking to promote tax education.

Our research entailed interviews with stakeholders from the Indonesian DGT, local tax offices, and educational institutions to gain a comprehensive picture of the implementation of the Patur program. We used Suchman's legitimacy theory and Scott's institutional theory to evaluate the legitimacy of the program and the impact of cultural-cognitive, normative, and regulative structures on its operation.

The aspiration of the Indonesian government is for the Patur program to achieve cognitive legitimacy within the national educational framework, which implies a deep understanding of the program's intent and significance by both tax offices and schools. However, our analysis suggests that the program has yet to fully realize this anticipated legitimacy. The research uncovered a robust normative foundation within the program, highlighting the mutual recognition of its significance by both the tax authority that administers it and the schools that integrate it into their curriculum. The consensus is clear: there is a shared belief in the necessity of the Patur program to engender tax awareness among students and recognition of the program's pivotal role in tax education for the youth.

Our findings underscore the critical interplay between the normative and cultural-cognitive pillars. The broad guidelines provided by the DGT for the Patur program allow considerable latitude for tax offices to tailor program implementation to the diverse characteristics of schools and their students. This adaptability is beneficial because it allows tax office officials to optimize the relevance and effectiveness of the program in different educational contexts. However, this same adaptability requires that tax offices have the requisite expertise to develop and deliver tax-related educational content. Given that the program relies primarily on tax officials who typically lack formal pedagogical training, we advocate for a strategic partnership between educators and tax officials to improve the delivery of tax education.

In conclusion, while the Patur program has established a strong normative foundation, achieving full legitimacy within Indonesia's educational ecosystem requires addressing the gap in specialized instructional competencies. Strengthening the collaboration between the DGT and educational institutions can facilitate a more impactful and nuanced approach to tax education, ultimately fostering a more tax-aware future generation.

BIBLIOGRAPHY

A *Articles/Books/Reports*

Abbas, Yulianti, Christine Tjen and Panggah Tri Wicaksono, 'Tax Education and Tax Awareness: A Study on the Pajak Bertutur Indonesian Tax Education Program' (2021) 16(1) *Journal of the Australasian Tax Teachers Association* 198

Andreoni, James, Brian Erard and Jonathan Feinstein, 'Tax Compliance' (1998) 36(2) *Journal of Economic Literature* 818

Bahari, Anis Barieyah Mat and Lai Ming Ling, 'Introducing Tax Education in Non-Accounting Curriculum in Higher Education: Survey Evidence' (2009) 7(1) *Journal of Financial Reporting and Accounting* 37

Casto, Hope G and John W Sipple, 'Who and What Influences School Leaders' Decisions: An Institutional Analysis of the Implementation of Universal Prekindergarten' (2011) 25(1) *Educational Policy* 134

Eriksen, Knut and Lars Fallan, 'Tax Knowledge and Attitudes Towards Taxation: A Report on a Quasi-Experiment' (1996) 17(3) *Journal of Economic Psychology* 387

Jongbloed, Ben, Jürgen Enders and Carlo Salerno, 'Higher Education and Its Communities: Interconnections, Interdependencies and a Research Agenda' (2008) 56(3) *Higher Education* 303

Kwok, Betty Yuk Sim and Rita Wing Yue Yip, 'Is Tax Education Good or Evil for Boosting Tax Compliance? Evidence from Hong Kong' (2018) 32(4) *Asian Economic Journal* 359

Linnér, Susanne, Lena Larsson, Göran Gerdin. Rod Philpot, Katarina Schenker, Knut Westlie, Kjersti Mordal Moen and Wayne Smith, 'The Enactment of Social Justice in HPE Practice: How Context(s) Comes to Matter' (2022) 27(3) *Sport, Education and Society* 228

Loo, Ern Chen, Margaret McKerchar and Ann Hansford, 'An International Comparative Analysis of Self Assessment: What Lessons Are There for Tax Administrators?' (2005) 20(4) *Australian Tax Forum* 669

Morgan, Annette and Donovan Castelyn, 'Taxation Education in Secondary Schools' (2018) 13(1) *Journal of the Australasian Tax Teachers Association* 307

Niemirowski, Pauline, Steve Baldwin and Alexander J Wearing, 'Tax Related Behaviours, Beliefs, Attitudes and Values and Taxpayer Compliance in Australia' (2003) 6(1) *Journal of Australian Taxation* 132

Okello, Andrew, 'Managing Income Tax Compliance Through Self-Assessment' (Working Paper No WP/14/41, International Monetary Fund, March 2014) <https://www.imf.org/external/pubs/ft/wp/2014/wp1441.pdf>

Organisation for Economic Co-operation and Development (OECD), *Revenue Statistics in Asia and the Pacific 2022: Strengthening Tax Revenues in Developing Asia* (Report, 2022) <https://doi.org/10.1787/db29f89a-en>

Scott, W Richard, *Institutions and Organizations: Ideas, Interests, and Identities* (SAGE Publications, 4th ed, 2014)

Suchman, Mark C, 'Managing Legitimacy: Strategic and Institutional Approaches' (1995) 20(3) *Academy of Management Review* 571

Timothy, Joshua and Yulianti Abbas, 'Tax Morale, Perception of Justice, Trust in Public Authorities, Tax Knowledge, and Tax Compliance: A Study of Indonesian SMEs' (2021) 19(1) *eJournal of Tax Research* 168

Zimmerman, Monica A and Gerald J Zeitz, 'Beyond Survival: Achieving New Venture Growth by Building Legitimacy' (2002) 27(3) *Academy of Management Review* 414

DO SMALL BUSINESS OWNERS CARE? PERCEPTIONS OF SMALL BUSINESSES OWNERS AND THEIR LITERACY

MELISSA BELLE ISLE,* BRETT FREUDENBERG† AND TAPAN SARKER‡

ABSTRACT

The way that taxpayers interact with a tax system is complicated to understand. There is some evidence that the way taxpayers perceive the tax system can influence the way they interact with it. This is particularly important for small business owners ('SBOs'), as they can be central to the operation of their business. This article considers the perception of SBOs in relation to usefulness of their business records and financial statements and examines whether there is a relationship with the SBO's literacy in terms of business tax, financial statements, computer accounting software ('CAS') and their overall literacy. While there seems to be little relationship between perceptions and literacy, of all the literacies considered CAS literacy was at times the most significant.

Keywords: Tax compliance, literacy, perception, managerial benefit, small business

* Griffith University. Email: m.belleisle@griffith.edu.au.
† Griffith University. Email: b.freudenberg@griffith.edu.au.
‡ School of Business, University of Southern Queensland. Email: tapan.sarker@usq.edu.au.

I INTRODUCTION

There are arguments that tax compliance activity actually aids the management of a small business,[1] which if realised can theoretically go towards reducing the regressive nature of tax compliance costs.[2] Part of this argument is that if not for tax compliance, many small businesses may not have extensive business records.[3] However, while there may be better records due to tax obligations, it is not clear to what extent these records are actually used by small business owners ('SBOs') to determine the financial health of their business. The reasons that these potential managerial benefits may not actually be fully realised might be due to several factors. For example, SBOs may have the perception that records created are just for legal obligations required by the relevant tax system and do not provide insights into the business performance. Alternatively, the records created for tax purposes are too old (historical) to be immediately useful. Also, the records created do not contain the business management information required to provide insight into business performance. Even when these businesses records have the ability to form the basis of financial statements, there may be the perception that financial records don't really assist a SBO to understand their business performance.[4] A potential related factor to using these records may relate to the literacy of the SBO in terms of professional financial statements, business tax and/or computer accounting software ('CAS'). Without sufficient literacy in these areas, SBOs may not be able to fully understand the potential information in these records and statements.

Even when advisors are engaged by SBOs, advisors may be largely engaged for tax compliance, so the advisors themselves do not have the time, expertise, to advise on business performance. For example, a study in the context of New Zealand finds that tax advisors mostly failed to discuss any managerial benefits associated with the tax compliance activities of their small and medium clients.[5] This can lead to concerns about whether advisors themselves will be active in reflecting on the business performance when completing tax reporting requirements.

Consequently, this research seeks to consider the perceptions of Australian SBOs in the service sector as to the usefulness of business and tax records in helping manage their business, as well as consider if these perceptions are related to one of four literacies considered of business tax, financial statements, CAS, and an aggregated overall literacy score.

---

1 Philip Lignier, 'The managerial benefits of tax compliance perception by small business taxpayers' (2009) 7(2) *eJournal of Tax Research* 106.

2 Philip Lignier and Chris Evans, 'The Rise and Rise of Tax Compliance Costs for the Small Business Sector in Australia' (2012) 27(3) *Australian Tax Forum* 615; Philip Lignier, Chris Evans and Binh Tran-Nam, 'Tangled Up in Tape: The Continuing Tax Compliance Plight of the Small and Medium Enterprise Business Sector' (2014) 29(2) *Australian Tax Forum* 217.

3 Philip Lignier, 'Measuring the managerial benefits of tax compliance: A fresh approach' (2009) 24(2) *Australian Tax Forum* 117.

4 Abdel K Halabi, Rowena Barrett and Robyn Dyt, 'Understanding Financial Information used to Assess Small Firm Performance' (2010) 7(2) *Qualitative Research in Accounting & Management* 163, 171. SBOs in Australia, eg, did not believe that financial reports reflect real business figures.

5 Sue Yong and Brett Freudenberg, 'Perceptions of Tax Compliance by SMEs and Tax Practitioners in New Zealand: A Divergent View?' (2020) (26) *New Zealand Journal of Taxation Law and Policy* 57, 76.

The reason for focusing on small businesses in the service sector,[6] is their relative importance to the economy. In Australia, small businesses contribute 34.2% of the total private sector income of gross value added ('GVA'),[7] and they make up 98% of all private sector businesses.[8] Additionally, Australian small businesses employ 44.2% (4.94 million of 11.18 million) of all private sector employees.[9] Particularly, small businesses in the service sector provide more than three-quarters of the economy's income[10] and employ more than 87% of all Australian private sector employees. Further analysis suggests that small businesses make up a large part of the service sector. For example, small service sector businesses accounted for $393 billion in income and employed 4,127,000 of the total service sector employment of 9,410,000.[11] Furthermore, in Australia, the service sector is growing faster than any other industry and currently accounts for three out of five of Australia's most globally significant industries.[12]

As part of this it is important to reflect upon the qualitative characteristics that are likely to be exhibited by small businesses, as these characteristics can aid to understand the challenges and opportunities that they have. Generally, small businesses are internally controlled and are funded with private equity; the owner is normally the majority equity holder and often the only individual deriving an income from the business activity.[13] Other small business characteristics include centralised management with a short-range perspective; poor management skills; decision-making process being intuitive rather than based on detailed planning; SBOs having a strong influence in the decision-making process; with informal and inadequate planning and record keeping processes; as well as having a lack of technical knowledge and specialist staff.[14] These qualitative factors highlight how leading and important the SBO can be to the operation of the small business. It is for this reason that this research focuses on the perception and literacy of SBOs as they are likely to be central to the business decisions being made.

---

6 In Australia, service is defined as an activity that delivers help, utility or care, an experience, information, or other intellectual content. Most of the activity is intangible rather than residing in any physical product: Australian Services Roundtable, Submission no 44 to the House Standing Committee on Economics, Finance and Public Administration, 'Inquiry into the Current and Future Directions of Australia's Service Industries' (November 2006).

7 Australian Bureau of Statistics, Australian Industry, 2018-19 (Catalogue No 8155.0, 29 March 2020) ('ABS 8155.0').

8 Australian Bureau of Statistics, Counts of Australian Businesses including Entries and Exits (Jun 2015 to Jun 2019) (Catalogue No 8165.0, 2 February 2020) ('ABS 8165.0').

9 Australian Bureau of Statistics (n 7).

10 Income for this research is reported as gross value Added ('GVA') as opposed to gross domestic product due to the focus of the research on the service industry.

11 Department of Industry, Innovation, Science, Research and Tertiary Education, 'Australian Small Business Key Statistics and Analysis' (Report, December 2012).

12 These include foreign students in tertiary education, international tourism expenditure and Australian investment fund assets: Australian Services Roundtable (n 6).

13 Rob MacGregor and Lejla Vrazalic, 'A Profile of Australian Regional SME Non-Adopters of E-Commerce' (2008) 16(1) *Small Enterprise Research* 27, 30-31.

14 This list is based on research that considered small and medium enterprises, which small businesses are a part of. It is suggested that these characteristics by their nature are relevant to small businesses: MacGregor and Vrazalic (n 13).

While qualitative features are important, for this research project, the term 'small businesses' incorporates those businesses identified by their quantitative measures by the Australian Taxation Office ('ATO') and the Australian Bureau of Statistics ('ABS') as being 'micro' and 'small'.[15] Broadly, small businesses will be those with an annual turnover of $10 million or less and a full-time workforce of 20 or fewer employees.

The reminder of the paper is structured as follows. Part II provides a broad summary of key literature concerning managerial benefits and perceptions. This is followed by Section 3 that presents relevant literacies for SBOs, followed by a summary of key findings in related studies presented in Part IV. Part V outlines the research methodology undertaken in the study including the demographics of the participants, which will be followed by the results in Part VI. Through the analysis of the results overall observations will be made, with limitations and future research being outlined in Part VII. Finally, Part VIII concludes the study.

II PERCEPTIONS AND LITERACY OF SBOS

Low comprehension has been seen as a consequence of the combination of limitations in SBOs' ability and perceptions.[16] Previous research has suggested that understanding financial statements is important for small business decision making, business growth, and performance.[17] For example, the information contained in reports can be extracted to evaluate profitability measures, cash flow, and ratio analysis.[18] Research from Australia and the US has indicated that SBOs do not have a reasonable level of understanding of financial statements.[19] Furthermore, owner's perception about the usefulness of financial reports could influence to what extent they use them.[20] For example, SBOs in Australia did not believe that financial reports reflect real business figures.[21] In the US, SBOs suggested they are incapable of analysing the figures within financial statements so regard these as futile.[22] It appears from these responses that financial statement literacy can inhibit SBOs from utilising important information to ascertain the financial position of their business.

An inter-related concept is cash flow management, as small business success can relate to this. Effective cash flow management practices consist of keeping financial accounts; maintaining a business plan and a cash budget; keeping records of revenue, expenses, creditor and debtor invoicing; and maintaining an inventory schedule.[23] Previous

---

15 Australian Bureau of Statistics (n 8); Australian Taxation Office, 'Taxation Statistics 2015-16' (27 April 2018) ('ATO Tax Stats 2015-16').

16 Arthur R DeThomas and William B Fredenberger, 'Accounting Needs of Very Small Business' (1985) 55(10) *The CPA Journal* 14, 18-19; Halabi, Barrett and Dyt (n 4).

17 DeThomas and Fredenberger (n 16) 21; Robyn Dyt and Abdel K Halabi, 'Empirical Evidence Examining the Accounting Information Systems and Accounting Reports of Small and Micro Business in Australia' (2007) 15(2) *Small Enterprise Research* 1, 5; Halabi, Barrett and Dyt (n 4), 167.

18 Dyt and Halabi (n 17).

19 DeThomas and Fredenberger (n 16); Halabi, Barrett and Dyt (n 4).

20 DeThomas and Fredenberger (n 16) 18-19; Halabi, Barrett and Dyt (n 4).

21 Halabi, Barrett and Dyt (n 4) 171.

22 DeThomas and Fredenberger (n 16) 22-23.

23 Alejandro Drexler, Greg Fischer and Antoinette Schoar, 'Keeping it simple: Financial literacy and rules of thumb' (2014) 6(2) *American Economic Journal: Applied Economics* 1, 13.

research in Australia and the United Kingdom have suggested that SBOs are not actively involved in systematic cash flow management practices.[24] While day-to-day recording of activities involving cash inflow and outflow may be undertaken, the process involved in receiving and making payment for those activities, or in managing cash once received, may not be actively conducted.[25] This might be explained in part by the SBOs' perceptions about the efficiency and effectiveness of their own cash flow management systems.[26] It might also reflect the perceived lack of value that SBOs place on such practices. It is these concepts about the perceptions of SBOs in relation to the usefulness of records to assist with cash flow management, as well as the literacies that are analysed in this research.

As discussed, SBOs can be central to their business operations. Due to time and money constraints the way they perceive the usefulness of something could dictate how much time and resources they will put towards something, as could their understanding. Small business success may be influenced by the managerial capabilities of SBOs and if inadequate can cause failure of the business.[27] This can especially be the case at the commencement of the business, as the technical skills and knowledge of the SBO can be central.[28] This in part can be due to not having the financial resources to seek external advice and support, as well as the desire to have control. This can be of concern as such skills and knowledge about financial management can be lacking at the start-up of their business.[29]

A *Managerial Benefits*

Running any business will generally result in tax obligations, including not only the payments of taxes, but also the reporting of obligations (such as lodging tax returns). At the Federal level in Australia, the tax obligations of a small business can include (but are not limited to) fringe benefits tax ('FBT'),[30] Goods and Services Tax ('GST'),[31] income tax,[32] and pay as you go ('PAYG') withholding.[33] Additionally, there is the superannuation guarantee (SG),[34] which is not a tax system, however, due to the reliance of the calculation of SG based on PAYG withholding, and the regularity of reporting obligations, it is included in this research. Reporting obligations can include preparing annual income tax

---

24 Melissa Belle Isle and Brett Freudenberg, 'Calm Waters: GST and Cash Flow Stability for Small Businesses in Australia' (2015) 13(2) *eJournal of Tax Research* 492, 514; Michael Peel, Nicholas Wilson and Carole Howorth, 'Late Payment and Credit Management in the Small Firm Sector: Some Empirical Evidence' (2000) 18(2) *International Small Business Journal* 17, 19.

25 Belle Isle and Freudenberg (n 24), 514; Peel, Wilson and Howorth (n 24) 19.

26 Australian Taxation Office, 'Small Business Engagement 2017' (5 April 2018) 36 ('ATO SB Engagement').

27 Pearl Dahmen and Eileen Rodríguez, 'Financial Literacy and the Success of Small Businesses: An Observation from a Small Business Development Centre' (2014) 7(1) *Numeracy* 1, 3.

28 DeThomas and Fredenberger (n 16).

29 Peel, Wilson and Howorth (n 24) 19, expect for those businesses operating in finance and accounting.

30 *Fringe Benefits Tax Assessment Act 1986* (Cth) ('*FBT Act*').

31 GST registration is mandatory for enterprises with a turnover of $75000 or more, although voluntary registration is available to enterprises below this threshold see *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 23-5.

32 *Income Tax Assessment Act 1997* (Cth); *Income Tax Assessment Act 1936* (Cth).

33 If the organisation is an employing entity. Non-employing entities are not required to adhere to PAYG.

34 *Superannuation Guarantee (Administration) Act 1992* (Cth).

and FBT returns, lodgement of Business Activity Statements ('BAS') every month or quarter, which details GST, PAYG instalments on income tax and PAYG withholding tax from employee wages.

Not surprisingly, compliance with these tax obligations can lead to compliance costs for SBOs, which extend beyond the monetary cost to pay someone to do the compliance work, but also lost time (opportunity cost) for the SBO, as well as stress.[35] Studies have consistently demonstrated such costs can be regressive for small businesses.[36]

These interactions with the tax system by the SBOs can lead to negative perceptions, as SBOs may feel like an unpaid tax collector[37] and that tax reduces their over-all profit margins.[38] However, there is the potential for some benefits to be derived from this tax compliance. One of the potential benefits of tax compliance can be managerial benefits.[39] That is, from keeping tax records this can provide SBOs greater insight to their operations.[40] The idea is that managerial benefits arise in the form of improved decision making and control over the business as a consequence of the imposition of regular record-keeping required for taxes, especially value added taxes, such as a GST.[41] Research has demonstrated that for small businesses, if it was not for tax obligations they may not even have business records.[42] In particular, micro businesses have been found to be unwilling to pay to obtain accounting information in the absence of tax compliance obligations.[43] Also, there is some suggestion that for non-complying taxpayers the ability to realise managerial benefits may provide more incentives to improve tax compliance rather than the imposition of penalties.[44]

However, while the generation of tax reports and business records have the potential to assist SBOs there are a number of reasons that might contribute to few SBOs actually realising such managerial benefits from their tax records. Inhibiting factors can include the negative perceptions of SBOs that such accounting information can actually assist them in running their business.[45] This interaction may also be influenced by SBOs' low literacy in areas of business tax, financial statements and CAS, which may inhibit the use

35 Nahida Faridy, Brett Freudenberg, Tapan Sarker and Richard Copp, 'The hidden compliance cost of VAT: An exploration of psychological and corruption costs of VAT in a developing country' (2016) 14(1) *eJournal of Tax Research* 166.

36 Lignier and Evans (n 2); Lignier, Evans and Tran-Nam (n 2).

37 Yong and Freudenberg (n 5).

38 Melissa Belle Isle and Brett Freudenberg, 'Taxing my cash flow: The influence of tax on small service sector business cash flow' (2021) 16(1) *Journal of Australasian Tax Teachers Association* 1.

39 Lignier (n 1).

40 Ibid.

41 Binh Tran-Nam, 'Tax compliance costs methodology – a research agenda for the future' in C Evans, J Pope and J Hasseldine (eds), *Tax Compliance Costs: A Festschrift for Cedric Sandford* (Prospect, 2001) 51-68.

42 Lignier (n 3).

43 Ibid.

44 Nahida Faridy, Brett Freudenberg and Tapan Sarker, 'What is in it for me? The potential for managerial benefits to improve tax compliance' (2018) 33(2) *Australian Tax Forum* 307.

45 Lignier (n 3) 114.

of and/or understanding of such records.[46] The perceptions of SBOs about the usefulness of accounting and accounting information may be influenced by their own characteristics of education, knowledge of accounting and business experience.[47] Also the records generated for tax obligations may not be 'fit for purpose' in helping understand the business performance, as well as the business cash flow. This could include the perception that tax records are too old once they are generated.

These potential influences of being able to fully realise the managerial benefits from records are now discussed below.

B *Use of Records*

Australian and New Zealand small businesses have been found to predominantly use accounting information for tax purposes.[48] Consequently, even though accounting records are used for tax purposes, there is doubt as to whether these records were used for managing their business compared to completing tax returns. Even when a SBO seeks an advisor's assistance, it is not clear whether advisors have the skills and/or the capacity to assist SBOs to fully realise these managerial benefits. Research demonstrates that small businesses are only likely to see an advisor a few times a year, and mostly this interaction relates to fulfilling tax obligations.[49] If this interaction is so infrequent and mainly focused on tax obligations, it may be that the business health is not fully canvassed. This could explain why New Zealand tax practitioners mostly failed to discuss any managerial benefits associated with the tax compliance activities of their small and medium enterprise ('SME') clients.[50] This can lead to concerns about whether practitioners themselves will be active in reflecting on the business performance when completing tax reporting requirements. This might also because that tax practitioners perceive that they are paid to assist with tax compliance, and not paid to provide business performance advice. This in part could be related to small businesses being reluctant or unable to afford to pay for additional services.

In relation to GST, it has been found that for Australian small businesses only two management areas were clearly recognised as being of benefit from the obligation to comply with GST, being the maintenance of their record keeping systems, and providing information for their income tax obligations.[51] This supports the notion that tax creates the incentive to create records, which then can assist in complying with the tax at hand,

46 Melissa Belle Isle, Brett Freudenberg and Tapan Sarker, 'Is the literacy of small business owners important for cash flow management?: The experts' perspective' (2018) 13(1) *Journal of Australasian Tax Teachers Association* 31; Melissa Belle Isle, Brett Freudenberg and Tapan Sarker, 'The Business Tax Literacy of Australian Small Businesses' (2022) 37(1) *Australian Tax Forum* 65; Melissa Belle Isle, Brett Freudenberg and Tapan Sarker, 'Top of the Grade: Factors that could influence small business literacy' (2022) 24(1) *Journal of Australian Taxation* 5.

47 Faridy, Freudenberg and Sarker (n 44).

48 Lignier (n 3); Sue Yong and Fiona Martin, 'Tax compliance and cultural values: the impact of "individualism and collectivism" on the behaviour of New Zealand small business owners' (2016) 31(2) *Australian Tax Forum* 289.

49 Yong and Freudenberg (n 5).

50 Ibid 76.

51 Melissa Belle Isle, Brett Freudenberg and Richard Copp, 'Cash flow benefit from GST: Is it realised by small businesses in Australia? (2014) 29(3) *Australian Tax Forum* 417.

as well as other taxes (here income tax). However, research found that there was a strong negative perception about being able to utilise this GST information for business credit management and decision making.[52] This would seem to suggest little or no managerial benefits in terms of business operation and cash flow management were realised.

Other research has established that SBOs have limited use of financial reports as they place minimal significance on financial information.[53] SBOs believed that the main purpose of record-keeping and producing reports is for tax purposes. This is supported by other research that included SMEs and found that records created are just for legal tax obligations and raised concerns whether business owners even considered that the records would be useful in understanding the business performance.[54]

Instead of any actual tax or business records, more importance can be placed on keeping up-to-date with their cash/bank balance, a figure perceived as a better measure of their business performance.[55]

C *Perceptions and Resources*

Due to time and money constraints the way SBOs perceive the usefulness of something could dictate how much time and resources they will dedicate towards it. Cullis and Lewis have stated that what can be most pivotal is taxpayers' values, attitudes, perceptions and morals in terms of tax compliance.[56] Braithwaite on the other hand has argued about motivational postures in a Wheel of Social Alignment, where she suggests that tax compliance is influenced by the (i) technical, (ii) perceptions and (iii) the other.[57] In terms of 'perceptions' she argues that this has three components: perceptions of benefits, fairness and moral obligations. These components can work together to influence a taxpayer's behaviour in terms of tax compliance.

In terms of SMEs, the factors of high tax rates, perceptions of tax fairness, government spending priorities, tax service quality, and personal norms can influence tax compliance decisions.[58] However, if businesses are faced with paying additional 'top up' tax as the instalments of their income tax were too low, this can lead to disgruntle feelings.[59] Business owners can perceive taxes as a loss of money, and taxes can restrict their

---

52 Ibid 439.
53 Halabi, Barrett and Dyt (n 4).
54 Yong and Freudenberg (n 5).
55 Sue Yong, Deryl Northcott and Keith Hooper, 'Culture and the tax compliance behaviour of ethnic business owners' (2014) 20 *New Zealand Journal of Taxation Law and Policy* 71.
56 John Cullis and Alan Lewis, 'Why people pay taxes: From a conventional economic model to a model of social convention' (1997) 18 (2-3) *Journal of Economic Psychology* 305.
57 Valerie Braithwaite, 'Tax and democracy: Bygone ideas or time for reinvention?' (Conference Paper, Australasian Tax Teachers Association Conference, 18-20 January 2017).
58 Banele Dlamini, 'Determinants of tax non-compliance among small and medium enterprises in Zimbabwe' (2017) 9(4) *Journal of Economics and Behavioral Studies* 242; Michael Wenzel, 'Motivation or rationalisation? Causal relations between ethics, norms and tax compliance' (2005) 26(4) *Journal of Economic Psychology* 491.
59 Bernadette Kamleitner, Christian Korunka and Erich Kirchler, 'Tax compliance of small business owners' (2012) 18(3) *International Journal of Entrepreneurial Behaviour & Research* 330. Of course, this means that they have more cash on hand during the year which can be important due to financial constraints.

freedom to decide. This perception of 'loss' may be critical given loss aversion theory, where people can place more emphasis on losing something compared to gaining.[60] According to behavioural finance, losses can hurt twice as much as gains yield pleasure.[61]

In terms of perception, it has been found that taxes have been negatively resented by the SBOs as they conjured up notions of bureaucracy, disincentives to work hard and limiting their entrepreneurial freedom.[62]

In a study of both New Zealand and Malaysian taxpayers there was some interesting relationships between tax literacy, perceptions of the tax system and compliance.[63] Saad found that tax knowledge and tax complexity had 'significant positive path coefficients with fairness perceptions in New Zealand and Malaysia' meaning that an 'increase in tax knowledge would significantly improve fairness perceptions'.[64] Saad also found that 'tax fairness' did not just relate to the imposition and administration of tax laws, but also government spending of the tax revenue raised.[65] Unfortunately, the Saad research did not consider the perceptions of taxpayers conducting a business. Consequently, it is important to have a better appreciation of the perceptions of SBOs, as their issues and interaction with the tax system could be different to individuals (non-business) taxpayers.

An OECD commissioned report explored a qualitative survey undertaken in the United Kingdom regarding the motivation behind SMEs' compliance with tax regulations.[66] The research was built around ethnographical work with 16 representative SMEs supplemented by focus groups. The research took six months where SMEs were observed in their day-to-day operations. Of particular relevance to this study is the findings that SMEs have poor tax habits and can rely heavily on their tax advisors. Additionally, tax is not perceived as falling part of the 'natural rhythm' of the business in terms of orders, customer interactions, deliveries, and sales. Overall, this can lead to poor perceptions about tax and the outcomes, as 'tax compliance is seen as an activity for which SMEs get no return'.[67]

III SBO Literacy

It appears that the literacy of an SBO may influence the potential to realise managerial benefits. Small business failure has been affiliated with several barriers in the business environment including financial constraints, market imperfections, resource restrictions,

60 Amos Tversky and Daniel Kahneman, 'Loss aversion in riskless choice: a reference-dependent model' (1991) 106(4) *Quarterly Journal of Economics* 1039.
61 Ibid.
62 Erich Kirchler, 'Reactance to taxation: Employer's attitudes towards taxes' (1999) 28(2) *Journal of Socio-Economics* 131.
63 Natrah Saad, 'Fairness Perceptions and Compliance Behaviour: Taxpayers' Judgments in Self-Assessment Environments' (PhD Thesis, University of Canterbury, 2011).
64 Ibid 437.
65 Ibid 420.
66 OECD, 'Forum on Tax Administration: SME Compliance SubGroup - Understanding and Influencing Taxpayers' Compliance Behaviour' (Report, 2010).
67 Ibid.

inadequate technical expertise and limited managerial skills.[68] The inability of the SBO to recognise the influence of these barriers on their business can cause further detrimental consequences. This is particularly relevant given the central role played by the SBO in their business operations. Some of these barriers are outside of the control of the SBO. For example, in Australia, small business financial constraints were evident during the global financial crises.[69] However, many internal barriers could potentially be overcome by an increased level of SBO literacy.[70] Part of this is being able to manage cash flow effectively, which takes skills, as well as having the records to be able to demonstrate insights to the business operations.

Literacy can be extended to include the specific circumstances of the individual. For example, there are extended definitions for literacy in respect of finances, information technology, taxation, accounting, statistics, and health, plus others that develop over time.[71] A business owner may need to possess many different literacy skills to manage a business. This could be problematic for SBOs, considering that they are often the sole decision maker in all areas of the business, which effectively requires their literacy to be multifaceted. From a cash flow management perspective, SBO literacy skills could relate to finance, taxation, information technology, cash management, economics, and accounting. This research focuses on the literacy of SBOs in terms of professional financial literacy, CAS literacy and business tax literacy.

The professional financial literacy of SBOs is important for small businesses when competing in the marketplace. Their larger competitors are more likely to employ experts in the fields of accounting or finance to propose financial decisions and implement effective cash flow management practices.[72] In contrast, the small business may rely on the knowledge and abilities of the SBO, or of an external advisor who is afforded a snap-shot view of the individual business situation.[73] This means that, in order to remain solvent in the market, SBOs need adequate financial foundations that allow them to make smart financial decisions. They also need to implement strategic business plans that allow them to recognise risk, maintain cash flow and utilise assets to ensure maximum profit

---

68 Dedy Suahputra Sijabat and Taufik Fathurohman, 'The Relationship of MSME Owners Financial Literacy Score and MSME's Performance: Case Study of MSME's in School of Business and Management Bandung Institute of Technology' (2017) 2(1) *Journal of Innovation, Business and Entrepreneurship* 23.

69 Belle Isle, Freudenberg and Copp (n 51).

70 Sandra J Huston, 'Measuring financial literacy' (2010) 44(2) *Journal of Consumer Affairs* 296. In recent times the notion of 'capability (compared to literacy) has arisen, as capability covers not only a person's understanding something but also the confidence and capability to actual use that knowledge.

71 Ibid 307.

72 Jack Foley, 'We Really Need to Talk About Owner-Managers and Financial Awareness!' (2018) 25(1) *Small Enterprise Research* 90.

73 Ibid.

generation.[74] This can be a tough ask, as SBOs are multitasking in their business and carrying out a multitude of roles from primary generator of income, human resource manager and administration assistant to financial controller.

It is suggested that SBOs having adequate professional financial literacy can assist with everyday functions in the workplace, as well as the ability to understand what records are telling you. The understanding of financial statements is a component of professional financial literacy. Important skills for professional financial literacy may include reading and understanding balance sheets, income statements, cash flow statements,[75] and preparation of a Cash Budget.[76] It also includes the ability for SBOs to determine the limitations of their own financial ability and to know when it is necessary to seek advice if the information within the statements is confusing or inaccurate.[77]

In today's business environment Information and Communication Technologies ('ICT') are constantly evolving. ICT restrictions can also be evident where the user lacks confidence in their ability to operate the ICT and has difficulty retaining knowledge on how the ICT functions.[78] These restrictions can inhibit small businesses to be more competitive in the marketplace, as ICT knowledge can provide them with the ability to gather, store and analyse internal information to ensure that their business operates to maximum efficiency.[79] For many small businesses in Australia one such ICT software that can provide real-time reporting is a CAS system, which can generate many of the professional financial statement reports.[80] CAS literacy for this research considers the use

---

74 Ibid; Jacob Nunoo and Francis Kwaw Andoh, 'Sustaining Small and Medium Enterprises through Financial Service Utilization: Does Financial Literacy Matter?' (Paper, Agricultural and Applied Economics Association Annual Meeting, 12-14 August 2012); William T Sucuahi, 'Determinants of Financial Literacy of Micro Entrepreneurs in Davao City' (2013) 1(1) *International Journal of Accounting Research* 44; Sean Wise, 'The Impact of Financial Literacy on New Venture Survival' (2013) 8(23) *International Journal of Business and Management* 30.

75 The Australian Accounting Standards Board makes Accounting Standard AASB 107 *Statement of Cash Flows* under *Corporations Act 2001* (Cth) s 334 outlines the benefits of a statement of cash flows; a statement of cash flows, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the entity to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different entities. It also enhances the comparability of the reporting of operating performance by different entities because it eliminates the effects of using different accounting treatments for the same transactions and events.

76 Reva Berman Brown, Mark N K Saunders and Richard Beresford, 'You owe it to Yourself: The Financially Literate Manager' (2006) 30(2) *Accounting Forum* 171, 188.

77 Chukuakadibia E Eresia-Eke and Catherine Raath, 'SMME Owners' Financial Literacy and Business Growth' (2013) 4(13) *Mediterranean Journal of Social Sciences* 397.

78 Paul Matthews, 'ICT Assimilation and SME Expansion' (2007) 19(6) *Journal of International Development* 817, 819; Timothy L Pett and James A Wolff, 'SME Identity and Homogeneity – Are There Meaningful Differences between Micro, Small, and Medium-Sized Enterprises?' (2012) 6(2) *Journal of Marketing Development and Competitiveness* 48, 49.

79 Leonora C Hamilton and Ramachandra Asundi, 'Technology usage and innovation: its effect on the profitability of SMEs' (2008) 31(11) *Management Research News* 830; Pett and Wolff (n 78) 49.

80 Mike Rich, 'IT-Savvy Businesses are more Profitable' (2012) 25(11) *NZ Business* 26, 27.

of a CAS to create common financial statements, as well as the automation of invoicing and debt collection.

Tax literacy is commonly referred to in the literature as tax knowledge. Tax knowledge has been defined as an understanding of tax policy that is essential to a taxpayer's situation within the region or country in which that taxpayer resides.[81] The definition has been extended to suggest that it is a taxpayer's understanding and mindfulness of the tax legislation.[82]

The failure to possess a sufficient level of tax literacy can result in taxpayers engaging in both intentional and unintentional non-compliance behaviour.[83] For example, lacking the ability to recognise basic tax concepts can result in taxpayers not complying and incurring a tax debt with the tax authority.[84] Tax debts occur primarily as a result of administration mistakes or cash flow shortfalls.[85] Cash flow shortfalls, such as when a major debtor does not pay on time, may result in the SBO using their tax funds as an unofficial line of credit, using the tax held to pay important suppliers and/or staff.[86]

There appears to be some indication that tax literacy can influence how taxpayers comply with the tax system, as well as their perception overall of the tax system, including perceptions of fairness of the tax system.[87] While it has been observed that SBOs can have inadequate tax knowledge,[88] SBOs have been measured as having greater tax literacy than the general public.[89]

81 Newman Wadesango et al, 'Literature Review on the Impact of Tax Knowledge on Tax Compliance among Small Medium Enterprises in a Developing Country' (2018) 22(4) *International Journal of Entrepreneurship* 1, 2.

82 Ibid 5.

83 Natrah Saad, 'Tax Knowledge, Tax Complexity and Tax Compliance: Taxpayers' View' (2014) 109 *Procedia - Social and Behavioral Sciences* 1069, 1070; Wadesango et al (n 81) 2 and 4.

84 Eliza Ahmed and Valerie Braithwaite, 'Understanding Small Business Taxpayers issues of Deterrence, Tax Morale, Fairness and Work Practice' (2005) 23(5) *International Small Business Journal* 539, 543; Toni Chardon, Brett Freudenberg and Mark Brimble, 'Tax Literacy in Australia: Not Knowing Your Deduction from Your Offset' (2016) 31(2) *Australian Tax Forum* 321, 345; Guilia Mascagni and Fabrizio Santoro, 'What is the Role of Taxpayer Education in Africa?' (International Centre for Tax and Development, 2018); Elisabeth Poppelwell, Gail Kelly and Xin Wang, 'Intervening to Reduce Risk: Identifying Sanction Thresholds Among SME Tax Debtors' (2012) 10(2) *eJournal of Tax Research* 403.

85 Ibid 415.

86 Belle Isle and Freudenberg (n 38) 7.

87 Saad (n 63).

88 Ahmed and Braithwaite (n 84).

89 Brett Freudenberg et al, 'Tax Literacy of Australian Small Businesses' (2017) 18(2) *Journal of Australian Taxation* 21.

Greater tax literacy could lead to greater compliance.[90] Research has demonstrated that education and tax law literacy may have a positive impact on compliance.[91] It appears that taxpayers consider that if they had improved tax law literacy their compliance would improve.[92] Increased tax law literacy may improve taxpayers' attitude toward the tax system,[93] and thereby may have a positive influence on the willingness to be compliant.[94] Whether their behaviour would change is questionable, but it could assist those who do want to comply as suggested by McKerchar's findings.[95]

The study by Saad found for some scenarios that having better knowledge of the tax system will improve tax compliance,[96] but, in other scenarios, no such relationship was found.[97] The difference in the results was attributed to whether there is a greater chance of the taxpayer being detected for non-compliance (ie, document trail). However, when there seemed to be lower chance of detection (ie, cash in hand) then greater tax literacy did not necessarily lead to greater tax compliance. It may be that if there is opportunity for non-compliance with little chance of detection, then taxpayers may still be non-compliant even with greater tax literacy.[98] However, these conclusions need greater research to determine whether this is the case or not.

Enhanced tax literacy, has been associated with a positive perspective about the fairness of taxes, and helps recognise the deliverable benefits of the tax system (and provision of Government services) to the taxpayer.[99] Improved tax literacy is also advantageous for determining the correct calculation of the tax liability, and for implementing tax minimisation strategies.[100] However, it is recognised that in order for taxpayers to successfully fulfil all of their tax responsibilities without assistance from experts, taxpayers would need to be highly skilled in tax law and provisions.[101] This is not a common circumstance for the majority of taxpayers as it is acknowledged that part of tax literacy is knowing when to seek professional advice.

---

90 Jeyapalan Kasipillai and Abdul Jabbar, 'Tax compliance attitude and behaviour: Gender & ethnicity differences of Malaysian taxpayers' (2003) *The Malaysian Accountant* 1; Erich Kirchler, Apolonia Niemirowski and Alexander Wearing, 'Shared subjective views, intent to cooperate and tax compliance: Similarities between Australian taxpayers and tax officers' (2006) 27(4) *Journal of Economic Psychology* 502.

91 Paul Muoki Nzioki and Osebe Rawlings Peter, 'An analysis of factors affecting tax compliance in the real estate sector in Kenya: a case study of real estate owners in Nakuru town, Kenya' (2014) 5(11) *Research Journal of Finance and Accounting* 1.

92 Saad (n 83).

93 Knut Eriksen and Lars Fallan, 'Tax Knowledge and attitudes towards taxation: A report on a quasi-experiment' (1996) 17(3) *Journal of Economic Psychology* 387.

94 Nurlis Islamiah Kamil, 'The Effect of Taxpayer Awareness, Knowledge, Tax Penalties and Tax Authorities Services on the Tax Compliance: (Survey on the Individual Taxpayer at Jadobdetabek and Bandung)' (2015) 6(2) *Research Journal of Finance and Accounting* 104.

95 Margaret McKerchar, 'Understanding small business taxpayers: Their sources of information and level of knowledge of taxation' (1995) 12(1) *Australian Tax Forum* 25.

96 Saad (n 63) 320. For Scenario 1: overstating Business expenses.

97 For Scenario 2: underreporting cash income.

98 Saad (n 63) 323.

99 Freudenberg et al (n 89); Mascagni and Santoro (n 84); Poppelwell et al (n 84).

100 Ahmed and Braithwaite (n 84) 543; Saad (n 83), 1070; Wadesango et al (n 81) 2.

101 Saad (n 83).

It is due to these reasons that this research seeks to consider any potential relationship between SBO perceptions and their literacies.

IV RELATED RESEARCH FINDINGS

This article builds upon prior research by considering the potential relationship between perception and literacy of SBOs. Prior research reported a small qualitative study of 17 interviews with SBOs,[102] which found that service SBOs can perceive that GST, PAYG withholding, and SG can have negative consequences for cash flow stability. In particular, the amount of the tax liability for PAYG withholding and SG, when paid to the ATO each quarter, can result in cash flow constraints. [103] In respect of the negative impact of GST this can be due to a combination of business factors and not just the tax itself, such as market competition, the variability of incoming revenue and the non-receipt of payments from trade debtors before the GST liability is due to the ATO.[104]

A later study reported a survey which measured four literacies of SBOs, being financial statements, CAS, business tax, and then aggregating these to form an 'overall literacy' score. This was achieved by developing 43 literacy questions for SBOs, which comprised seven questions related to the understanding of financial statements, ten questions concerning the use of a CAS system and twenty-six business tax questions. See Appendix A for a list of the literacy questions.

From the responses to these questions, four literacy scores were created for: financial statement literacy; CAS literacy; business tax literacy; and an overall literacy Similar scoring of knowledge has been carried out in prior tax literacy research by Chardon et al.[105]

The financial statements literacy questions explored service SBOs' understanding of the information contained in financial statements and the use of that information to determine liquidity, working capital, profit and cash availability.

Table 1 demonstrates that the mean literacy score for financial statements achieved by participants was 4.70 of a possible 7, equating to 67.14%. This means overall that two-thirds of service SBOs answered their financial statement literacy questions correctly. It appears that their financial statement literacy is greater than their CAS and business tax literacy (see later).

Table 1: Mean Score for business tax, financial statement and CAS

Literacy score type	Total score available	Mean score of SBOs	Mean as a % of total
Financial statement literacy score	7	4.70	67.14%

102 Belle Isle and Freudenberg (n 38).
103 Ibid.
104 Ibid.
105 Chardon et al (n 84).

CAS literacy score	10	5.52	55.20%
Business tax literacy score	26	10.89	41.88%
Overall literacy score	43	21.54	50%

To determine whether service SBOs make use of CAS to implement cash flow practices, participants were asked to confirm whether they engaged in certain activities that have previously been identified as favourable to business success.[106] These questions, included six questions relevant to creating reports in CAS and four questions related to carrying out cash inflow activities. A mean CAS literacy score for participant service SBOs was determined to be 55.2%. Accordingly, just over half of the service SBOs answered the CAS questions in the affirmative.

For the business tax literacy score service SBOs were asked questions related to each of the five major tax systems; income tax, PAYG withholding, SG, GST and FBT.[107] A business tax literacy score and an literacy score relevant to each tax system was ascertained for each service SBO participant, which has been reported elsewhere.[108] An overall business tax literacy score was achieved by adding the correct answers to the business tax literacy questions to achieve a total score for each service SBO.

[106] Australian Taxation Office (n 26).

[107] These are reported elsewhere: see Belle Isle et al (n 46). This related research also includes an analysis of whether there is any relationship between the demographics of the participants and their literacy scores.

[108] Ibid.

As displayed in Table 1, the mean business tax literacy score equates to 10.89 out of a possible 26. When calculated as a percentage, service SBOs have a mean business tax literacy score of 41.88%, which means that, on average, service SBOs get only 42% of tax questions correct. This means that business tax literacy is lower than financial statements and CAS. These three literacies scores were then aggregated to give an overall literacy score out of 43, which was calculated to have a mean score of 21.54 (approximately 50%). To expand our knowledge and understanding this article provides important insights as to the potential relationship (if any) between the literacies of SBOs and the perception of the usefulness of tax records and financial statements through a large-scale survey.

V RESEARCH METHODOLOGY

To ascertain the literacies and perceptions a survey was constructed using a web-link to the survey created in the Survey Monkey online survey platform. This web-link was used on multiple platforms to engage with SBOs in the service sector. The advantages of surveys conducted using a web-link are that they are both time and cost effective, along with their ability to reach larger geographical areas more effectively.[109] Ethical clearance for the research was obtained and included such caveats as anonymity and the ability of participants to withdraw at any time.[110]

The sample of SBOs in Australia was achieved through three different sampling techniques: convenience, snowball and stratified sampling.[111] Convenience sampling was used to contact both professional and personal contacts of the research team using email, Facebook and LinkedIn. These contacts included participants of a qualitative stage of the project, students (current and past) and small businesses known to the research team. Engagement with these contacts also resulted in snowball sampling techniques, as possible participants were encouraged to share the survey with their own networks. Participants were also sought using snowball sampling by contacting industry associations and representatives of professional bodies. These groups shared the web-link for the survey with their network or member listing using newsletters, mass email distribution and website blogs. Groups involved in distributing the survey, included Business South Australia, The Tax Institute, Australian Institute of Credit Management, and a variety of groups within Griffith University including the Griffith Alumni, Entrepreneurship Seminar Series and the Griffith News Blog.[112]

The final method of sampling used for the large-scale survey was a stratified sample of businesses registered for an Australian Business Number ('ABN') in Australia. Businesses were categorised by their geographical location and, as a result, the strata for the project were the States or Territories of Australia. Those chosen for stratified sampling included

---

109 Edith de Leeuw, 'To Mix or Not to Mix Data Collection Modes in Surveys' (2005) 21(2) *Journal of Official Statistics* 233, 234; Floyd J Fowler, *Survey Research Methods* (Sage Publications, 4th ed, 2009).

110 Full Research Ethics Clearance: GU Ref No 2016/194.

111 John W Creswell and Vicki L Plano Clark, *Designing and Conducting Mixed Methods Research* (Sage Publications, 2007) 123.

112 See Mitch Knox, 'Calling small businesses: Griffith researcher wants to help your cash flow' Griffith University (Web Page, 13 February 2019) <https://news.griffith.edu.au/2019/02/13/calling-small-businesses-griffith-researcher-wants-to-help-your-cash-flow>.

Tasmania, New South Wales, Victoria, Western Australia, and the Australian Capital Territory. The Northern Territory was excluded due to time restrictions, as the random sample selection could not be concluded before the survey closing date. A conscious decision, made to exclude Queensland from the stratified sample method, was because the research team are all based in Queensland, and that small business participants who were drawn from the convenience and snowball sampling were more likely to be in Queensland because the researchers' personal and professional networks were predominantly from Queensland.

As a result of the variety of sampling techniques employed for the large-scale survey, it is impossible to ascertain a specific response rate. An alternative in this situation is the identification of a completion rate. This is calculated by the number of participants who began the survey in comparison to those who completed the survey. A total of 259 started the survey and a total of 116 completed it, giving a completion rate of 45%. Note the survey was concluded in June 2019 and therefore the data was collected prior to the economic effect of the COVID-19 pandemic.

Once the survey closed for data collection, the results were extracted from Survey Monkey and imported into Microsoft Excel (Excel), a preparatory tool for initial data cleaning. The file of completed questionnaires was then imported into the research data analysis software, Statistical Package for the Social Sciences (SPSS).[113] Data coding was then carried out. The variable types relevant to the survey data were scale and nominal categories.

For those questions structured in a Likert scale format, a new variable was created in 'scale' category to ensure that the coding of the data excluded answers where participants selected 'not applicable', 'not sure', 'advisor's job' or 'never thought of it'. Coding in such a way allowed for analysis of the results according to answers that fulfilled the Likert scale; this in turn prevented distortion of the values relevant to those who agreed or disagreed with statements being posed to participants.

The first draft of the survey was pilot tested by the researchers and then tested by a sample of small business owners, business advisers and tax academics. Important feedback was received relating to formatting and grammatical errors.

A *Participants*

The survey link was accessed by 259 respondents over the period between 1 October 2018 and 30 June 2019. Of these 259, only 116 completed the survey in totality as some were excluded as not a relevant small business or did not complete all parts of the survey. It should be noted that not all questions were relevant to all participants. While 116 is slightly disappointing, engaging small businesses in research has been previously identified as problematic.[114] Nevertheless, the results are still useful to demonstrate insights into the literacy of SBOs and its potential relationship to the tax system and the

[113] Version 26 of SPSS was used to conduct data analysis for this research.

[114] Belle Isle et al (n 51); Ian Wallschutzky and Brian Gibson, 'Small Business Cost of Tax Compliance' (1993) 10(4) *Australian Tax Forum* 511.

usefulness of financial statements and CAS. Table 2 details the descriptive characteristics of the survey participants.

The 116 participants who completed the survey represented 16 Australian and New Zealand Standard Industrial Classification categories. The survey sample included almost two-thirds of Australian-born service SBOs and slightly more than one-third migrant service SBOs. In terms of education, more than 90% of service SBOs held a tertiary qualification, including postgraduate, undergraduate and TAFE qualifications. The most popular business structure, the company, was followed by sole traders, who collectively made up 72% of the participants. The business age categories of the participants were all represented, with more than 40% of businesses being in operation for more than 10 years, and with 19% representing the youngest business category of less than two years. The participants primarily employed five or fewer employees, with 44% employing between 1 and 5 employees and 40% non-employing. In terms of annual income, more than 95% of the participants earned $2,000,000 or less.

Table 2: Summary of participant characteristics

Demographic	Categories	N = 116	Percentage
Residency	Less than 5 years	1	0.9%
	More than 5 years but less than 10 years	7	6.0%
	More than 10 years but less than 15 years	8	6.9%
	More than 15 years but less than 20 years	8	6.9%
	More than 20 years	17	14.7%
	I was born in Australia	75	64.7%
Education	Left school before completion of year 10	1	0.9%
	Year 10	1	0.9%
	Year 12	8	6.9%
	TAFE qualification	23	19.8%
	University undergraduate degree	36	31.0%
	University post graduate degree	47	40.5%
Business Structure	Sole Trader	40	34.5%
	Partnership	6	5.2%
	Company	44	37.9%
	Trust	9	7.8%
	Combination of Company and Trust	16	13.8%
	I'm unsure of the business structure	1	0.9%
Business Age	Less than 2 years	22	19.0%
	More than 2 years but less than 5 years	19	16.4%
	More than 5 years but less than 10 years	28	24.1%
	More than 10 years	47	40.5%
Number of Employees (excluding the owner)	Zero	46	39.7%
	1 to 5	51	44.0%
	6 to 10	9	7.8%
	11 to 20	10	8.6%
Past Business Experience	Yes	62	53.4%
	No	54	46.6%
Annual Turnover	Under $50000	30	25.9%
	$50001-$200000	36	31.0%
	$200001-$2000000	44	37.9%
	$2000001-$5000000	4	3.4%
	$5000001-$10000000	2	1.7%

VI RESULTS

To examine the importance that service SBOs place on different concepts to understand their business performance, participants were asked to record their perceptions about a variety of statements. These responses explored service SBOs' perception about benefits and/or burdens to cash flow from the three areas of literacy focused on in this research. Perception responses were then compared to literacy scores to determine if the perception of service SBOs has a relationship with their knowledge. This was thought to be useful, given that a person's perceptions about something could influence their future behaviour.[115]

A *Service SBO Perceptions of Accuracy*

The first set of questions asked service SBOs as to their perceptions of whether business records were accurate due to the five Federal tax systems considered, as well as the business activity statement ('BAS'). Table 3 illustrates that most service SBOs appear to recognise that their business records are accurate because of their business tax compliance obligations, as more than 80% agreed or strongly agreed (excluding those who selected 'not applicable') that the accuracy of their business records can be attributed to the requirement to report for these business tax systems. In terms of which tax system seem to aid more accurate business records, PAYG withholding (93.4%) appears to be the tax system that provides the most accuracy. Then in descending order this is followed by SG (88.5%), GST (88.3%), BAS (87.5%) and income tax (83.2%). Those taxes with greater business record accuracy might be attributed to the greater frequency of reporting for PAYG withholding, SG and GST, compared to reporting annually for income tax.[116] FBT was the weakest of the five Federal tax systems in contributing to accurate business records (71.4%).[117] The perception of law accuracy due to FBT could be that it is a unique tax system with unique valuation calculations required. This could also highlight how tax records could be more beneficial if aligned to business and accounting practices, rather than 'messing up' accounting records.[118] Also FBT could be a tax that does not follow the 'normal rhythm' of the business.[119]

115 Melissa J Ferguson and John A Bargh, 'How Social Perception Can Automatically Influence Behavior' (2004) 8(1) *Trends in Cognitive Sciences* 33.
116 Other research has also observed such circumstances: Yong and Freudenberg (n 5) 61.
117 Those that selected not applicable are not included in the calculation.
118 Yong and Freudenberg (n 5) 75.
119 OECD (n 66).

Table 3 Accurate business records

Business records are accurate as a result of recording transactions for these taxes ….	Not Applicable	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
GST	22	6 (6.4%)	0 (0.0%)	5 (5.3%)	25 (26.6%)	58 (61.7%)
FBT	88	0 (0.0%)	2 (7.1%)	6 (21.4%)	6 (21.4%)	14 (50.0%)
Income Tax	27	6 (6.7%)	2 (2.2%)	7 (7.9%)	32 (36.0%)	42 (47.2%)
PAYG Withholding	40	2 (2.6%)	0 (0.0%)	3 (3.9%)	26 (34.2%)	45 (59.2%)
SG	46	2 (2.9%)	0 (0.0%)	6 (8.6%)	22 (31.4%)	40 (57.1%)
BAS	20	6 (6.3%)	0 (0.0%)	6 (6.3%)	29 (30.2%)	55 (57.3%)

These findings appear to support related research findings that SBOs are largely confident about the accuracy of their revenue and expenses records, as well as their debtor and records.[120] It appears that recording transactions because of these taxes does contribute to more accurate business records. However, it should be acknowledged that accurate records by themselves does not ensure they are being used beyond completing tax returns. This is important as tax records can (and are different) to management records. For example, it is unlikely that 'taxable income' of a business would equate to the accounting concept of 'profit' for the same period, nor is it the same as considering the cash flow of the business for the same period.

B Service SBO Literacy and Usefulness of Financial Statements

Use of financial statements in small businesses has been found to have a positive relationship with improved performance and with the capacity to make informed decisions.[121] However, research suggests that SBOs often undervalue the information that

120 Melissa Belle Isle and Brett Freudenberg, 'I know it all? The relationship between small business tax and other literacies and their confidence' *Australian Tax Review* (forthcoming).

121 Miriam Bruhn and Bilal Zia, 'Stimulating Managerial Capital in Emerging Markets: The Impact of Business Training for Young Entrepreneurs' (2013) 5(2) *Journal of Development Effectiveness* 232, 234 and 248.

can be obtained from financial statements.[122] In order to determine service SBO perception of the usefulness of financial statements, questions in the survey explored the extent that participants considered financial statements as being a worthwhile instrument for cash flow management and to determine cash flow.

Service SBOs were first asked if they perceived financial statements to be useful for the management of cash flow. Participants were able to select an answer within a scale of strongly disagree to strongly agree or to select an alternate response categorised under the heading of 'not applicable' (see Table 4). The results were significantly positive for all financial statements, with the balance of the bank account being the highest rated financial statement (94% agreeing). Technically the 'balance of bank account' is not a financial statement, but it was included in the survey as prior research indicated that this was used by SBOs as a major indicator of business health,[123] which was confirmed by small business experts in a separate study.[124] The prior qualitative study determined that service SBO reliance on cash levels in the bank was justified by participants due to the real-time availability of the information.[125] It is this 'real time' availability that could be a key to improved perceptions about the usefulness of information and statements. This supports other research that found that small businesses use the bank balance as a measure of cash availability and performance.[126]

The results about the perceptions about the other financial statements appear to be more favourable than the feedback collected in a prior qualitative study.[127] This prior research suggested that three in every five service SBOs place minimal value on the use of financial statements for cash flow management. For example, almost 80% of service SBOs had implied that they place no value on preparing a cash budget.[128] However, it must be recalled that this prior qualitative study only consisted of 17 participants. In contrast, in this survey of the 95 participants who registered an answer other than not applicable, more than 90% believe that preparation of a cash budget is useful to the management of cash flow. Similarly, the Balance Sheet and Statement of Cash Flow were undervalued in the qualitative study, whereas the survey responses suggest that these statements are favourable to cash flow, with 76% and 85% of affirmative responses recorded respectively. Responses relating to the Profit and Loss Statement suggest that service SBOs in the survey place a higher value on the usefulness of this financial statement than that recorded in the qualitative study. Almost two-thirds of participants viewed the Profit and Loss Statement as beneficial in the qualitative study, and 85% suggested it was valuable for cash flow management in the survey. These results appear to indicate that service SBOs do perceive the value of information contained in financial statements as useful in managing their business cash flow.

122 Halabi, Barrett and Dyt (n 4) 171.
123 Belle Isle and Freudenberg (n 38).
124 Belle Isle, Freudenberg and Sarker (n 46).
125 Belle Isle and Freudenberg (n 38).
126 Halabi, Barrett and Dyt (n 4), 167-74.
127 Belle Isle and Freudenberg (n 38).
128 Ibid.

Table 4: SBO perception of the usefulness of financial statements

Usefulness of financial statements for cash flow management	Not Applicable	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Prepare cash budget	21	2 (2.1%)	2 (2.1%)	3 (2.6%)	45 (47.9%)	42 (44.7%)
Balance Sheet	15	4 (4.0%)	7 (6.9%)	13 (11.2%)	46 (45.5%)	31 (30.7%)
Profit and Loss Statement	11	2 (1.9%)	3 (2.9%)	11 (9.5%)	47 (44.8%)	42 (40.0%)
Statement of cash flows	15	5 (5.0%)	2 (2.0%)	8 (7.0%)	41 (41.0%)	44 (44.0%)
Knowing the balance of the bank account	1	2 (1.7%)	1 (0.9%)	4 (3.4%)	44 (38.3%)	64 (55.7%)

* Note: 'not applicable' is not included in the percentage calculations due to the other responses being part of a Likert scale (which are then used for statistical analysis).

Of course, these financial statements are not tax records or tax statements (such as the income tax return or the BAS). When compared to the usefulness of business records due to tax (Table 3) to those financial statements considered (Table 4), it appears that the bank account balance (94%) and cash budget (92.6%) have higher agreeance than most tax records, except PAYG-W (93.4%). The Profit and Loss (84.8%), Statement of Cash Flow (85%) have similar levels of agreeance to the tax records of BAS (87.5%), SG (88.5%), and GST (88.3%). The Balance Sheet (76.2%) ranks lowly, with just slightly more agreeance than the FBT records (71.4%).

In an attempt to ascertain if there was any relationship between perception of the usefulness of financial statements and the four literacy scores of service SBOs a statistical analysis was conducted. Table 5 displays the results of the simple linear regression tests carried out at a .05 level of significance.

The test outcomes suggest that the perception of benefits service SBOs envisage from using financial statements for cash flow management are not consistent with their actual literacy levels. This could imply that the perception of value of financial statements by service SBOs is regardless of their individual literacy (which might include their ability to extract meaningful information to determine their business cash flow situation). The only test outcome that resulted in a linear relationship was between CAS literacy score and the usefulness of the Statement of Cash Flow, with a result of .042. This might be related to how the literacy questions were comprised. For business tax and professional financial literacy, the questions were knowledge based (see Appendix A), whereas the questions for CAS were more based on actions. This different measuring was because it was not possible to see participants generate the relevant reports from their CAS. For example, some of the CAS literacy questions were:

> I create the following in the business computer accounting software:
>
> - A Balance Sheet at least every 3 months.
> - A Profit and Loss Statement at least every 3 months.
> - A Statement of Cash Flows at least every 3 months.
> - A Cash Budget at least once a year.
> - Reports for taxation at least every 3 months.

This means, that, provided participants answered accurately, then CAS literacy score as framed demonstrates generation of the reports (and hopefully their subsequent use).

The outcome of the regression tests relevant to financial statement literacy score could also indicate that, although service SBOs confirm that financial statements are useful for cash flow management, they may not put this into practice in their business. Financial statement literacy score was confirmed to have the highest mean score of all literacy scores:

Table 1. The perception of the usefulness of financial statements was significantly high, so it was envisaged that financial statement literacy score would likely predict service SBO perception. These results could suggest that not all service SBOs who value financial statements have a level of literacy that allows them to extract meaningful information from them for cash flow management. This could be a positive outcome of the research, as even though service SBOs may not have a level of literacy to understand financial statements today, the importance they place on financial statements for cash flow management could potentially motivate them to increase their literacy in the future. Or it may mean that they do not actively use that for financial statement literacy.

Table 5: The relationship between service SBO literacy (IV) and perception about the usefulness of financial statements (DV)

Literacy score, perception and usefulness of financial statements to cash flow management	Sum of Squares	df	Mean Square	F	Sig.
Preparation of a cash budget (DV)					
Overall literacy score (IV)	.821	1	.821	1.186	.279[b]
Business tax literacy score (IV)	.195	2	.195	.289	.592[b]
Financial statement literacy score (IV)	.003	1	.003	.004	.947[b]
CAS literacy score (IV)	1.113	1	1.113	1.616	.207[b]
The Balance Sheet (DV)					
Overall literacy score (IV)	.276	1	.276	.247	.620[b]
Business tax literacy score (IV)	2.016	1	2.016	1.895	.172[b]
Financial statement literacy score (IV)	1.397	1	1.397	1.305	.256[b]
CAS literacy score (IV)	2.382	1	2.382	2.181	.143[b]
The Profit and Loss Statement (DV)					
Overall literacy score (IV)	.030	1	.030	.038	.845[b]
Business tax literacy score (IV)	.166	1	.166	.216	.643[b]
Financial statement literacy score (IV)	.046	1	.046	.060	.807[b]
CAS literacy score	.219	1	.219	.276	.601[b]
The Statement of Cash flow (DV)					
Overall literacy score (IV)	.139	1	.139	.127	.723[b]
Business tax literacy score (IV)	.352	1	.352	.339	.561[b]
Financial statement literacy score (IV)	.000	1	.000	.000	.997[b]
CAS literacy score (IV)	4.465	1	4.465	4.255	.042[b]
The balance of the bank account (DV)					
Overall literacy score (IV)	.037	1	.037	.060	.806[b]
Business tax literacy score (IV)	.378	1	.378	.645	.423[b]
Financial statement literacy score (IV)	.055	1	.055	.094	.706[b]
CAS literacy score (IV)	.009	1	.009	.014	.905[b]

* DV = dependent variable, IV = independent variable

C *Service SBO Literacy and Perception of Tax on Cash Flow*

Service SBO perception about the impact of business tax on cash flow was explored by looking at the imposition of tax administration and at possible scenarios that could alter the burden of tax on cash flow.

Prior research established that some service SBOs advocate that paying PAYG withholding on a more regular basis reduces the impact on cash flow.[129] As a result, the survey examined service SBOs' perception to determine whether they thought more regular payment of PAYG withholding would influence the management of cash flow (see Table 6). The results of comparing businesses that report for PAYG withholding who responded strongly/agree with those who strongly/disagree do not align with the qualitative study results. Just over half (52%) of the participants in the qualitative study responding to the statement related to PAYG withholding do not believe that paying the liability more often would be favourable to managing cash flow; in comparison, 24% believe it would be beneficial. This could imply that a large portion of service SBOs are unlikely to support a mandatory change in reporting PAYG withholding on a more regular basis.

Table 6: Service SBO positive perception of tax concepts that influence cash flow

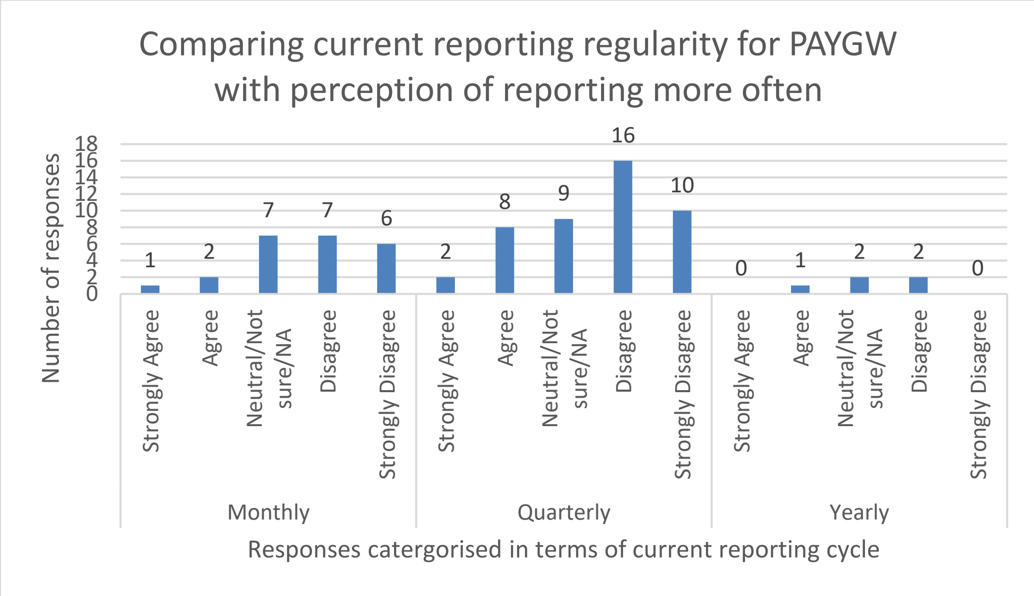
I think the following activities help me manage my cash flow	NA	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Paying PAYGW more often	25	17 (18.7%)	30 (33.0%)	22 (24.2%)	15 (16.5%)	7 (7.7%)
Paying SG more often	37	18 (22.8%)	21 (26.6%)	14 (17.7%)	19 (24.1%)	7 (8.9%)

* Note: 'not applicable' is not included in the percentage calculations due to the other responses being part of a Likert scale (which are then used for statistical analysis).

Figure 1 demonstrates the relationship between reporting PAYG withholding more often and the reporting cycle of those participants with PAYG withholding obligation. For participants who report monthly, 57% believed more frequent payment of PAYG withholding would not help with the management of cash flow. The responses from quarterly reporters, as a percentage are almost the same as those who are monthly, with 58% of participants disagreeing or strongly disagreeing. The small number of responses from participants reporting yearly means that discussing their perception of the benefits of changing payment cycles is difficult. Nevertheless, the data suggests that, regardless of whether participants report monthly or quarterly, service SBOs do not see any benefit in reporting PAYG withholding more frequently in terms of assisting them to manage their cash flow.

129 Belle Isle and Freudenberg (n 38).

Figure 1: Comparison of reporting cycle and payment of PAYG withholding on a more regular basis

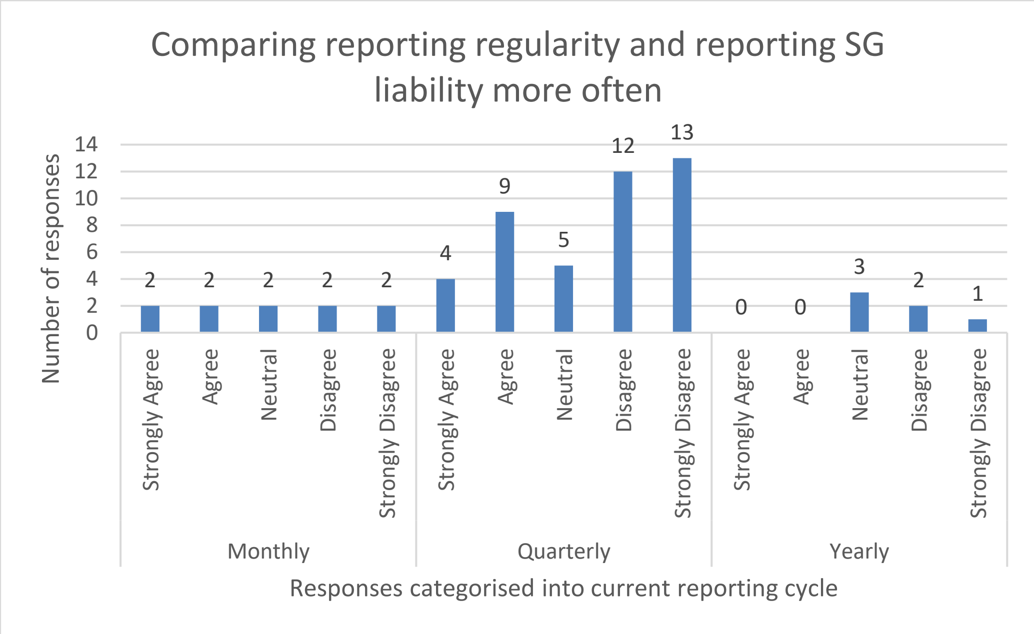


Service SBOs engaged in the prior qualitative study were asked to discuss any concerns they experienced from complying with SG,[130] with comments related to the use of clearing houses and the belief that if SG was paid at the same point in time as PAYG withholding payments were made to employees, it would reduce the burden on cash flow. Because SG is reliant on reporting for PAYG withholding, a similar question was posed to participants in the survey about whether it was beneficial to cash flow management to remit the SG liability on a more regular basis. It appears, when comparing the affirmative and negative responses, that although most respondents disagree, the difference between the number of participants who agree and those that disagree is not as substantial compared to the results for PAYG withholding. Just under half of the responding participants either disagree or strongly disagree that paying their SG liability more often would be benefit cash flow management (see Table 6). In contrast, approximately one-third propose that paying the liability more frequently would be an advantage to cash flow. However, almost one-third of the participants responded with not applicable, this could imply that participants are unsure or apprehensive about whether benefits could be realised.

Separating the responses according to those participants who have a SG obligation demonstrates that businesses reporting monthly have varying views on whether increasing reporting would influence cash flow (see Figure 2). In contrast, the results demonstrate a resistance by quarterly remitters to report and pay SG liability more frequently. However, this perception could be a result of quarterly reporters never having the opportunity to experience increased reporting opportunities, and therefore any proposal to increase it would need to be justified by the likely benefit that could be realised.

130 Ibid.

Figure 2: Comparison of reporting cycle and payment of SG on more regular basis



Small businesses earning less than $10 million were responsible for $15 billion of the overall ATO tax debt in 2018, so it was important to investigate service SBO knowledge about the effects of incurring a debt with the ATO.[131] Prior research has already established that just over one-third of participants in the survey have entered into a payment arrangement with the ATO in order to settle their tax liabilities.[132] This could indicate that one-third of participants have had cash flow problems, in being able to pay their tax obligations on time. In contrast, 68 participants (60%) suggested that they have either always settled their business tax obligations on time or, alternatively, if they are paying late, they are doing so before the ATO takes any recovery action. Given that late reporting and payment can be subject to fines and penalties, service SBOs were asked if they believed that paying tax late causes any negative consequences to their cash flow.[133]

131 Australian Taxation Office, 'Management of Small Business Tax Debt' (30 May 2019).
132 Belle Isle et al (n 46).
133 *Tax Administration Act 1953* (Cth) ('*TAA 1953*') ss 8C and 8E.

Table 7: Service SBO negative perception of tax concepts that influence cash flow

I think the following activities have a negative effect on me managing my cash flow	NA	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Numerous tax liabilities	15	8 (7.9%)	22 (21.8%)	25 (24.8%)	27 (26.7%)	19 (18.8%)
Paying taxes late	12	7 (6.7%)	15 (14.4%)	14 (13.5%)	55 (52.9%)	13 (12.5%)
Tax payment dates	13	11 (10.7%)	27 (26.2%)	33 (32.0%)	24 (23.3%)	8 (7.8%)

* Note: 'not applicable' is not included in the percentage calculations due to the other responses being part of a Likert scale (which are then used for statistical analysis).

The results shown in Table 7 demonstrate that 68 participants (65%) identify that paying and reporting a business tax liability after the due date can place extra strain on business cash flow. It is unclear if those not agreeing to the statement are aware that reporting and paying tax liabilities late can result in the ATO issuing a penalty of up to 20 penalty units.[134] A penalty can be charged on each occurrence that a business fails to comply and the current value of a penalty unit under Commonwealth Law is $210.[135] Effectively this could suggest that a business could incur a penalty of up to $4,200 on each occasion of being late lodging a business tax assessment. In respect to the influence of 'the number of tax liabilities' and 'the date for payment of tax liabilities', is perceived very negatively in terms of their effect on small business cash flow. Overall, just under one half of service SBOs feel that the number of business tax liabilities that they report and pay has a negative impact on the cash flow of their business. According to more than one-third of the service SBOs, the dates for payment of tax liabilities have no detrimental effect on cash flow relating to when business tax payments are due.

To determine whether service SBO perception of business tax systems is supported by actual literacy, statistical analysis was carried out on the tax perception statements compared to the four literacy scores. The results of simple linear regression testing at a significance level of .05 can be found in Table 8. The outcome of the testing implies that only one test of the twenty carried out, found a linear relationship between two variables. Paying PAYG withholding more often is linearly related to business tax literacy score, at the significance of .043. All other test results, as displayed in Table 8 show that service SBO perception is not significantly related to their literacy. This could suggest that service SBO perception is not driven by knowledge acquisition and might be more closely aligned to whether service SBOs envisage possible benefits or burdens of business tax concepts on their cash flow.

---

134 *Tax Administration Act 1953* (Cth) s 8E.

135 *Crimes Act 1914* (Cth) ('Crimes Act') s 4AA.

Table 8: The relationship between service SBO literacy (IV) and perception of how tax can influence cash flow (DV)

Literacy score, perception and the influence of tax on cash flow	Sum of Squares	df	Mean Square	F	Sig.
Paying PAYG Withholding more often would assist with management of cash flow (DV)					
Overall literacy score (IV)	3.08	1	3.088	2.079	.153[b]
Business tax literacy score (IV)	5.775	1	5.775	4.221	.043[b]
Financial statement literacy score (IV)	5.384	1	5.384	3.923	.051[b]
CAS literacy score (IV)	2.163	1	2.163	1.445	.233[b]
Paying SG more often (DV) would assist with management of cash flow					
Overall literacy score (IV)	.056	1	.056	.031	.860[b]
Business tax literacy score (IV)	1.233	1	1.233	.722	.398[b]
Financial statement literacy score (IV)	.182	1	.182	.106	.746[b]
CAS literacy score (IV)	3.289	1	3.289	1.876	.175[b]
The number of tax liabilities makes it difficult to manage cash flow (DV)					
Overall literacy score (IV)	.001	1	.001	.001	.981[b]
Business tax literacy score (IV)	.445	1	.445	.295	.588[b]
Financial statement literacy score (IV)	.132	1	.132	.087	.768[b]
CAS literacy score (IV)	1.103	1	1.103	.665	.417[b]
Reporting tax liabilities late is negative to cash flow (DV)					
Overall literacy score (IV)	.880	1	.880	.688	.409[b]
Business tax literacy score (IV)	.286	1	.286	.235	.629[b]
Financial statement literacy score (IV)	3.517	1	3.517	2.978	.087[b]
CAS literacy score (IV)	.419	1	.419	.327	.569[b]
The date that tax liabilities are due have a negative effect on cash flow (DV)					
Overall literacy score (IV)	.731	1	.731	.567	.453[b]
Business tax literacy score (IV)	1.414	1	1.414	1.144	.287[b]
Financial statement literacy score (IV)	.361	1	.361	.289	.592[b]
CAS literacy score (IV)	.959	1	.959	.745	.390[b]

* DV = dependent variable, IV = independent variable

D *Service SBO literacy and CAS Usefulness to Understand Cash Flow*

Previous research indicates that SBOs are not using their CAS to fully manage or understand their cash flow.[136] The survey, therefore, posed questions to service SBOs about their perception of the usefulness of CAS for cash flow and business management, to explore the perceived benefits received by participants. Service SBOs were initially asked if CAS was beneficial in helping to determine the cash flow position of their business. More than three-quarters of respondents affirmed that CAS is valuable in helping to determine the status of their cash flow (see Table 9). This result is comparable to the number of affirmative responses given in prior qualitative research, where 81% of participants recognised CAS as being instrumental in assisting their cash flow understanding.[137] The remaining participants suggested that they either do not recognise their software as being advantageous for determining cash flow or are unsure about whether there is a recognisable benefit.

Prior research also found that 100% of SBOs place significant importance on CAS for the effective operation of their business.[138] As a result, this relationship was explored in the survey, where service SBOs were asked if CAS was *'useful in ensuring the effective operation of their business*'. As illustrated in Table 9, the affirmative responses were not as strong as found in the qualitative study, although they were still high, with 81% of service SBOs suggesting that they recognise a benefit. The remaining 19% gave negative responses, with just over 10% being doubtful as to whether a benefit is received, and 9% denying that CAS contributes to the efficient operation of their business.

Table 9: Usefulness of CAS perceived by service SBOs

CAS is useful to	True N = 104 (%)	False N = 104 (%)	Unsure N = 104 (%)
Understanding cash flow position	79 (76%)	16 (15.4%)	9 (8.7%)
Effective business operation	84 (80.8%)	9 (8.7%)	11 (10.6%)
Accurate record keeping	101 (97.1%)	0 (0.0%)	3 (2.9%)

The final question explored whether service SBOs perceive CAS as assisting with *'maintaining accurate record keeping*'. Previous research demonstrates that small business experts suggest that small business record keeping is more reliable because of

136 Belle Isle and Freudenberg (n 24).
137 Belle Isle and Freudenberg (n 38).
138 Ibid.

CAS.[139] The results of the survey are comparable to expert feedback, with almost all service SBO participants believing that their records are accurate due to recording transactions in CAS. These findings also support prior research, which acknowledged that SBOs recognised significant benefits from using CAS to maintain financially accurate records of revenue and expenses and of debtor and creditor invoicing.[140] This would suggest that CAS is perceived by SBOs as very important to help them understand their business, as well as keep accurate records.

The perceived benefit (or burden) of the use of CAS for cash flow management was then compared to the four literacy scores of service SBOs. It should be acknowledged that, for testing, one-way ANOVA (as an alternative to simple linear regression) was carried because the answer format was not in Likert scale for the CAS confidence questions.

For the first two statements, whether CAS is useful '*to understand the cash flow position of my business'* and '*for the effective operation of my business'* the results in Table 10 illustrate that a linear relationship only exists when CAS literacy score is compared to the responses for, CAS is useful '*for effective operation of my business*' at a significance result of .034. CAS is perceived as important for effective business operation, which supports related research that found a relationship between business performance (as measured by profit) and CAS literacy.[141]

Regarding the statement that CAS is useful '*for accurate record keeping*,' the test results in Table 10 show an unexpected outcome. The results in Table 10 show that a total of 101 'yes' and 3 'unsure' responses were recorded. Preparing the data for testing means the unsure responses are removed, which in this situation leaves all remaining responses as 'yes.' As a result, it is impossible to calculate a mean difference for this statement to compare the mean to the literacy scores. However, given the extent of 'yes' responses, it would appear that CAS is useful for accurate record keeping but it is not possible to establish its relationship with the literacy scores.

139 Belle Isle et al (n 46).

140 Belle Isle and Freudenberg (n 38).

141 Melissa Belle Isle, Brett Freudenberg and Tapan Sarker, 'Does tax literacy matter? The relationship between small business literacy and business performance and cash flow' (forthcoming).

Table 10:The relationship between service SBO literacy (IV) and perception of the usefulness of CAS for cash flow management (DV)

Literacy score, perception and usefulness of CAS for cash flow management	Sum of Squares	df	Mean Square	F	Sig.
To understand cash flow position (DV)					
Overall literacy score (IV)	4.743	33	.144	1.024	.457
Business tax literacy score (IV)	2.836	24	.118	.790	.736
Financial statement literacy score (IV)	.914	7	.131	.917	.498
CAS literacy score (IV)	2.394	10	.239	1.843	.065
For effective operation of my business (DV)					
Overall literacy score (IV)	2.496	33	.076	.792	.763
Business tax literacy score (IV)	2.105	24	.088	.990	.490
Financial statement literacy score (IV)	.439	7	.063	.693	.678
CAS literacy score (IV)	1.652	10	.165	2.091	.034
For accurate record keeping (DV)					
Overall literacy score (IV)	.000	33	.000	-	-
Business tax literacy score (IV)	.000	24	.000	-	-
Financial statement literacy score (IV)	.000	7	.000	-	-
CAS literacy score (IV)	.000	10	.000	-	-

* DV = dependent variable, IV = independent variable

E *Overall*

The findings suggest that there was a perception by SBOs that business records are more accurate due to their tax obligations, with the highest accuracy provided by PAYG-Withholding. At the other end of the spectrum, FBT as perceived to provide the lowest accuracy of business records. Service SBOs' perception was examined to investigate the importance that they place on the use of financial statements for cash flow management. The balance of the business bank account was considered the most useful source of information for cash flow management. After the bank balance, service SBOs had high regard for creating a cash budget for cash flow management purposes.

Two financial statements, the Statement of Cash Flow and the Profit and Loss Statement were equally valued, and the Balance Sheet was supported by more than three-quarters of participants. Comparison of service SBO literacy to their perception about the usefulness of financial statements for cash flow management predominantly confirmed that perception is not explained by service SBO literacy. Only one test of the sixteen carried out resulted in a significant linear relationship, that between the Statement of Cash Flows and CAS literacy score. Considering that service SBOs place a high value on the use of financial statements for cash flow management, investing in the improvement of their literacy could be advantageous for increasing the use of financial statements in the future.

SBO perceptions was examined in relation to the usefulness of financial statements and CAS for cash flow management, along with the impact to cash flow of currently enacted and proposed tax administration concepts. SBOs affirm that all financial statements and CAS are useful for cash flow management. However, it should be acknowledged that the balance of the bank account and the preparation of a cash budget was more highly regarded as useful when compared to actual financial statements. For business taxation, SBOs believe that the multitude of tax payments complied with in each tax year can have unfavourable consequences to cash flow, as can paying tax liabilities after the due date. When perception was compared to SBO literacy, the results predominantly confirm that SBOs perception appears to be unrelated to SBO literacy.

Perception of service SBOs was then examined, with a focus on possible business tax administration concepts that could be implemented or that are currently in place to assist cash flow. Examination of perception was about whether cash flow is impacted by the multitude of tax liabilities and the dates those liabilities are due for payment. Service SBOs believe that having so many business tax liabilities is detrimental to cash flow, however, they do not agree that numerous tax liabilities have an unfavourable effect on cash flow. Service SBOs were asked to comment on whether remitting tax liabilities after the due date could result in negative consequences to cash flow. More than three-quarters of service SBOs perceived that this could be a likely outcome. Examined also was the possibility of whether paying a PAYG withholding and SG liability more often would be a favourable activity to help with cash flow management. Regardless of whether businesses reported monthly or quarterly for PAYG withholding, service SBOs did not perceive there would be any benefit to cash flow from initiating a more regular payment cycle. For SG, quarterly reporters suggested that reporting and paying their liability more often would not assist with managing cash flow. Comparing service SBO perception and literacy found that all tests resulted in a non-linear relationship except a linear relationship existed between paying a PAYG withholding liability more often and business tax literacy score. This suggests that service SBO perception of the way that business tax is administered cannot be explained by the level of literacy of service SBOs. This could imply that perception is influenced by other emotional factors[142] that service SBOs have about business tax, rather than the knowledge they have acquired of business tax systems.

The perception of service SBOs was explored in terms of the usefulness of CAS for cash flow management activities. A significant number of participants identified CAS as being instrumental in allowing for accurate record keeping. More than three-quarters of participants agreed that CAS was advantageous for activities such as the usefulness of CAS to determine cash flow position and the effective operation of the business. When

[142] Sally Dibb et al, 'Whose rationality? Muddling through the messy emotional reality of financial decision-making' (2021) 131 *Journal of Business Research* 826.

determining if the perception of service SBOs can be explained by their literacy, the test outcomes confirm that perception of CAS being useful for the effective operation of the business can be predicted by CAS literacy score. Testing of whether CAS is useful for accurate record keeping compared to literacy could not compute a result because all service SBOs confirm that they value CAS in performing this function. Note the CAS literacy scores were framed around what SBOs 'actions' were with CAS, compared financial statements and business tax literacy which focused on 'knowledge'. It may be that using some action-based questions may give a better indication of SBOs 'capability' in the relevant area. In recent times the notion of 'capability (compared to literacy) has arisen, as capability covers not only a person's understanding something but also the confidence and capability to actual use that knowledge.[143] Overall, in understanding the influence of literacy, it is not only about knowledge but also how that knowledge is used.

It is this 'real time' availability that could be a key to improved perceptions about the usefulness of information and statements. Recall that the bank account balance was perceived to be the most useful source of information for cash flow management, combined with the findings about the perceived usefulness of CAS, it is this 'real time' ability that appears to be most beneficial for SBOs. While the bank account balance is a rudimentary measure, if the CAS can be used to generate real time useful financial statements, then this could aid small business management.

VII Limitations and Future Research

There are several limitations to this study. Firstly, the meaning of the measures is self-reported by participants about their perceptions which may not be totally accurate to what occurs in practice. For example, this research is based on sensitive information related to small business management practices and the likelihood of SBOs engaging in the best possible activities to support the ongoing stability of their business. It is possible that some service SBOs may select answers that portray their ability or knowledge on a higher scale than that of reality due to their being self-conscious or concerned of their true capabilities. Similarly, CAS literacy were based on self-reported actions rather than being observed by the research team. Additionally, this research only considered SBOs in the service sector.

While this research provides some important insights there is need for future research. Future studies could focus on understanding SBOs perceptions of digital financial literacy and how it may influence their business. Also, future research could consider emotional factors about how SBOs consider the tax system, and whether this influences their perceptions. Furthermore, research could try to determine if there is a relationship with the literacies measured and tax compliance by SBOs.

Future research could consider if SBOs have a level of literacy to understand financial statements and if the importance they place on financial statements for cash flow management could potentially motivate them to increase their literacy in the future.

[143] Toni Chardon, 'Weathering the Storm: Tax as a Component of Financial Capability' (2011) 5(2) *Australasian Accounting Business & Finance Journal* 53; Elaine Kempson, Sharon Collard and Nick Moore, 'Measuring financial capability: an exploratory study' (Report, University of Bristol Personal Finance Research Centre, June 2005).

Research could replicate the United Kingdom study and do ethnographical work with SBOs over an extended period (six months) where SBOs are observed in their day-to-day operations and see how (and if) they use tax records and financial statements.

Given the findings for CAS literacy (with the statements based more on actions), it might imply that purely knowledge questions (as used for business tax and professional financial literacy) may not completely reflect the thorough literacy of SBOs. Future research could consider whether better measures of literacy could be developed.

Future research could consider if SBOs use business tax records (including income tax returns and BAS) to manage their business cash flow, rather than just meeting their tax obligations. Additionally, future research could consider if tax advisors discuss more than just tax obligations when meeting with SBOs to discuss what management insights the tax compliance is illuminating.

VIII CONCLUSION

Knowledge and perception may at times be related concepts. There has been concerns about the level of literacy of SBOs as to whether it was sufficient to allow them to run their business successfully. Also, there are concerns whether SBO perceptions towards certain factors could influence how they interact with financial statements and tax. This article reported a unique study of SBOs in Australia's service sector and compared to their perception in relation to the usefulness of tax records and financial statements. These perceptions were then compared to four literacy scores. There appeared to be little relationship between the four literacies scores considered and the perceptions measures. The only significant relationship found was CAS literacy score and that CAS is useful '*for effective operation of my business*'.

The business bank account was perceived as the highest rated financial instrument for cash flow management. Service SBOs also appear to value a cash budget, a Statement of Cash Flow and a Profit and Loss Statement for cash flow management. In support of the findings of prior qualitative research,[144] service SBOs suggest that CAS was of high importance for accurate record keeping, for determining the cash flow position and for the effective operation of their small business. In terms of business tax, service SBOs believe that the number of taxes that must be paid in each financial period and paying tax liabilities late can both have detrimental consequences for cash flow management. Generally, service SBOs do not perceive any benefit to cash flow management from increasing the payment cycle of tax liabilities, including PAYG withholding and SG. They also do not perceive that the date tax liabilities are due to be paid to the ATO is of concern to cash flow management.

This research provides us with some more insights into the potential relationship between SBO perceptions and their literacy. It is important that more research occurs to help better understand this important segment of the economy.

[144] Belle Isle et al (n 46).

APPENDIX A: OVERVIEW OF LITERACY QUESTIONS

Question overview: Questions related to the financial year ending 30 June 2018
Business Tax Literacy
The rate of Superannuation Guarantee for 2017 is 9.25%
For employees over the age of 18, Superannuation Guarantee only has to be paid for employees whose income per calendar month is $450 or more.
Payment of Superannuation Guarantee is not tax deductible for the employer
The amount of super contributions to be paid is based on ordinary time earnings and does not include overtime.
I must hold a tax invoice for all goods or services that I claim GST input tax credits for if they are over the value of $50 + GST
Businesses (excluding non-for-profits) should register for GST once their annual turnover is reaches $100,000.
Prices for the sale of goods/services to a consumer in Australia should be displayed or quoted as GST exclusive.
If your receipt for purchasing fuel at a petrol station is $80, the GST portion of that purchase is $8.
A benefit provided to an employee's spouse will not be subject to Fringe Benefits Tax (FBT).
Generally, travel to and from work in an employer's vehicle is not considered as "private use" by the employee.
The cost of providing staff with a light lunch whilst at work is exempt from FBT.
The FBT reporting year runs from 1st July to 30th June
Individuals can claim a 25% discount on capital gains for assets held > 12 months.
An immediate deduction can be claimed for the purchase of work equipment for $30,000 when it is used in the business over a number of years.
Generally, a deduction for mortgage interest can be claimed by a business operating from a home in accordance to the percentage area of the home that is used for business purposes.
If your business is GST registered then the business' assessable income for income tax will be excluding GST.
You can claim an immediate deduction for work clothing that you purchase from a supplier provided that it is made from durable material.
For a person on a 30% tax rate the 'after tax cost' of a fully deductible work related item of $1,000 will be $700.
For a person on a 30% tax rate who is entitled to a $1,000 tax offset will save $700 in tax.
PAYG Instalment offsets the final amount of income tax that the business has to pay at the end of the financial yr.
If you are required to pay a PAYG Instalment, you cannot vary the amount raised by the ATO from the assessment of your previous income.
The company income tax rate of 27.5% is available only for businesses with an aggregated turnover of $2 million dollars or less in the 2017-2018 year.
Records should be kept for tax purposes for a minimum of 7 years.

PAYG Withholding and Payroll Tax are the same tax system.
If the business employs staff (or plans to) it needs to register for PAYG withholding within the first month of paying that employee.
Employers will never have to collect PAYG Withholding when the engage a contractor.
CAS Literacy
I create the following in the business computer accounting software:
Balance Sheet at least every 3 months.
Profit and Loss Statement at least every 3 months.
Statement of Cash Flows at least every 3 months.
Cash Budget at least once a year.
Reports for taxation at least every 3 months.
Reports for employee obligations eg. Superannuation and PAYG Withholding.
Which of the following activities do you regularly carry out in your business computer accounting software?
Automated invoicing.
Automated invoice reminders.
Processing invoices on a weekly basis.
Reconcile transactions monthly.
Financial Statement literacy
If you wanted to determine the liquidity (or solvency) of your business you would need to use information contained in both the Profit and Loss statement and the Balance Sheet.
Working capital is calculated by dividing Current Assets by Current Liabilities.
If you receive full payment for work completed you have made a profit on that job.
Gross Profit is a better indicator of how your business is performing than Net Profit
Examples of 'Current Assets' include: Cash at Bank, Trade Debtors, Short-term investments, Petty Cash & Stock.
The Cash Flow Statement can be separated into three areas of cash flow from operations, financing & investment.
A Cash Flow Forecast or Budget helps businesses to predict cash surpluses or shortages.

BIBLIOGRAPHY

A *Articles/Books/Reports*

Ahmed, Eliza and Valerie Braithwaite, 'Understanding Small Business Taxpayers issues of Deterrence, Tax Morale, Fairness and Work Practice' (2005) 23(5) *International Small Business Journal* 539

Australian Taxation Office, 'Small Business Engagement 2017' (Report, 5 April 2018)

Australian Taxation Office, 'Taxation Statistics 2015-16' (Report, 27 April 2018)

Australian Taxation Office, 'Management of Small Business Tax Debt' (Report, 30 May 2019)

Belle Isle¸ Melissa and Brett Freudenberg, 'Calm Waters: GST and Cash Flow Stability for Small Businesses in Australia' (2015) 13(2) *eJournal of Tax Research* 492

Belle Isle, Melissa and Brett Freudenberg, 'Taxing my cash flow: The influence of tax on small service sector business cash flow' (2021) 16(1) *Journal of Australasian Tax Teachers Association* 1

Belle Isle, Melissa and Brett Freudenberg, 'I know it all? The relationship between small business tax and other literacies and their confidence' *Australian Tax Review* (forthcoming)

Belle Isle, Melissa, Brett Freudenberg and Richard Copp, 'Cash flow benefit from GST: is it realised by small businesses in Australia? (2014) 29(3) *Australian Tax Forum* 417

Belle Isle, Melissa, Brett Freudenberg and Tapan Sarker, 'Is the literacy of small business owners important for cash flow management?: The experts' perspective' (2018) 13(1) *Journal of Australasian Tax Teachers Association* 31

Belle Isle, Melissa, Brett Freudenberg and Tapan Sarker, 'The Business Tax Literacy of Australian Small Businesses' (2022) 37(1) *Australian Tax Forum* 65

Belle Isle, Melissa, Brett Freudenberg and Tapan Sarker, 'Top of the Grade: Factors that could influence small business literacy' (2022) 24(1) *Journal of Australian Taxation* 5

Belle Isle, Melissa, Brett Freudenberg and Tapan Sarker, 'Does tax literacy matter? The relationship between small business literacy and business performance and cash flow' (forthcoming)

Brown, Reva Berman, Mark N K Saunders and Richard Beresford, 'You owe it to Yourself: The Financially Literate Manager' (2006) 30(2) *Accounting Forum* 171

Bruhn, Miriam and Bilal Zia, 'Stimulating Managerial Capital in Emerging Markets: The Impact of Business Training for Young Entrepreneurs' (2013) 5(2) *Journal of Development Effectiveness* 232

Chardon, Toni, 'Weathering the Storm: Tax as a Component of Financial Capability' (2011) 5(2) *Australasian Accounting Business & Finance Journal* 53

Chardon, Toni, Brett Freudenberg and Mark Brimble, 'Tax Literacy in Australia: Not Knowing Your Deduction from Your Offset' (2016) 31(2) *Australian Tax Forum* 321

Creswell, John W and Vicki L Plano Clark, *Designing and Conducting Mixed Methods Research* (Sage Publications, 2007)

Cullis, John and Alan Lewis, 'Why people pay taxes: From a conventional economic model to a model of social convention' (1997) 18 (2-3) *Journal of Economic Psychology* 305

Dahmen, Pearl and Eileen Rodríguez, 'Financial Literacy and the Success of Small Businesses: An Observation from a Small Business Development Centre' (2014) 7(1) *Numeracy* 1

DeThomas, Arthur R and William B Fredenberger, 'Accounting Needs of Very Small Business' (1985) 55(10) *The CPA Journal* 14.

De Leeuw, Edith, 'To Mix or Not to Mix Data Collection Modes in Surveys' (2005) 21(2) *Journal of Official Statistics* 233

Dibb, Sally et al, 'Whose rationality? Muddling through the messy emotional reality of financial decision-making' (2021) 131 *Journal of Business Research* 826

Dlamini, Banele, 'Determinants of tax non-compliance among small and medium enterprises in Zimbabwe' (2017) 9(4) *Journal of Economics and Behavioral Studies* 242

Drexler, Alejandro, Greg Fischer and Antoinette Schoar, 'Keeping it simple: Financial literacy and rules of thumb' (2014) 6(2) *American Economic Journal: Applied Economics* 1

Dyt, Robyn and Abdel K Halabi, 'Empirical Evidence Examining the Accounting Information Systems and Accounting Reports of Small and Micro Business in Australia' (2007) 15(2) *Small Enterprise Research* 1

Eresia-Eke, Chukuakadibia E and Catherine Raath, 'SMME Owners' Financial Literacy and Business Growth' (2013) 4(13) *Mediterranean Journal of Social Sciences* 397

Eriksen, Knut and Lars Fallan, 'Tax Knowledge and attitudes towards taxation: A report on a quasi-experiment' (1996) 17(3) *Journal of Economic Psychology* 387

Faridy, Nahida, Brett Freudenberg and Tapan Sarker, 'What is in it for me? The potential for managerial benefits to improve tax compliance' (2018) 33(2) *Australian Tax Forum* 307

Faridy, Nahida et al, 'The hidden compliance cost of VAT: An exploration of psychological and corruption costs of VAT in a developing country' (2016) 14(1) *eJournal of Tax Research* 166

Ferguson, Melissa J and John A Bargh, 'How Social Perception Can Automatically Influence Behavior' (2004) 8(1) *Trends in Cognitive Sciences* 33

Foley, Jack, 'We Really Need to Talk About Owner-Managers and Financial Awareness!' (2018) 25(1) *Small Enterprise Research* 90

Fowler, Floyd J, *Survey Research Methods* (Sage Publications, 4th ed, 2009)

Brett Freudenberg et al, 'Tax Literacy of Australian Small Businesses' (2017) 18(2) *Journal of Australian Taxation* 21

Halabi, Abdel K, Rowena Barrett and Robyn Dyt, 'Understanding Financial Information used to Assess Small Firm Performance' (2010) 7(2) *Qualitative Research in Accounting & Management* 163

Hamilton, Leonora C and Ramachandra Asundi, 'Technology usage and innovation: its effect on the profitability of SMEs' (2008) 31(11) *Management Research News* 830

Huston, Sandra J, 'Measuring financial literacy' (2010) 44(2) *Journal of Consumer Affairs* 296

Kamil, Nurlis Islamiah, 'The Effect of Taxpayer Awareness, Knowledge, Tax Penalties and Tax Authorities Services on the Tax Compliance: (Survey on the Individual Taxpayer at Jadobdetabek and Bandung)' (2015) 6(2) *Research Journal of Finance and Accounting* 104

Kamleitner, Bernadette, Christian Korunka and Erich Kirchler, 'Tax compliance of small business owners' (2012) 18(3) *International Journal of Entrepreneurial Behaviour & Research* 330

Kasipillai, Jeyapalan and Abdul Jabbar, 'Tax compliance attitude and behaviour: Gender & ethnicity differences of Malaysian taxpayers' (2003) *The Malaysian Accountant* 1

Kempson, Elaine, Sharon Collard and Nick Moore, 'Measuring financial capability: an exploratory study' (Report, University of Bristol Personal Finance Research Centre, June 2005

Kirchler, Erich, 'Reactance to taxation: Employer's attitudes towards taxes' (1999) 28(2) *Journal of Socio-Economics* 131

Kirchler, Erich, Apolonia Niemirowski and Alexander Wearing, 'Shared subjective views, intent to cooperate and tax compliance: Similarities between Australian taxpayers and tax officers' (2006) 27(4) *Journal of Economic Psychology* 502

Lignier, Philip, 'The managerial benefits of tax compliance perception by small business taxpayers' (2009) 7(2) *eJournal of Tax Research* 106

Lignier, Philip, 'Measuring the managerial benefits of tax compliance: A fresh approach' (2009) 24(2) *Australian Tax Forum* 117

Lignier, Philip and Chris Evans, 'The Rise and Rise of Tax Compliance Costs for the Small Business Sector in Australia' (2012) 27(3) *Australian Tax Forum* 615

Lignier, Philip, Chris Evans and Binh Tran-Nam, 'Tangled Up in Tape: The Continuing Tax Compliance Plight of the Small and Medium Enterprise Business Sector' (2014) 29(2) *Australian Tax Forum* 217

MacGregor, Rob and Lejla Vrazalic, 'A Profile of Australian Regional SME Non-Adopters of E-Commerce' (2008) 16(1) *Small Enterprise Research* 27

Mascagni, Guilia and Fabrizio Santoro, 'What is the Role of Taxpayer Education in Africa?' (International Centre for Tax and Development, 2018)

Matthews, Paul, 'ICT Assimilation and SME Expansion' (2007) 19(6) *Journal of International Development* 817

McKerchar, Margaret, 'Understanding small business taxpayers: Their sources of information and level of knowledge of taxation' (1995) 12(1) *Australian Tax Forum* 25

Nzioki, Paul Muoki and Osebe Rawlings Peter, 'An analysis of factors affecting tax compliance in the real estate sector in Kenya: a case study of real estate owners in Nakuru town, Kenya' (2014) 5(11) *Research Journal of Finance and Accounting* 1

OECD, 'Forum on Tax Administration: SME Compliance SubGroup – Understanding and Influencing Taxpayers' Compliance Behaviour' (Report, 2010)

Peel, Michael, Nicholas Wilson and Carole Howorth, 'Late Payment and Credit Management in the Small Firm Sector: Some Empirical Evidence' (2000) 18(2) *International Small Business Journal* 17

Pett, Timothy L and James A Wolff, 'SME Identity and Homogeneity – Are There Meaningful Differences between Micro, Small, and Medium-Sized Enterprises?' (2012) 6(2) *Journal of Marketing Development and Competitiveness* 48

Poppelwell, Elisabeth, Gail Kelly and Xin Wang, 'Intervening to Reduce Risk: Identifying Sanction Thresholds Among SME Tax Debtors' (2012) 10(2) *eJournal of Tax Research* 403

Rich, Mike, 'IT-Savvy Businesses are more Profitable' (2012) 25(11) *NZ Business* 26

Saad, Natrah, 'Tax Knowledge, Tax Complexity and Tax Compliance: Taxpayers' View' (2014) 109 *Procedia – Social and Behavioral Sciences* 1069

Sijabat, Dedy Suahputra and Taufik Fathurohman, 'The Relationship of MSME Owners Financial Literacy Score and MSME's Performance: Case Study of MSME's in School of Business and Management Bandung Institute of Technology' (2017) 2(1) *Journal of Innovation, Business and Entrepreneurship* 23

Sucuahi, William T, 'Determinants of Financial Literacy of Micro Entrepreneurs in Davao City' (2013) 1(1) *International Journal of Accounting Research* 44

Tran-Nam, Binh, 'Tax compliance costs methodology – a research agenda for the future' in Chris Evans, Jeff Pope and John Hasseldine (eds), *Tax Compliance Costs: A Festschrift for Cedric Sandford* (Prospect, 2001) 51

Tversky, Amos and Daniel Kahneman, 'Loss aversion in riskless choice: a reference-dependent model' (1991) 106(4) *The Quarterly Journal of Economics* 1039

Wadesango, Newman et al, 'Literature Review on the Impact of Tax Knowledge on Tax Compliance among Small Medium Enterprises in a Developing Country' (2018) 22(4) *International Journal of Entrepreneurship* 1

Wallschutzky, Ian and Brian Gibson, 'Small Business Cost of Tax Compliance' (1993) 10(4) *Australian Tax Forum* 511

Wenzel, Michael, 'Motivation or rationalisation? Causal relations between ethics, norms and tax compliance' (2005) 26(4) *Journal of Economic Psychology* 491

Wise, Sean, 'The Impact of Financial Literacy on New Venture Survival' (2013) 8(23) *International Journal of Business and Management* 30

Yong, Sue and Brett Freudenberg, 'Perceptions of Tax Compliance by SMEs and Tax Practitioners in New Zealand: A Divergent View?' (2020) (26) *New Zealand Journal of Taxation Law and Policy* 57

Yong, Sue and Fiona Martin, 'Tax compliance and cultural values: the impact of "individualism and collectivism" on the behaviour of New Zealand small business owners' (2016) 31(2) *Australian Tax Forum* 289

Yong, Sue, Deryl Northcott and Keith Hooper, 'Culture and the tax compliance behaviour of ethnic business owners' (2014) 20 *New Zealand Journal of Taxation Law and Policy* 71

B Legislation

A New Tax System (Goods and Services Tax) Act 1999 (Cth)

Corporations Act 2001 (Cth)

Crimes Act 1914 (Cth)

Fringe Benefits Tax Assessment Act 1986 (Cth)

Income Tax Assessment Act 1997 (Cth)

Superannuation Guarantee (Administration) Act 1992 (Cth)

Tax Administration Act 1953 (Cth)

C *Other*

Australian Bureau of Statistics, Australian Industry, 2018-19 (Catalogue No 8155.0, 29 March 2020)

Australian Bureau of Statistics, Counts of Australian Businesses including Entries and Exits (Jun 2015 to Jun 2019) (Catalogue No 8165.0, 2 February 2020)

Australian Services Roundtable, Submission no 44 to the House Standing Committee on Economics, Finance and Public Administration, 'Inquiry into the Current and Future Directions of Australia's Service Industries' (November 2006).

Braithwaite, Valerie, 'Tax and democracy: Bygone ideas or time for reinvention?' (Conference Paper, Australasian Tax Teachers Association Conference, 18-20 January 2017)

Department of Industry, Innovation, Science, Research and Tertiary Education, 'Australian Small Business Key Statistics and Analysis' (Report, December 2012)

Knox, Mitch, 'Calling small businesses: Griffith researcher wants to help your cash flow' *Griffith University* (Web Page, 13 February 2019) <https://news.griffith.edu.au/2019/02/13/calling-small-businesses-griffith-researcher-wants-to-help-your-cash-flow>

Nunoo, Jacob and Francis Kwaw Andoh, 'Sustaining Small and Medium Enterprises through Financial Service Utilization: Does Financial Literacy Matter?' (Paper, Agricultural and Applied Economics Association Annual Meeting, 12-14 August 2012)

Saad, Natrah, 'Fairness Perceptions and Compliance Behaviour: Taxpayers' Judgments in Self-Assessment Environments' (PhD Thesis, University of Canterbury, 2011)

FICTITIOUS INCOME: SHOULD NEW ZEALAND TAX SOMETHING THAT DOESN'T EXIST?

ANDREW M C SMITH*

ABSTRACT

The legal conception of 'income' for tax purposes has traditionally been considered narrower than economists' and accountants' conceptions. However, in New Zealand, the definition of income for income tax purposes may cause amounts that would be not regarded as income from an accountant's or economist's perspective to be taxed. This may be identified as 'fictitious income'.

This article examines when fictitious income can arise under the *Income Tax Act 2007* (NZ) ('*ITA 2007*'). In some instances, it arises because of the capital/revenue dichotomy underpinning the *ITA 2007*, while in other instances, it arises from specific provisions which apply to certain types of transactions. The effects of bringing fictitious income into the ambit of income tax are discussed. The desirability of a more fundamental review in New Zealand of what constitutes income for tax purposes is considered, particularly in the light of the possibility of a future government taxing capital gains more comprehensively.

* School of Accounting and Commercial Law, Victoria University of Wellington Te Herenga Waka. Email: andrew.smith@vuw.ac.nz.

I Introduction

Over the past century, income tax has evolved to be the major source of revenue for most governments. Income tax has the key characteristic that it is an annual charge levied on a person's economic gain or betterment that has arisen over the year but, as it levies a proportion of that betterment, the taxpayer may still be financially better off after paying the tax, when compared to their financial position at the beginning of the year. As income tax is usually imposed on an annual basis, it creates a regular and sustainable source of tax revenue for governments as opposed to a one-off type of tax, such as estate duties or stamp duty.

Income tax as a form of tax can also be justified on grounds of fairness. While there are different notions and perspectives of what constitutes fairness in taxation, it is commonly defined in terms of equity, although not necessarily exclusively, usually from two perspectives – horizontal and vertical equity. Vertical equity occurs when persons in different circumstances are treated differently under a tax and often is used as justification for a progressive tax rate scale. Horizontal equity occurs when persons with the same wealth and income pay the same amount of tax. Horizontal equity is often cited as a justification for taxing capital gains as income among other measures.

But income tax can also be justified on grounds of fairness in that it falls on those with the ability to pay from the economic betterment they have enjoyed over a period. This is to be contrasted with taxes such as estate and stamp duties which do not consider economic betterment accruing over a period and will typically leave taxpayer (or their estate) financially worse off after their payment. Sometimes these types of taxes may prove difficult to collect if the taxpayer is unable to access cash to pay them.

While the basis of income tax can be linked to notions of fairness and equity, if income tax is to be 'fair' on those grounds then the definition of what is 'income' for tax purposes must align with what is in reality income or economic betterment over a defined period. On the other hand, an income tax could be challenged on grounds that it is not 'fair' if taxpayers are deemed to have derived income upon which they must pay income tax if they have not actually enjoyed any commensurate economic betterment giving them resources to pay the tax.

This article concerns this issue, which does not appear to have been considered before in these terms. It examines where New Zealand income tax be imposed on amounts when no underlying economic betterment has occurred over the income year, or secondly that the amount of income brought to tax is inflated beyond the actual economic betterment enjoyed by the taxpayer from an accounting or economic perspective. The fact that this can occur in several areas under the *Income Tax Act 2007* (NZ) ('*ITA 2007*') raises a wider question about how appropriately New Zealand's income tax base has been defined. The issue is in essence the reverse of the much-debated issue of whether capital gains should be comprehensively taxed in New Zealand. Both these are examples of a broader conceptual issue namely what should be regarded as income in New Zealand for tax purposes. it is hoped that it might inform the ongoing debate about taxing capital gains by arguing there is a case that a fundamental review of what is income for income tax purposes is required if New Zealand if capital gains are to be more comprehensively taxed in New Zealand rather than bolting on additional tax provisions to the existing income tax base.

This article examines these issues by explaining how fictitious income can arise under *ITA 2007* and why and placing these into two main categories. Secondly, it explains the consequences flowing from taxing amounts of fictitious income and why there is a case for revision of the existing income tax base in New Zealand.

II DIFFERENT CONCEPTS OF INCOME

American economist Irving Fisher over a hundred years ago made the point that all aspects of economic activity involve income of some kind and without any income, there would be no economy to speak of. He observed: 'Income plays an important role in all economic problems. It is income for which capital exists; it is income for which labour is exerted; and it is the distribution of income that constitutes the disparity between rich and poor.'[1]

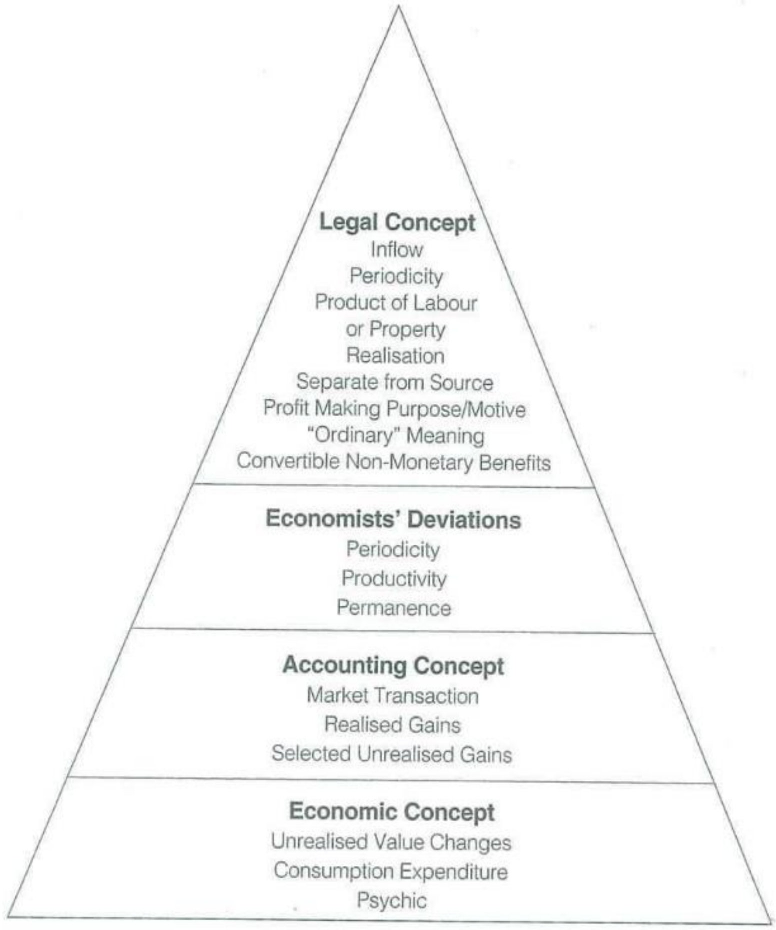
However, there is no universally agreed definition of what is 'income'. Depending upon the discipline followed, there are alternative views of what constitutes income with some factors in common between the different definitions. This point is best illustrated by Kevin Holmes's 'income pyramid' which captures economic, accounting, and legal (tax) definitions of income.[2] His pyramid is organised from the broadest (economic concept) to the narrowest (the legal concept) which he terms a constriction on income.[3]

[1] Irving Fisher, 'Comment on President Plehn's Address' (1924) 14(1) *American Economic Review* 64.

[2] Kevin H Holmes, *The Concept of Income: A multi-disciplinary analysis* (IBFD Publications, 2001).

[3] Ibid 241. We gratefully acknowledge Kevin Holmes's permission to recreate this diagram.

Figure 1: Holmes's Income Pyramid



An interesting issue arising from Holmes's income pyramid is that 'psychic income' does not fit within any of the three approaches. 'Psychic income' is understood to mean the personal enjoyment or status one enjoys from undertaking a particular activity rather than a monetary reward. There are obviously major issues trying to identify where psychic income has been derived let alone trying to quantify it, so its omission from Holmes' pyramid is probably warranted.

Economists have spent considerable time defining what is income from an economic perspective, the best known being the Haig-Simons definition followed by public finance economists.[4] Under the Haig-Simon approach, income is the increase in a person's wealth

[4] Haig and Simons worked independently publishing similar views starting in 1921 and later in 1938. Robert M Haig, 'The Concept of Income – Economic and Legal Aspects' in *The Federal Income Tax*

over a period (whether realised or not) plus the value of all goods and services consumed during the period. No distinction is made as to the source of the increase in wealth increase nor the source of funding for consumption, so gifts and other windfalls give rise to income in the same way as amounts derived from the ownership of capital assets or the provision of labour. Implicit also in this concept of income is the notion of capital maintenance. An increment in wealth would only give rise to income after initial capital was unimpaired. There are significant practical limitations in the Haig-Simon concept of income being the basis for imposing income tax. The absence of liquid assets to pay tax is one along with the practical issues of how to accurately measure unrealised increments in wealth over a period.

The Haig-Simons income definition has attracted widespread attention from public finance economists and tax reformers as a starting point for defining the income tax base from the 1960s. It was influential in the work of the Carter Commission in Canada which led subsequently to the Canadian Government more comprehensively taxing capital gains.[5] It was also adopted as a normative concept of income by Harvard professor Stanley Surrey,[6] and prominent US public finance economists such as Richard Goode[7] and John Witte[8] among many others. Thus, it can be reasonably asserted that the Haig-Simons definition of income has a degree of acceptance as a definition of income from an economic perspective and one that is relevant in setting the income tax base.

The accountant's concept of income is a bit different from that of economists and is somewhat narrower due to one difference in that unrealised gains are not commonly recognised until they are realised, although unrealised losses are more likely to be taken into account in respect of assets which are held for resale. Over several years this difference in recognising unrealised amounts may be more a timing issue rather than one of permanent difference between the accounting and economic concepts of income.

In New Zealand income is largely defined in *ITA 2007* pt C. While this is statute law, common law concepts of income are included by virtue of s CA 1(2). While it is difficult to detect any underlying principles or themes that underpin the various amounts that are regarded as income for tax purposes, what is regarded as income for tax purposes is narrower than the concepts of income held by economists and accountants which is shown again in Holmes' income pyramid. Capital gains are not regarded as income and do not require specific exclusion or exemption from the statutory tax base because they are not income in the first place. The differentiation between capital and revenue receipts is still important in determining income from the carrying on of a business income and property sales (both real and personal), while due to provisions of subparts *ITA 2007*

(Columbia University Press, 1921) 1, 1-28 and Henry Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press, 1938) 49.

5 *Report of the Royal Commission on Taxation* (Final Report, 1966).

6 Stanley S Surrey, *Pathways to Tax Reform* (Harvard University Press, 1973) 12-22.

7 Richard Goode, 'The Economic Definition of Income' in Joseph A Pechman (ed), *Comprehensive Income Taxation* (Brookings Institute, 1977) 3, 7-10.

8 John F Witte, *The Politics and Development of the Federal Income Tax* (University of Wisconsin Press, 1986).

subpts CE and EW, this dichotomy is not applicable in respect of employment income or income from financial arrangements.

However, some amounts are brought to tax under provisions of the *ITA 2007* and fall within the pinnacle of Holmes's pyramid being legal income which does not belong in the lower levels of that pyramid where accounting and economic concepts of income lie. These types of income are termed in this article 'fictitious income' because, from an accounting or economic perspective, no income arises but the taxpayer is liable to tax on these amounts. In essence, taxpayers are being taxed on something where no or limited economic betterment arises, thus leading to income tax being a form of penalty in certain situations or raising the effective tax rate on other types of income.

The next two parts will examine situations where amounts can be subject to income tax when, from an economic or accounting perspective, no income has arisen which are categorised under two headings. The first category is where fictitious income arises due to the general conceptual underpinnings of the *ITA 2007* such as the capital revenue dichotomy and the adoption of strict historical cost accounting to determine assessable income. The second section covers situations where fictitious income arises due to specific provisions in the *ITA 2007* that apply to certain transactions.

III Fictitious Income Arising Under Structural Features of *ITA 2007*

Since its enactment over 125 years ago, New Zealand tax law has been underpinned by a capital/revenue dichotomy reflecting the country's British legal heritage. Not all amounts received by a taxpayer are necessarily assessable to income tax, nor will all losses or outgoings suffered by the taxpayer be deductible in determining their taxable income.

What constitutes assessable income and deductible expenditure are not defined in a symmetrical way in *ITA 2007*. Despite an extensive number of statutory provisions defining what is income (appearing mainly in *ITA 2007* pt C), the concept of income is additionally left open to common law concepts in s CA 1(1). On the other hand, deductions are only permitted against assessable income if they are specifically authorised by *ITA 2007*. Common law has no role in determining what outgoings are deductible for income tax purposes.

A *Interrelationships Between Capital and Revenue Amounts*

The capital/revenue dichotomy underpinning *ITA 2007* appears predicated that incoming or outgoing amounts can be easily classified as revenue or capital and that an amount classified as capital has no effect on the determination of taxable income and vice-versa. But often this is not the case as can be seen in the decision of the Privy Council in *CIR v Wattie*[9] where a non-assessable capital sum paid by a landlord to a tenant as an inducement to enter a long-term lease in effect was recovered by the landlord in higher increased periodic lease payments which were tax-deductible to the tenant.[10] The taxpayer in *Wattie* enjoyed a capital/revenue mismatch of increased deductions offset by

[9] [1999] 1 NZLR 529.

[10] *ITA 2007* was revised after the *Wattie* decision so that all payments from a landlord to a tenant are assessable to tax unless in respect of a residential lease. Thus, the capital/revenue mismatch enjoyed by the taxpayer in *Wattie* can no longer occur. See *ITA 2007* ss CC 1, CC 1B, and CC 1C.

non-assessable capital receipt. Another example of this phenomenon in the other direction, this time favouring the revenue, is when a company pays a dividend (giving rise to income) but the price of the underlying share correspondingly falls when the dividend is paid which will be regarded as a capital loss if the shares were held on capital account.

If a company takes over another company through an exchange of shares the transaction would usually be capital in nature assuming the vending shareholders of Company A hold the shares on capital account. One capital asset (ie, shares in company A) is exchanged for another capital asset (shares in Company B).

However, there is no symmetrical tax treatment if a holding company (Company B) wishes to 'spin-out' its holding in Company A to the shareholders of Company B – in effect reversing the takeover of Company A. A distribution of shares in Company A to the shareholders of Company B gives rise to an assessable dividend as it is a transfer of value. It disregards that a spin-out of a major subsidiary will result in a reduction in the price of Company B shares which is compensated by a receipt of shares in Company A. The capital loss is disregarded but income is recognised through the spin-out of Company B shares. The dividend in effect is fictitious because the resultant capital loss from the spinout is ignored.

In some limited situations, this issue could be resolved by the spinout being undertaken as a share repurchase. Under *ITA 2007* companies can repurchase and cancel their own shares on a tax-free basis for the vending shareholders if the repurchase exceeds certain thresholds (either the capital reduction or interest reduction brightline tests) to the extent the company has 'available subscribed capital'. However, given that the tax-free consideration is limited to the amount of 'available subscribed capital', this may not always be sufficient to cover the full value of the share issued in a spin-out.

B *Capital Expenditure Which Does Not Create an Asset*

One outcome of how the capital limitation in s DA 2(1) applies compared to how capital expenditure is recognised for financial reporting purposes under International Financial Reporting Standards, is that expenditure may not qualify for an income tax deduction on grounds that it is capital in nature, but no asset can be recognised for accounting purposes.[11] This is because either the non-deductible capital expenditure may not create an asset or that one cannot be recognised as it is not sufficiently separate and identifiable and/or the taxpayer may not have control over it. Thus, for financial accounting purposes, the expenditure in question must be treated as a current year expense through the profit and loss account.

The result of such expenditure being disallowed as a deduction will also lead to taxable income being inflated beyond what might be regarded as income from an economic or

[11] There is a strange outcome from the rules applying to company liquidations in that any expenditure that is not deductible at the corporate level because it is capital in nature will end up being ultimately deductible when the company is wound up under *ITA 2007* s CD 44. This is because in applying the formula in s CD 44(1), the variable 'capital losses' does not include expenditure which is disallowed as being capital in nature. Capital losses can only arise from the disposal of capital assets. See *ITA 2007* ss CD 44(9), (9BA) and (9B).

accounting perspective. A good example of how this can occur is the decision *Fullers Bay of Islands Ltd v CIR*.[12] The case concerned the deductibility of legal fees incurred to challenge an unsuccessful tender from which the taxpayer had hoped to significantly expand their existing business. The challenge was also unsuccessful along with a claim for a tax deduction for the legal expenses incurred in making the challenge on grounds that they were capital in nature. However, the expenditure under review did not create any kind of asset from an accounting or economic perspective nor did the expenditure enhance the taxpayer's existing business operations in any way.[13] From any other perspective apart from tax, the amount was expenditure or loss of the taxpayer. Thus, the denial of the deduction to the taxpayer artificially inflated the company's taxable income for the relevant income year because an amount expended that year was in reality a current expense of the period.

C *No Recognition of The Declining Value of Money*

The use of strict historical accounting to determine the taxable income of businesses during times of inflation will lead to an effective overstatement of income. Prominent tax economist Charles McLure Jr terms income that has been inflated by the presence of inflation as 'fictitious income'[14] also emphasising that the distortions that taxation produces are 'aggravated' by inflation.[15] Holmes in his book on the concept of income also refers to income arising due to the effects of inflation as 'illusory income'.[16] The phenomenon of taxable income being inflated due to the presence of inflation has not attracted much comment in the last few decades because of low inflation but even with lower rates of inflation the compounding effects over the medium and long term can still be significant.

New Zealand income tax law ignores the effects of the declining purchasing power of money.[17] In an era of relatively low (but still creeping inflation) this is not usually much of an issue if assessable income is derived around the same time as the deductible expenditure is incurred to produce that assessable income. The distortionary impact of inflation leading to an overstatement of taxable income is greatest when taxpayers incur costs years ahead of the resulting assessable income but are not able to deduct these costs until the assessable income has been derived. Thus, yesterday's costs are matched with today's revenues. A secondary issue is not only is income that is subject to tax inflated, but the income from the activity may be subject to tax all in one income year (despite the income accruing over several income years), and for individuals, it may now be subject

[12] (2006) 22 NZTC 19,716 (CA).

[13] Since the decision of the Court of Appeal in *Fullers*, an express provision was introduced in 2021 allowing the deduction of certain types of 'feasibility expenditure' although it is limited to certain situations. The provision allows qualifying 'feasibility expenditure' to be deductible over five years although there is an immediate deduction if the amount is below $10,000. This $10,000 threshold mirrors s DB 62 which allows an immediate for certain legal expenses below $10,000.

[14] C E McLure Jr, 'The evolution of tax advice and the taxation of capital income in the USA' (1984) 2 *Environment and Planning C: Government Policy* 251, 251.

[15] Ibid 252.

[16] Holmes (n 3) 342-48.

[17] See *Lowe v CIR* [1981] 1 NZLR 326.

to tax at the top individual tax rate of 39%. In some instances, *ITA 2007* allows taxpayers to spread the income over several years (eg, with timber sales) but with others, in particular land sales, there is no scope to spread.

The problem of matching yesterday's costs with today's revenues also arises with depreciable assets where annual depreciation deductions are determined by an asset's historical cost, not the asset's replacement cost. Capital-intensive industries are particularly affected by this issue leading to significant overstatement of income (ie, fictitious income) in times of inflation.

Aside from depreciable assets, the same issue arises elsewhere such as land sales in particular land subdivisions. In large-scale subdivision schemes where the scheme is carried out in stages over many years, costs incurred many years prior will be deducted against income from sales in the current income year. A large amount of net income is likely to under this scenario is likely to be attributable to the declining value of money rather than the subdivision process itself. Advocates for the revenue will typically advance the argument that such taxation protects the tax base but fails to recognise that effect of such overstatement of income results in the effective tax rate on income from land subdivision being much higher than for alternative forms of investment. Any investor looking to invest in a land subdivision scheme must take into account that the tax paid on subdivision schemes is effectively much higher than other alternative investments and will seek to offset it by seeking a higher nominal rate of return from the scheme. It is the ultimate purchaser of the subdivided land which will bear the tax in the form of higher prices for subdivided land – something that has been ignored in recent debates concerning housing affordability.

Businesses that carry on activities with a long trading cycle (eg, vineyards, forestry) may also suffer from the taxation of fictitious income as expenditure may well be incurred years before assessable income arises. In some instances, the effects of inflation are partly mitigated by allowing expenditure to be deducted in the income year in which it is incurred (allowing the deduction to be taken in current dollars) rather than being deferred to when assessable income arises. With forestry sales, there is also an option to spread the resulting income over several income years.[18]

IV FICTITIOUS INCOME ARISING UNDER SPECIFIC PROVISIONS OF ITA 2007

In addition to the conceptual underpinnings of the income tax regime which may lead to overstatement of income discussed in the previous section, there are also other instances where fictitious amounts of income arise for tax purposes due to specific provisions (or regimes) in *ITA 2007*.

A *Drawings of Trading Stock by Owners of Unincorporated Businesses*

ITA 2007 s GC 1 requires when a person disposes of trading stock for nil consideration or for less than market value, they are deemed to have sold it at 'market value' for income tax purposes. In the case of a sole trader the withdrawal of trading stock for personal

[18] See *ITA 2007* s EI 1(2). A similar provision exists for spreading lump sum cultural copyrights in s EI 3(2).

consumption or for donation to a charity requires income to be recognised when in fact no gain has been realised. The result is that a sole trader who withdraws trading stock for their personal use is forced to recognise income from trading with themselves when from an accounting perspective they cannot make a profit from trading with themselves nor from a contract law perspective they cannot contract with themselves. Depending on how one ascertains a 'market' price, income may not necessarily arise from an economic perspective either.

A key problem with the application of s GC 1 is that the term 'market value' is not defined in the ITA 2007. This gives rise to the question as to whether the 'market value' is one prevailing in a retail market or a wholesale one. In the IRD's opinion market value for s GC 1 can be determined:

> with reference to the market or markets into which the sole trader would have otherwise sold the particular trading stock in the ordinary course of business. In instances where trading stock is sold in different markets (eg, retail and trade) the relevant market will depend on the individual circumstances of the sole trader's business.[19]

The provision in s GC 1 is a codification of the decision of the UK courts in *Sharkey v Wernher*,[20] where horses, bred as part of a business of operating a stud farm, were transferred from the stud farm's books for use in the taxpayer's horse racing and training activities which were a hobby and not part of the stud farm's operations. The UK Appeal Court held that the taxpayer was required to recognise the transfer at the prevailing market value of the horses and triggering the recognition of income (and a considerable amount of income tax) when in fact no sale had taken place from a legal perspective. The taxpayer had contended that the transfers should have taken place at cost recognising that because the costs of breeding the horses had already been recognised in their accounts some adjustment was necessary from an income tax perspective. The outcome of the decision was that the taxpayer was forced to recognise income from trading with themselves.

Despite the decision in *Sharkey* being nearly 70 years old, it continues to attract debate,[21] and has reverberated even in New Zealand today with s GC 1,[22] as it also has the effect of forcing taxpayers to recognise income when donating trading stock to charities when a donation of money would attract a credit for individuals or a deduction for companies.[23] In reconciling the approach of the court in *Sharkey v Wernher* and its extension to all sales

---

19 'Questions We've Been Asked QB 14/01 Income Tax – Adjustments for trading stock (including raw materials) taken for own use or consumption' (Report, 2014) para 12.

20 [1956] AC 58.

21 For an example, see Michael Littlewood, 'The Tax Consequences of Withdrawals of Trading Stock: Resolving the Conundrum of *Sharkey v Wernher*' (2005) 35 *Hong Kong Law Journal* 327.

22 Although the principle in *Sharkey v Wernher* is codified in s GC 1, the NZ Law Society has pointed out that the rule in *Sharkey v Wernher* could still apply in New Zealand: see New Zealand Law Society, 'Re: Initial Policy think piece: Donated Trading Stock' (Letter, 1 September 2020) para 12.

23 See ibid. There have sometimes been temporary dispensations from the income-triggering provisions of section GC 1 in respect of the COVID-19 pandemic from 17 March 2020 to 16 March 2022. In the absence of such provisions, a business could face further financial distress from donating trading stock (especially perishable stock) when they were prevented from trading due to the COVID lockdowns.

of trading stock in section GC 1, little consideration appears to have been made of the fact that the valuation of livestock at market value is a common practice to determine the income of livestock producers but not by most other taxpayers. Under this approach income is recognised when livestock are born,[24] while for most other taxpayers' income is only recognised when a sale is made. This practice of recognising income when an item is placed into inventory (rather than when it is sold) is sometimes used also for financial reporting purposes by commodity producers such as gold miners. In common with the livestock farmer, miners also share the problem of the difficulty in attributing costs of producing inventories on hand at the end of the income year which is avoided through this 'mark-to-market' approach.

For a retailing enterprise (smaller ones being more likely to trade as a sole trader or through a partnership) how the trading stock used privately was initially acquired will determine whether income is triggered under s GC 1. If private purchases were made directly from the same source as where the trading stock was acquired from, no income would be triggered because the private purchases would not constitute trading stock as it would not be 'property that a person who owns or carries on a business has for the purpose of selling or exchanging in the ordinary course of business'. But if the retailer bought the trading stock and recorded the sale in their accounts as a purchase, any subsequent drawing of the trading stock for private use attracts an adjustment under s GC 1 triggering the recognition of income on the premise that they had derived income by trading with themselves. It also seems anomalous that a simple difference in the way in which the acquisition of trading stock is recorded would make the difference between fictitious income being recognised or not under s GC 1.

Section GC 1 reflects both an underlying policy that trading stock is always held on revenue account,[25] and an approach that assets can be transferred for income tax purposes between different 'accounts' of the same taxpayer (ie, revenue, capital, private) with tax consequences even though no transaction has occurred with another party.[26]

B *The Financial Arrangement Rules*

The financial arrangement rules are a comprehensive code found in *ITA 2007* subpt EW for the taxation of debt securities which are termed 'financial arrangements'. Despite one of the stated purposes of the financial arrangement rules in s EW 1(3)(b) being 'to require the parties to a financial arrangement to disregard any distinction between capital and

24 See *ITA 2007* subpt EC. Potentially more income could be recognised when the livestock is sold if the sale price is above the standard value recognised when the livestock was born. Similarly, a deduction may be taken if the sale price is below the standard value.

25 Under *ITA 2007* s CB 2 when a business is sold there is a deemed realisation of the business's trading stock which is on revenue account.

26 See also to the High Court decision in *Rank Xerox (NZ) Limited v CIR* (1983) 6 NZTC 61,501. This case concerned a taxpayer who owned assets used in a hiring business which were subsequently reconditioned after being hired out and were sold as part of a business involving the sale of second-hand photocopiers. The Court held that there was a transfer of the used copiers from capital account to revenue account and that a transfer price needed to be adopted at the point of the transfer from the hiring business to the reconditioning business reflecting the market value of the copiers at the point they entered the reconditioning process.

revenue amounts', a capital revenue boundary is effectively maintained in respect of certain losses.[27] The rules are also characterised by the absence of transaction symmetry for many taxpayers, allowing the revenue to 'pick the eyes out' of investments that are profitable but denying recognition of losses if the same or similar investment produces losses. This is to be contrasted to the symmetrical treatment of excepted financial arrangements under s CB 4 for example.

The financial arrangement rules can result in the recognition of fictitious income being taxed when from any other perspective a loss is suffered. This is due to two provisions in the financial arrangement rules. The first is under the 'base price adjustment' ('BPA') which all taxpayers who are a party to a financial arrangement must calculate when they cease to be a party to it. There are four variables in the BPA, the last of which is termed 'amounts remitted'. This variable includes amounts that would have been paid or payable to the person (i.e. holder or investor) but were not received because the amount has been remitted by the person to whom it was payable to or by law.[28] The effect of this variable in the BPA formula is that the amount remitted is effectively treated as having been received by the person even though it was not, thereby denying them a deduction for the amount remitted.[29] Outside loans between family members[30] where forgiveness of debt is essentially a gift, remittance in a commercial context only occurs because the debtor is financially distressed or bankrupt.[31]

There is a second provision that mirrors the intent behind the 'amounts remitted' variable in the BPA. If the financial arrangement is a tradeable security (such as a bond or note), the investor could cease to be a party to a financial arrangement by selling it to another investor on the secondary market. If the borrower is financially distressed, the price obtained for the financial arrangement on the secondary market will be depressed. Under the BPA formula, no adjustment would be required because no amount had been remitted by the holder. In this instance section EW 39 applies as if the amount received for the disposal of the financial arrangement is affected by unfavourable factors, the person is deemed to have received an amount of consideration that they would have otherwise derived if the consideration had not been affected by any of the unfavourable factors listed in s EW 39(1)(d). The effect again is to deny a deduction for loss of loan principal, the same as would occur under the BPA if the investor had remitted any amount owing.

---

27 This quarantining of capital losses arising in respect of a financial arrangement does not occur if the taxpayer is carrying on a business of dealing in financial arrangements (s EW 39(2)) or can otherwise obtain a deduction for bad debts under *ITA 2007* s DB 31(3).

28 *ITA 2007* s EW 31(11)(a).

29 A deduction may be allowed for the amount remitted as a bad debt under s DB 31(3) if the taxpayer carries on a business that includes dealing or holding financial arrangements of the type where the bad debt arose.

30 Loans denominated in New Zealand Dollars, interest-free and repayable upon demand are excepted financial arrangements for the lenders: see s EW 5(10).

31 While lenders may be denied a deduction for amounts remitted under the base price adjustment, the borrowers are still required to recognise income equal to the amount remitted.

The effect of these two provisions is to deny any deduction for loss of monies lent while leaving the taxpayer exposed to taxation from any interest received in cash. There is not even scope to write back interest income received from the financial arrangement in earlier income years unless it was accrued income which is not ultimately received in cash.[32] In New Zealand around 2008 nearly 30 finance companies collapsed taking around $6 billion of savings of mainly retired people.[33] These failures illustrate how fictitious income can be taxed in the context of significant economic losses.

In addition to this issue of how fictitious income can arise in the context of financial distress of the financial arrangement's issuer, there is also a lack of symmetry in the treatment of creditworthiness changes with regard to financial arrangements. If a taxpayer buys a financial arrangement at a discount due to poor creditworthiness and then the issuer's creditworthiness subsequently improves, any resulting gain is fully assessable but not if a loss is incurred in the reverse situation.

Public officials have argued to this author that this outcome is the result of retaining the capital/revenue dichotomy in the absence of a comprehensive capital gains tax. That argument is fallacious for two reasons. Firstly, the non-deductibility of losses due to declines in creditworthiness is not matched with an exclusion of any gains arising from creditworthiness upgrades. It also conflicts with the one of purposes of the financial arrangement rules in s EW 1(3)(b) that parties to a financial arrangement are to 'disregard any distinction between capital or revenue amounts'. Secondly, the carveout of losses due to creditworthiness declines ignores the risk and return relationship that underpins market interest rates. It effectively penalises portfolio investors who are willing to bear higher risk compensated by higher interest rates. Returns from higher interest rates are fully taxed, but the corresponding losses of capital due to higher-risk loans are ignored leading to over-taxation.

A possible explanation of how these provisions in the financial arrangement rules were allowed to be enacted was that during the 1980s and early 1990s, New Zealand underwent a major tax reform programme commencing with the introduction of fringe benefit tax. At the time the financial arrangement rules were enacted around 1986-87 it was anticipated that the Government would soon adopt more comprehensive taxation of capital gains which at that point the issue about the isolation of capital losses for some taxpayers under the financial arrangement rules would be addressed. The government later decided to 'defer' the introduction any reforms to the taxation of capital gains and thus the anomalous situation under the financial arrangement rules for capital losses remains unresolved.

32 A deduction is permitted if interest from the financial arrangement has been taxed but not received by the taxpayer before the debtor defaults under s DB 31(2).

33 See 'Deep freeze list – Finance industry failures' *Interest.co.nz* (Web Page) <https://www.interest.co.nz/saving/deep-freeze-list>.

C *The Foreign Investment Fund Rules*

The Foreign Investment Fund ('FIF') rules[34] apply to New Zealand tax residents' interests in offshore entities and funds ranging from equity shares to interests in foreign life insurance and offshore pension funds. The major issue with such interests is that no or little income is typically distributed regularly from such investments when it would be subject to tax on a receipts basis which is used to recognise income from domestic equity investments.

Based on the principle that New Zealand tax-residents should be taxed on their worldwide incomes, even to the extent of their share of undistributed income in offshore entities, the FIF rules were designed to tax these interests. The major problem with that approach is that the New Zealand investors cannot usually obtain detailed information about their share of undistributed income in the offshore entities and thus proxies are necessary to quantify the amount of income that should be attributed to investors even if it is undistributed.

Five different methods to attribute FIF income are offered in the FIF rules as proxies for an investor's share of underlying income. They are:

(1) Comparative value ('CV') method;

(2) Attributable FIF Income method;

(3) Deemed rate of return ('DRR') method;

(4) Fair dividend rate ('FDR') method; and

(5) Cost method.

Taxpayers who are parties to FIF interests do not have an unfettered choice between the five methods. There are conditions and restrictions upon the use of some methods (eg, the comparative value and the attributable FIF method). In practice, the comparative value, deemed rate of return, and the cost methods are the ones most likely to be used. Of these three, the deemed rate of return and the comparative value methods require taxpayers to have access to market values for the FIF interests, while the cost method does not.

1 *Market Listed Offshore Securities*

If the FIF interests are listed on a recognised stock exchange, the main method to be used is FDR method. Under this method, a taxpayer is deemed to have derived a return of 5% on the market value of the investment at the beginning of the income year (usually 1 April).[35] Any distributions received are ignored for tax purposes, however, a foreign tax

---

34 See *ITA 2007* ss EX 28 to EX 73.

35 If the FIF interest is acquired during the income year, then no income is attributed in that year if the interest is still held at the end of the income year. If the interest is bought and sold within the same income year, then a 'quick sales' adjustment is required, and income will be attributed to that income year in respect of that income year.

credit is still granted if any foreign withholding tax has been deducted from dividends paid.[36]

Individual taxpayers (and family trusts) have the annual option of shifting to the comparative value method if they wish. This means that if the total return for the income year (unrealised capital gains, realised capital gains plus any distributions received) is less than 5%, then the taxpayer is taxed on the actual return only. However, there is a floor of nil income for the year, a loss cannot be recognised. This option of using the CV method, however, is not available to managed funds, KiwiSaver funds, or companies. They must pay tax on a deemed 5% return annually irrespective of whether a gain or loss is made.

Whether or not the taxpayer qualifies for the CV concession under the FDR method, there is no adjustment when the FIF interest is finally disposed of.

The effect of these FIF rules in practice can widely vary. The deemed income under the FDR method could closely approximate the dividends received which is theoretical justification for the method in the first place. On the other hand, the deemed return could effectively represent capital gains (both realised and unrealised) which would not usually be taxed if interests were held in similar New Zealand resident and ASX-listed companies.

If the objective of the FDR method is to tax a hypothetical dividend return, it is a crude measure and the amount of 5% is usually higher than the yields enjoyed from a portfolio of shares in most foreign companies (other than some larger ASX listed ones). The FDR method is likely to tax some unrealised capital gains especially if no dividends are received in an income year.

Do the FIF rules result in fictitious income being taxed? There is no simple answer – it depends on the actual circumstances of each FIF interest. The FIF rules may result in the muddying of the traditional capital/revenue dichotomy but in other circumstances may effectively maintain it. The FIF rules can lead to under-taxation of actual income instead of over-taxation due to fictitious income. Two factors that play in that result are the extent of the diversification of the portfolio and the number of income years the assessment is being made over. Over several years, with a well-diversified portfolio the FIF rules are less likely to give rise to taxation of fictitious income and instead result in under-taxation if capital gains are to be seen on revenue account. However, no adjustment is permitted if economic losses are suffered, nor there is any provision to write back income recognised in earlier years if an overall loss is suffered.

The extent to which fictitious income is brought to account is affected by primarily two factors: whether regular dividends are paid and whether the gain/loss made on the disposal of the shares is regarded as income or a non-assessable capital gain. Regarding the latter point it is worth contrasting the tax treatment of shares in New Zealand resident

[36] The foreign tax credit would be limited to the NZ tax attributed to that segment of FIF income.

and Australian ASX-listed shares held on capital account[37] where only dividends received are assessable.

Under the FDR method, if dividends are not paid, the assessable income is entirely capital gain. However, there is a significant restriction on the recognition of capital losses especially for companies and managed funds (including portfolio investment entities ('PIEs') that cannot use the comparative value method as an option. For these taxpayers, there is a significant risk that income deemed under the FIF rules is fictitious from any perspective if the shares are sold at a loss.

Where dividends are paid regularly, the FDR method under the FIF rules brings less fictitious income to account and produces amounts of income closer to that which would be reported from owning shares in New Zealand-resident and ASX-listed company shares where gains/losses on the shares are on capital account.

2 *Unlisted Offshore Securities and Other FIF Interests*

If the FIF interests consist of unlisted securities, then the FDR method cannot be applied. Instead, the cost method must be applied. The cost method is based on a similar concept to that of the FDR method in that a 5% annual return is deemed, but this time it is based on the total cost of acquiring the FIF interest and effectively compounds over each income year and does not consider any distributions received. In some instances, the cost basis can be ascertained at the beginning of the income year using an independent market valuation or from 'general public audited financial statements'. However, interests in foreign life insurance policies and some foreign pension schemes are unlikely to qualify for such treatment. For unlisted FIF interests, there is a risk that over time the 5% deemed return will compound and increasingly diverge from the actual income derived from the underlying interest. Again, there is no adjustment when the FIF interest is sold.

The current tax treatment of FIFs represents a political compromise brokered by the fifth Labour Government in the 2004-07 period between a hard-line approach advocated by its advisers (in particular Treasury) since the late 1980s that New Zealand should adopt very comprehensive worldwide taxation of its tax residents even to the extent of undistributed income that might be held in offshore entities (including collective investment vehicles such as superannuation and life insurance policies) and taxpayers who wanted offshore investments to be taxed on the same basis as local investments. The FDR method was seen as an acceptable compromise to taxpayers as well as providing some protection to the tax base from tax avoidance through offshore investment. It also must be recognised that the FIF rules will tax fictitious income in only some instances and in others may result in significant under-taxation.

D Interest Deductions for Residential Rental Property

On 23 March 2021, the Government announced that it would phase out deductions for interest incurred in deriving rental income from the renting of residential properties with

[37] PIEs also enjoy a statutory exclusion from the taxation of capital gains arising from the disposal of shares in New Zealand-resident and Australian ASX companies. See *ITA 2007* s CX 55.

enabling legislation being passed in early 2022.[38] Interest deductions for residential rental properties owned on the announcement rate (23 March 2021) are being phased out over several years with 87.5% being deductible for the 2022 income year, 75% deductible for the 2023 income year, 50% deductible for the 2024 income year, 25% deductible for the 2025 income year and deductions being completely phased out by the 2026 income year. Newly built residential properties will be exempt from this interest apportionment, while any existing residential property purchased after 27 March 2021 will not be eligible for any interest deductions.

For most landlords, interest expense is the largest outgoing they incur. The effect of eliminating a deduction for interest incurred on monies borrowed to finance residential property will be to increase the tax payable on rental income (resulting in tax payable on some amount of fictitious income) or to have income tax payable on what is fictitious income when an underlying loss has been incurred.

The denial of interest deductions is in addition to the quarantining of losses from the rental of residential properties. However, the effect of the elimination of interest deductibility will be that fewer losses will be recognised for income tax purposes that are subject to the quarantining rules.

In some instances, the denied interest deduction can be restored when the property is sold. If a residential rental property is sold and the proceeds are assessable under the 10-year bright line test,[39] the denied interest can then be deduced from the profit derived on sale. However, the deduction is limited to bringing the taxable gain to nil rather than permitting the recognition of a loss on sale (which is quarantined anyway).

At the time this restriction was introduced, the economy was experiencing a huge growth in residential property prices, and it was justified on the grounds that interest deductibility was a 'loophole' not available to owner-occupiers.[40] At best it served to restrain investor demand for existing residential properties and did appear to result in a temporary reduction in price growth. It appears that the longer-term economic effects were not considered nor longer-term social impacts if the supply of rental properties was reduced. The inspiration for the denial of interest deductibility appears to have come from the UK,[41] where interest is no longer a deductible expense for UK residential landlords. Instead, a tax credit of 20% is granted for interest expense which effectively results in a partial interest deduction for high-income landlords.[42] The effects of this measure are also similar to New Zealand's denial of interest deductibility with anecdotes

38 See *ITA 2007* subpt DH.

39 See *ITA 2007* s CB 6A.

40 It should be noted that this restriction on interest deductibility was not extended beyond residential property which undermines the 'loophole' argument to some degree.

41 *Finance Act 2015* (NZ) s 24.

42 The UK standard tax rate is 20% (applying to incomes between £12,571 and £50,270) is 20% so the interest credit instead of a deduction is neutral for taxpayers with incomes in that range. For taxpayers with incomes above £50,270 where tax rates of 40% and 45% may apply, the interest tax credit provides only partial relief.

from the UK about this measure resulting in landlords being liable to amounts of tax greater than the actual return derived by them effectively taxation of fictitious income.[43]

E *Income Arising Under the Bright-line Test for Residential Property Sales*

Under *ITA 2007* s CB 6A sales of residential properties sold within 10 years of acquisition are subject to tax.[44] While there are exemptions for a taxpayer's 'main home', this exemption will not apply to all residential home sales within the 10-year period and sometimes only partially if the property in question has not been exclusively used as a main home during the 10-year period.[45]

Taxpayers who sell residential properties that have exclusively been used for income producing purposes within 10 years will be able to deduct all holding costs (such as rates, insurance, repairs and maintenance, and possibly some interest) on an annual basis. Where the issue becomes problematic is when the property subject to tax upon sale has been used for private purposes but does not qualify for the main home exemption as, for example, may occur with a holiday house. Usually, the costs associated with holding and maintaining a private residence are not deductible because no income is produced from the property and the costs are also private and domestic. Expenditure that is private and domestic is not deductible under *ITA 2007* s DA 2(2). But if the property that was used for private and domestic purposes is subject to tax upon its disposal, the issue arises as to whether it should be possible for all expenses incurred in holding and maintaining that property to be deductible at least in the income year when the property was sold even though deductions could not be sustained in the year that the expenditure was incurred.

This issue has come to the attention of tax policymakers who released in 2009 a consultation document exploring this issue.[46] In the consultation document three options were examined. The first was to allow apportionment of holding costs according to the value of the private use and the gain derived on sale. The second option was to allow a deduction for all holding costs and the third was to deny any deduction. Perhaps unsurprisingly for a document prepared by revenue officials, they concluded the third outcome was preferable. Such an approach would further inflate the amount of income recognised from the property sale already which was already inflated by inflation. The gain on sale could also be brought to tax all in one income year attracting the highest individual tax rates.

Despite the document's release in October 2019 and submissions on the document's proposals closing on 1 November 2019, it has taken until early 2023 for further progression by the IRD on this important issue with the release of an exposure draft of

---

[43] See Raju Gajurel, 'A Guide on Interest Relief Restriction Section 24 on Landlords' *UK Property Accountants* (Web Page, 6 September 2022) <https://www.ukpropertyaccountants.co.uk/section-24-mortgage-interest-relief-restriction-landlords>.

[44] Certain 'new builds' are only subject to a 5-year period under the bright-line rule in s CB 6A instead of 10 years.

[45] Properties can used for other purposes for up to 12 months without losing their 'main home' status.

[46] Inland Revenue Department, 'Holding costs for privately used land that is taxable on sale' (Report, October 2019).

an Interpretation Statement.[47] Interestingly, after four years of consideration, the IRD has decided to address this key issue by an Interpretation Statement of existing law rather than any legislative amendment which leaves open that the IRD's position can potentially be challenged through the courts. Consequently, taxpayers caught by the 10-year bright-line rule where they have used their property for private purposes, still face uncertainty as to how they calculate their income derived from the sale of privately used land. There is still considerable risk that the profit upon sale which they must tax on is inflated because not all the expenditure incurred in producing that income is deductible. Surely if capital gains from the sale of property are to be taxed, it is necessary to own the property in the first place and thus surely the holding costs should be deductible? Secondly, if the profit on the sale is derived by an individual, because all the income is subject to tax in the year of disposal and not spread over all the income years the gain was accrued, much of it could end up being taxed at the top individual tax rate of 39%.

As mentioned in the previous section, a rapid increase in house prices in 2021 had created major issues for the government which led to the restrictions on interest deductibility discussed in section IV D. The extension of the bright line rule to 10 years appears driven by a belief that housing speculation would be discouraged and the problems remedied if home sellers were subject to tax. However little thought appears to have been given to how net income should be calculated from the sale of property used for private purposes that falls within the bright-line rule.

V ANALYSIS

Parts III and IV of this article have outlined situations under *ITA 2007* that may lead to either taxation of fictitious income or overstatement of taxable income even where there is some underlying economic income. The author's experience in delivering earlier versions of this article at a conference is that many tax scholars have not considered the impact of the various matters explained in parts III and IV in terms of fictitious income being subject to tax.

Several issues flow from the analysis in this article. Firstly, this article shows how unevenly New Zealand's tax base is currently defined, even putting aside the issue that many capital gains do not fall within the income tax base. There has been little debate to date about sectors of the economy that are effectively over-taxed under current tax rules which it is hoped this article will shed some light on.

Secondly, while taxing fictitious income may boost the Government's revenues, it will also have economic and social impacts. Although the core provisions of *ITA 2007*, as they apply to resident taxpayers, adopt a 'global' approach (as opposed to schedular), where all types of income are taxed using the same tax rate scale, this approach is in essence undermined in several areas due to uneven effective tax rates arising for different types of income even though there is no sound (or even explicit) policy reason for doing so. The over-taxation of what is fictitious income creates economic distortions in the same way as does the under-taxation or nil taxation of capital gains, which will affect the allocation of capital in the New Zealand economy.

---

[47] Inland Revenue, Exposure Draft, *Deductibility of holding costs for land*, PUB00417, 2023.

The rapid decline in residential property prices in 2022 and 2023 combined with the phasing out of interest deductions for residential landlords has now resulted in landlords having to pay income tax in an income year when on any measure they have made an overall loss going forward.[48] There are some anecdotes that landlords may be forced to sell as they are unable to meet the cash flow deficit arising from their rental properties or they may seek higher returns from the short-term letting market for tourists.[49] Either of these alternatives risks the outcome that there are fewer residential properties available for long-term rental. Even if landlords decide to retain their existing properties, the non-deductibility of interest raises their costs which will eventually be passed on to tenants in higher rents. A reduced supply of rental housing nor additional pressures on rents are desirable from a social perspective given the current problems with housing availability and affordability as well as homelessness.[50]

As explained in section III C, the tax treatment of land subdividers may also result in over-taxation of income from that activity. Since the current tax treatment of land subdividers has been in place since 1973, most current investors will have compensated for the over-taxation of land subdivision schemes when entering into them by seeking higher nominal returns which will be passed on to home builders in higher prices for building sections and finished homes.

The FIF rules can also result in over-taxation when tax is imposed on investments where no gain or income has accrued. This risk arises particularly for managed funds (eg, KiwiSaver funds) which must be contrasted to the statutory exclusion[51] they enjoy from paying tax on any capital gains derived from the sale of interests in New Zealand-resident and ASX-listed Australian-resident companies.[52] This creates a tax bias as to how they invest favouring Australasian investments over diversification into other capital markets. Again, no explicit policy reason has ever been given for this preference nor has any consideration appear to have been given about the resulting distortions.

The final issue arising from the taxation of fictitious income is how the New Zealand income tax base is currently defined and how it should be revised going forward if legislators decide in the future to tax capital gains more comprehensively. New Zealand's income tax base has been expanded incrementally in a haphazard way since income tax was first introduced in 1892 with more and more amounts being subject to income tax through various reforms and ad hoc amendments. While the concept of 'economic

48 See sections IV D and IV E.

49 Tony Alexander, 'Rental squeeze about to tighten as landlords chase the easy cash' *OneRoof* (Web Page, 26 April 2023) <https://www.oneroof.co.nz/news/tony-alexander-rental-squeeze-about-to-tighten-as-landlords-chase-the-easy-cash-43472>.

50 These outcomes are being reported in the UK where a 20% tax credit for interest expense was introduced for landlords in place of a deduction: see (n 42). See also Miles Brignall, 'Landlords sell up in Great Britain as buy-to-let market sours' *The Guardian* (online, 13 November 2023) <https://www.theguardian.com/money/2023/nov/13/landlords-sell-up-in-great-britain-as-buy-to-let-market-sours>.

51 *ITA 2007* s CX 55.

52 A further bias in favour of New Zealand equity investment arises from the dividend imputation regime, whereby imputation credits are usually only received from New Zealand-resident companies.

income' has underpinned more recent reforms to some parts of the income tax regime, for example, the financial arrangement rules, the comparative value method under the FIF rules, and the taxation of lump sums in conjunction with property leases, it has not been comprehensively applied to reform all parts of *ITA 2007*.[53] In other parts of *ITA 2007*, such as the sale of both real and personal property, the relevant provisions have remained unchanged for many decades and a revenue/capital dichotomy still applies.

This incremental pattern of extending New Zealand's income tax base is further perpetuated by the second Tax Working Group's 2019 proposals to more comprehensively tax capital gains.[54] The Working Group proposed that the existing income tax base should be extended to include the sale of property and assets which are currently outside the tax net and to tax nominal gains arising from their disposal. No adjustments were proposed for inflation over the long term nor any adjustments for 'lumpy' realisations of gains in one income year for individuals taxed under a progressive tax rate scale when the gain had accrued over many income years. Thus, their proposals would also lead to over-taxation of long-term capital gains in a similar way as has been explained earlier in this article in respect of land sales.

Because no preferences or adjustments were proposed for capital gains, the Working Group side-stepped the difficult issue of delineating between ordinary gains and capital gains. If they had proposed tax preferences for capital gains (such as the 50% discount for some capital gains in Australia) the case for reviewing the existing income tax base would have been much stronger.

If New Zealand is to tax capital gains on a more comprehensive basis, then this author argues that a comprehensive review should be made of what is income first and legislators should be prepared to review the existing tax base rather than merely extending it. The issue has indirectly come to the fore with the release of the IRD's report on high-wealth individuals which has highlighted unrealised gains enjoyed by such individuals and has ignited debates as to whether they can be taxed.[55] If New Zealand is to tax capital gains more comprehensively, some sort of preference will probably be necessary which should involve a careful review of the existing income not just to exclude fictitious income but to more appropriately classify what constitutes income and what is a capital gain.

This leaves one final issue concerning the impact of inflation on the determination of taxable income. It is this author's opinion that if inflation rates can be reduced to within monetary targets of 1%-3%, the impact of inflation on the income tax regime will not be so significant and that comprehensive indexation would not be warranted. It would also lead to considerable complexity and high compliance costs. However, more consideration needs to be given to specific types of activity where inflation does impact upon taxable

53 See *ITA 2007* ss CC 1, CC 1B, and CC 1C.

54 Tax Working Group, *Future of Tax: Final Report Volume II, Design Details of the Proposed Extension of Capital Gains Taxation* (Final Report, February 2019).

55 See Inland Revenue Department, 'High-wealth individuals research project' (Report, April 2023) and Kieran Murray, John Wallace, and Mehrnaz Rohani, 'Effective tax rates imposed on the income of New Zealand residents' (Report, Sapere Research Group, 2023).

income, in particular, land subdivision schemes among others. Broader income-spreading provisions are also warranted for individuals where income has accrued over several income years.

VI Conclusions

This article has highlighted numerous situations where taxpayers are liable to pay tax on fictitious income either where there is no underlying net income or the amount of taxable income has been inflated. Despite the core provisions of *ITA 2007* taxing all types of income derived by a resident taxpayer using the same tax rate scales, effective tax rates are uneven depending on the type of income earned when there is no explicit policy to have tax preferences for certain activities. Not only are economic distortions created but there are likely to be social impacts in respect of both rental and owner-occupier housing.

New Zealand's income tax regime has in recent times received considerable criticism that capital gains are not comprehensively taxed leading to unfairness and equity issues. If New Zealand wishes to improve the fairness and neutrality of its income tax regime to include capital gains in its tax base it would appear necessary that a comprehensive review is necessary of what constitutes income for income tax purposes before such changes are made.

BIBLIOGRAPHY

A Articles/Books/Reports

Deductibility of holding costs for land, PUB00417 Exposure Draft (Report, Inland Revenue, 2023

Fisher, Irving, 'Comment on President Plehn's Address' (1924) 14(1) *American Economic Review* 64

Goode, Richard, 'The Economic Definition of Income' in Joseph A Pechman (ed), *Comprehensive Income Taxation* (Brookings Institute, 1977) 3

Haig, Robert M, 'The Concept of Income – Economic and Legal Aspects' in *The Federal Income Tax* (Columbia University Press, 1921) 1

Holmes, Kevin H, *The Concept of Income: A multi-disciplinary analysis* (IBFD Publications, 2001)

Inland Revenue Department, 'Holding costs for privately used land that is taxable on sale' (Report, October 2019)

Inland Revenue Department, 'High-wealth individuals research project' (Report, April 2023)

Littlewood, Michael, 'The Tax Consequences of Withdrawals of Trading Stock: Resolving the Conundrum of *Sharkey v Wernher*' (2005) 35 *Hong Kong Law Journal* 327

McLure Jr, C E, 'The evolution of tax advice and the taxation of capital income in the USA' (1984) 2 *Environment and Planning C: Government Policy* 251

Murray, Kieran, John Wallace, and Mehrnaz Rohani, 'Effective tax rates imposed on the income of New Zealand residents' (Report, Sapere Research Group, 2023)

Report of the Royal Commission on Taxation (Final Report, 1966)

Simons, Henry, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press, 1938)

Surrey, Stanley S, *Pathways to Tax Reform* (Harvard University Press, 1973)

Tax Working Group, *Future of Tax: Final Report Volume II, Design Details of the Proposed Extension of Capital Gains Taxation* (Final Report, February 2019)

Witte, John F, *The Politics and Development of the Federal Income Tax* (University of Wisconsin Press, 1986)

B Cases

Lowe v CIR [1981] 1 NZLR 326

[1999] 1 NZLR 529

(2006) 22 NZTC 19,716 (CA)

Rank Xerox (NZ) Limited v CIR (1983) 6 NZTC 61,501

Sharkey v Wernher [1956] AC 58

C *Legislation*

Finance Act 2015 (NZ)

Income Tax Act 2007 (NZ)

D *Other*

Alexander, Tony, 'Rental squeeze about to tighten as landlords chase the easy cash' *OneRoof* (Web Page, 26 April 2023) <https://www.oneroof.co.nz/news/tony-alexander-rental-squeeze-about-to-tighten-as-landlords-chase-the-easy-cash-43472>

Brignall, Miles, 'Landlords sell up in Great Britain as buy-to-let market sours' *The Guardian* (online, 13 November 2023) <https://www.theguardian.com/money/2023/nov/13/landlords-sell-up-in-great-britain-as-buy-to-let-market-sours>

'Deep freeze list – Finance industry failures' *Interest.co.nz* (Web Page) <https://www.interest.co.nz/saving/deep-freeze-list>

Gajurel, Raju, 'A Guide on Interest Relief Restriction Section 24 on Landlords' UK Property Accountants (Web Page, 6 September 2022) <https://www.ukpropertyaccountants.co.uk/section-24-mortgage-interest-relief-restriction-landlords>

New Zealand Law Society, 'Re: Initial Policy think piece: Donated Trading Stock' (Letter, 1 September 2020)

How Good Is Your Business Structure? A Survey of Australian SME Advisors

Barbara Trad,* Brett Freudenberg,† John Minas‡ and Craig Cameron§

Abstract

There are a variety of business structures that might be recommended to a client, all with different advantages and disadvantages. This article reports the evaluation by Australian advisors about their own recommended business structure for small and medium enterprises ('SME'). In other related research it was demonstrated across a variety of SME scenarios that there were four main business structures recommended, being a trading company with shares held by a discretionary trust, a trading discretionary trust with a corporate trustee, a tax consolidated group with shares held by a discretionary trust, or a company. After recommending a business structure for their hypothetical clients, advisors were then surveyed to evaluate their recommended structure against a matrix of factors considered important for SMEs. The analysis of this evaluation provides unique insights into the strengths and weaknesses of the structures recommended and advances our understanding as to when such structures might be appropriate.

Keywords: business structure**,** small and medium enterprises, trading company**,** trading trust; discretionary trust, tax consolidated group.

* Griffith University. Email: b.trad@griffith.edu.au.
† Griffith University. Email: b.freudenberg@griffith.edu.au.
‡ Monash University. Email: john.minas@monash.edu.
§ University of the Sunshine Coast. Email: ccameron1@usc.edu.au.

I INTRODUCTION

Determining the most appropriate business structure is a difficult assessment, as it has significant implications for a business and the way it operates, including legal obligations and how tax is imposed.[1] A small and medium enterprise ('SME') advisor might consider a number of factors in determining the most appropriate structure, including tax considerations,[2] limiting personal liability,[3] asset protection,[4] access to equity funding,[5] and compliance costs.[6] There may be no 'perfect' structure, and given that each business structure has certain advantages and disadvantages, the decision about selecting a business structure can be based on weighing up those advantages and disadvantages.[7] Additionally, part of this difficulty is the variety of client circumstances, such as industry, size and asset held, as well as the current and future plans (which could alter over time).

[1] Brett Freudenberg and Dale Boccabella, 'Changing Use of Business Structures: Have University Business Law Teachers Failed to Reflect this in Their Teaching?' (2014) 9(1) *Journal of the Australasian Tax Teachers Association* 180.

[2] Numerous studies have demonstrated there is a potential influence by tax arbitrages for taxpayers when considering the choice of a business structure. In the United States, research by Scholes and Wolfson and Gordon and Mackie-Mason has considered the effect on business structure choice due to the 1986 Tax Reforms: Myron Scholes and Mark Wolfson, 'Issues in the Theory of Optimal Capital Structure' in Sudipto Bhattacharya and George Constantinides (eds), *Frontiers of Modern Financial Theory* (Rowman and Littlefield, 1989); Roger Gordon and Jeffrey Mackie-Mason, 'Effects of the Tax Reform Act of 1986 on Corporate Financial Policy and Organizational Form' (National Bureau of Economic Research No w3222, 1990).

[3] Barbara Trad, and Brett Freudenberg, 'All Things Being Equal: Small Business Structure Choice' (2017) 12(1) *Journal of Australasian Tax Teachers Association* 136: in a survey of small businesses, it was found that, overall, this would conclude that asset protection and limited liability appear to be driving motivations for the choice of business structures, as their aggregated weighted score was 61. However, tax does appear to be a strong consideration as well. This is because tax characteristics were six of the highest ten factors (3rd, 4th, 6th, 7th, 8th and 9th), and when these weighted averages are aggregated, they amount to 100, exceeding the aggregated average of asset protection and limited liability. Particularly, it would indicate that access to the small business concessions is seen as very important (3rd), as well as retaining income at low tax rates (4th).

[4] Brett Freudenberg, 'Tax on my Mind: Advisors' Recommendations for Choice of Business Form' (2013) 42(1) *Australian Tax Review* 33: Freudenberg explored the important considerations regarding the formation of businesses in a survey of 81 advisors. This study found that, on average, the most important factor was considered to be asset protection (8.26 on a 10-point scale), which was seen to be more important than tax benefits/savings (6.84), which ranked second. This could indicate that, while tax is important, it is not the dominant reason for choosing a business structure. Other important factors related to liability exposure: level of risk (4th: 5.96) and limited liability (5th: 5.95).

[5] Ayers et al found that non-tax factors, such as the size and the age of the business, the ownership structure and the business risk are all important considerations in choosing the business structure: Benjamin Ayers, Bryan Cloyd and John Robinson, 'Organizational Form and Taxes: An Empirical Analysis of Small Businesses' (1996) 18 *Journal of the American Taxation Association* 49.

[6] Brett Freudenberg, 'Advisors' Understanding of Tax Compliance for Choice of Business Form' (2013) 4(1) *Global Review of Accounting and Finance* 1. This study demonstrated that many advisors were not aware of empirical studies demonstrating the difference in compliance cost and the different types of business structures.

[7] For example, Scholes and Wolfson's theory, under which business structure choice is a trade-off between tax and non-tax costs, with firms likely to choose a business structure that minimises these costs: Myron Scholes and Mark Wolfson, *Taxes and Business Strategy: A planning approach* (Prentice-Hall, 1992).

An important part of the Australian economy are SMEs, which can be described as heterogeneous, given they cover a diverse range of industries and circumstances. Qualitative characteristics might be used to describe SMEs, including that, normally, the business is independently owned and operated, with membership interests closely held and not publicly traded. Furthermore, most, if not all, capital is contributed by equity members and managers, with members likely to participate in the management of the business.[8] While these qualitative characteristics can provide insight, there is a tendency to utilise quantitative characteristics to identify SMEs,[9] such as annual turnover, assets, and employment.[10] For example, the Australian Taxation Office ('ATO') defines SMEs, for the purpose of *Taxation Statistics*,[11] as a business with an annual turnover of less than $100 million, including the categories micro (less than $2 million), small ($2 million to less than $10 million) and medium ($10 million to less than $100 million).[12] The Australian Bureau of Statistics ('ABS') defines an SME as a business employing fewer than 200 full-time equivalent employees, and within this definition they include the categories: micro (less than five employees), small (five to less than 20 employees) and medium (20 to less than 200 employees).[13] The study in this article uses a definition based on a combination of the ATO and ABS characteristics. Specifically, an SME business is defined as one with an annual turnover of less than $100 million, and less than 200 equivalent full-time employees.

The reason for focusing on SMEs is that they are key players in national economies globally, generating employment and contributing to gross domestic product ('GDP').[14] Across developed and developing countries, SMEs play a key role in promoting sustainable economic growth, providing employment, fostering innovation, and reducing income inequities.[15] SMEs are a fundamental component of the Australian economy, representing over 99% of all businesses and they significantly contribute to the Australian economy in terms of employment and GDP. Specifically, SMEs account for 67% of employment and 57% of GDP.[16] SMEs are present in all sectors of the Australian

---

[8] Scott Holmes and Brian Gibson *Definition of Small Business* (University of Newcastle, 2001); and Judith Freedman, 'Small Business Taxation: Policy Issues and the UK' in *Taxing Small Business: Developing Good Tax Policies* (Conference Series) (Australian Tax Research Foundation, 2003).

[9] Ann Hansford, John Hasseldine and Carole Howorth, 'Factors Affecting the Costs of UK VAT Compliance for Small and Medium-Sized Enterprises' (2003) 21(4) *Environment and Planning C: Government and Policy* 479.

[10] Holmes and Gibson (n 8) 1.

[11] An annual publication of the ATO.

[12] Australian Taxation Office, 'Taxation Statistics: A summary of Tax Returns for the 1990–91 to 2018–19 Income Year – Entity Size Classification' (Report, 2021).

[13] Australian Bureau of Statistics, 'Counts of Australian Businesses, Including Entries and Exits, June 2017 to June 2021, 8165.0, Table 10' (Report, 2021).

[14] Viral Pandya, 'Comparative Analysis of Development of SMEs in Developed and Developing Countries' (International Conference on Business and Management, Thailand, 6- 7 September 2012) 426.

[15] Bashir Fida, 'The Role of Small and Medium Enterprises (SMEs) in Economic Development' (2008) *Enterprise Development, Free Online Library*.

[16] Australian Small Business and Family Enterprise Ombudsman, 'Affordable capital for SME growth' (Report, 2018) <https://www.asbfeo.gov.au/sites/default/files/2021-11/ASBFEO-affordable-capital-for-SME-growth.pdf>.

economy, but they are concentrated in construction, professional, scientific, technical, rental, hiring, and real estate services.[17]

In Australia, SMEs may operate as sole traders, partnerships, trusts,[18] companies, or a combination of structures.[19] Income tax return data reveals that of the 2,401,874 taxpayers in the 2020/21 tax year who indicated they were conducting an active business, 41% were companies, 29% were sole proprietors, 20% trusts, and 10% partnerships: Table 11.[20]

Table 11: Businesses by Type of Legal Organisation, June 2019 – June 2021

Entity	2019–2020	2020–21
Total Companies	926,665	986,515
Sole Proprietors	687,569	707,971
Total Partnerships	240,013	236,114
Trusts	459,847	471,274
Total	2,314,094	2,401,874

Source: Australian Bureau of Statistics, Counts of Australian Businesses, including Entries and Exits, June 2017 to June 2021, 8165.0, Table 10 (2021). Note the ABS data differs to the ATO, as the ABS data only concerns actively trading businesses, whereas the ATO data includes businesses not necessarily being active.

In considering the business structures used by SMEs in Australia, Table 11 indicates that most businesses in Australia are 'micro' businesses, with less than $2 million in turnover. Within this micro range are 99% of sole proprietors, 96% of partnerships, 91% of trusts, and 89% of companies.[21] In the small range (>$2m to <$10m turnover), the company appears to be the preferred structure, accounting for two-thirds of structures, followed by trusts (24%), partnerships (7%) and sole proprietors (3%). In the medium range (>$10m to <$100m turnover), companies appear to dominate, accounting for 78% of business structures, followed by trusts at 17%. However, caution should be exercised when utilising these data, because they do not incorporate the use of a combination of business structures for the one enterprise.[22] Furthermore, while there is a variety of trusts, it has been estimated that the majority (80%) are discretionary trusts.[23]

---

[17] Australian Bureau of Statistics (n 13).
[18] Note, unlike in other jurisdictions, Australian businesses can utilise a trust for trading activities: Freudenberg and Boccabella (n 1). Note that, legally, the trust is not a separate legal entity.
[19] Brett Freudenberg, 'Fact or Fiction? A sustainable tax transparent form for closely held businesses in Australia' (2009) 24(3) *Australian Tax Forum* 375.
[20] Australian Bureau of Statistics (n 13).
[21] Australian Taxation Office, 'Taxation Statistics: A Summary of Tax Returns for the 2018–19 Income Year, Number of Entities by Size' (Report, 2021).
[22] Mark Giancaspro, Sylvia Villios and Chris Graves, 'The Use of Family Trusts in Small Business and Family Enterprise, ASBFEO Final Report' (Report, University of Adelaide, South Australia, 2019); Freudenberg (n 19).
[23] Giancaspro, Villios and Graves (n 22) 31-32. Australian Taxation Office, 'Taxation Statistics: A Summary of Tax Returns for the 1990–91 to 2018–19 Income Year' (Report, 2021) <https://data.gov.au/data/dataset/taxation-statistics-2018-19/resource/d6f6266c-7ad2-461a9552f5736cc0d30f?inner_span=True>.

Table 12: Lodgement of tax returns by size: 2018–19 (operating businesses)

Entity size	Sole proprietors	Companies	Partnerships	Trusts
Micro (> $0 to <$2m)	1,374,329	793,185	219,292	331,051
Small (>$2M to <$10Mm)	3,190	73,326	7,238	26,647
Medium (>$10m to < $100m)	335	20,427	1,006	4,551
Large (>$100m to <$250m)	9	1,685	65	186
Very large (>$250m)	4	1,366	51	60
Total	1,377,867	889,989	227,652	362,495

Source: Australian Taxation Office, *Taxation Statistics: A Summary of Tax Returns for the 2018–19 Income Year*, *Number of Entities by Size* (2021).

The motivation for the research reported in this article is to consider how Australian advisors would evaluate their recommended business structure for SMEs against a matrix of 23 factors that have been identified in the literature as important for SMEs. The following question arises in this context - is it the case that a focus on tax means other attributes are not relevant or is it the case that some business structures appear to better meet these factors? Currently, our understanding in Australia about the implications of business structure recommendation is very scant.[24] While there are assertions of what is occurring and why, there is very little empirical evidence to substantiate this.[25] Prior research in this area considers business structures in isolation,[26] although there is growing evidence that, in Australia, businesses will use a combination of structures for the one enterprise.[27] If a combination of business structures are being recommended for the one enterprise, this may lead to various issues arising, some advantageous and some disadvantageous.[28] It may be that these issues could be different compared to if just one structure was used. Also, given the variety in combinations – different combinations may lead to different results. No prior Australian research has analysed this phenomenon in a methodical way.

The research reported in this article provides quantitative data to better understand and to provide insights about the consequences of the professional advisors' advice. This provides the ability to triangulate prior reported qualitative data.[29] This article takes the previous studies one step further by testing whether the initial reported qualitative reasons are consistent with the survey data. Additionally, the survey data provides a way of measuring to what extent the various factors are (or are not) fulfilled. This multi-

[24] Freudenberg (n 4); Trad and Freudenberg (n 3).
[25] Alex C Evans, 'Why We Use Private Trusts in Australia: The income tax dimension explained' (2019) 41(2) *Sydney Law Review* 217.
[26] Such as just considering sole proprietors in isolation, or the use of a company. Per Davidsson, Paul Steffens and Scott Gordon, *Comprehensive Australian Study of Entrepreneurial Emergence (CAUSEE): Design, Data Collection and Descriptive Results* (Handbook of Research on New Venture Creation, 2011).
[27] Giancaspro, Villios and Graves (n 22).
[28] Barbara Trad et al, 'Not in Isolation: The Rationale for a Combination of Business Structures in Australia' (2023) 51(3) *Australian Business Law Review* 162.
[29] Barbara Trad et al, 'Choice of Australian Business Structures in the SME Sector: What Do Advisors Recommend?' (2023) 52(3) *Australian Tax Review* 177.

factored approach strengthens the research validity of the findings and highlights important nuances between the business structures.

The remainder of this article proceeds as follows. Section Two provides a broad summary about SMEs, including the considerations and impediments that are relevant when recommending a business structure. The findings of related research into business structure choice are discussed in Section Three, which is followed by the research methodology in Section Four. The survey results are then analysed in Section Five. Through the analysis of the results recommendations are proposed, with future research outlined in Section Six, followed by the conclusions in Section Seven.

II SMEs

To understand what SMEs may need from a business structure it is important to understand some of the factors (including impediments) they may face, as a business structure may aid or hinder these considerations. It is these factors reported in the prior literature that are used as a basis to develop the evaluation matrix used in the survey later discussed.

A *Factors*

Compared to large businesses, SMEs can face financial limitations and other competitive disadvantages, which can limit their ability to access finance or equity.[30] Financing this sector can be risky, and financial institutions can be hesitant to provide finance to SMEs, especially if there is no tangible property to secure loans. This can result in higher borrowing costs for SMEs.[31] Pizzacalla argues that smaller businesses are vulnerable to cyclical recessions caused by bank lending practices and credit 'crunches'.[32] The issue of finance has been the focus of several government reports; these reports have concluded that borrowing costs could be high for SMEs.[33] This can result in owners being a major funder of their own business operations, including the need for internally generated retained profits to support business operations. Research has demonstrated that equity funding for the SME sector is usually limited to the owners' personal capital and savings, especially when the business is small.[34]

---

[30] Alain Jousten, 'SMEs and the Tax System: What Is so Different about them?' (2007) 8(2) *CESifo Forum (Info Institute for Economic Research at the University of Munich)* 14.

[31] Abbas Valadkhani, George Chen and Bernice Kotey, 'Asymmetric Changes in Australia's Small Business Loan Rate' (2014) 43(4) *Small Business Economics* 945.

[32] Mark Pizzacalla, 'Developing a Better Regime for the Preferential Taxation of Small Business' (PhD thesis, Monash University, 2014).

[33] Parliament of Australia, 'Parliamentary Joint Committee on Corporations and Financial Services: Access for Small and Medium Business to Finance' (Report, 2011) <https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Service>; Australian Small Business and Family Enterprise Ombudsman, 'Inquiry into Small Business Loans' (Report, December 2016) <https://www.asbfeo.gov.au/policy-advocacy/policy-insights/small-business-loans-inquiry-2016>; Treasury, 'Family Businesses in Australia – Different and Significant: Why They Shouldn't Be Overlooked' (Report, October 2014); Australian Small Business and Family Enterprise Ombudsman (n 16).

[34] Reserve Bank of Australia, 'Submission to the Inquiry into Access for Small and Medium Business to Finance' (Submission No 3, February 2011) 1.

SME owners may encounter risks when conducting a business; this is because owners might have to risk everything, including investing personal funds as capital, providing personal guarantees and indemnities, and devoting their time to managing and directing the business. Liability exposure in a business operation can arise through wrongful acts by directors, managers, or employees. Furthermore, the business structure can influence liability exposure. For instance, owners of businesses operating as sole traders or general partnerships are personally liable and responsible for any debts incurred by the business, and creditors may sue the owners personally to satisfy the debts.[35] In circumstances where a sole trader or a general partnership is utilised and the business owner has personal unpaid debts, creditors may claim against business profit or assets to satisfy the debts. Along with the liability for debts, business owners operating as a sole trader or partnership are personally liable for any torts or injuries that occur because of any acts or omissions by owners, managers, directors, or employees.[36] This can mean for sole traders and general partners that personal assets such as the family home can be at risk. Therefore, for this reason, asset protection may be a significant consideration for SME owners.

The application of multiple tax regimes (such as income tax and goods and services tax ('GST')), and the regulatory 'red tape' for a typical SME owner can lead to complexity. In general, Australian SME owners must comply with both state and federal tax regimes, and they are required to lodge at least one or more of the following: income tax returns, Business Activity Statement ('BAS'), payroll tax returns, Workcover annual returns, and Fringe Benefits Tax ('FBT') returns. These legislative requirements can challenge SME owners and distract them from their core business activities.[37] Unlike large firms which can employ internal tax advisors, many SMEs may not have adequate funds to do so.[38] The application of multiple tax regimes could be a problem for SMEs; for example, small businesses (including micro-businesses) are associated with the highest percentage (90%) of non-compliance with the superannuation guarantee scheme.[39]

The way these taxes apply, especially income tax, can vary depending upon the business structure utilised. Below is a broad overview of the tax treatment of four main business structures — sole proprietorships, partnerships, companies, and trusts. Essentially, flow-through taxation is only available for sole proprietors, general partnerships, and trusts (although losses are trapped within trusts). Companies are taxed separately to

---

[35] *Partnership Act 1891* (Qld) s 12(1); Mitchell Crusto, 'Unconscious Classism: Entity Equality for Sole Proprietors' (2008) 11(2) *Journal of Constitutional Law* 215.
[36] *Donoghue v Stevenson* [1932] AC 562.
[37] Board of Taxation, 'Scoping Study of Small Business Tax Compliance Costs: A Report to the Treasurer, Attorney-General's Department' (Report, 2007).
[38] Robert Blackburn and Robin Jarvis, 'The Role of Small and Medium Practices in Providing Business Support to Small-and Medium-Sized Enterprises' (Report, International Federation of Accountants, 2010) 1.
[39] Inspector-General of Taxation, 'Review into the ATO's Administration of the Superannuation Guarantee Charge' (Report, 2010).

their members, with members being assessable on dividend distributions to them, although members can claim imputation credits for tax already paid at the entity level.[40]

For sole proprietorships and partnerships,[41] income from the business is distributed to the owners, whereby the owners are taxed at their personal marginal tax rates.[42] The losses of the business pass through to the owners to be included in their personal tax return, although losses can be subject to the non-commercial loss provisions.[43] In a partnership, the partners' respective share of the partnership net income or losses[44] forms part of their individual assessable income and is taxed at their relevant marginal tax rates.[45]

Companies are taxed at the corporate tax rate, which is currently 30% or 25% for a company with an annual aggregated turnover of less than $50 million.[46] The company profits can be either distributed as dividends to its members (shareholders), whereby the members are assessed on the distribution with a credit for tax paid by the company.[47] Alternatively, profits can be accumulated in the company as 'retained earnings' to be reinvested back into the business. Australia has adopted an imputation system for the taxation of corporations[48] and their members. Pursuant to an imputation system, the corporation is still taxed separately on its income, although resident members in receipt of franked dividends from Australian resident corporations can obtain credit for a proportional amount of income tax paid by the corporation.[49]

---

[40] Also, limited partnerships are taxed as companies in Australia: Except for the tightly regulated venture capital Incorporated Limited Partnerships: *Income Tax Assessment Act* (Cth) 1936 ('ITAA 1936') s 94D (2) excludes them from the definition of 'corporate limited partnership'.

[41] *ITAA 1936* s 92. A general partnership is subject to tax flow-through, with partners paying tax in accordance with their individual shares of the net partnership income or loss. The term 'sole trader'/'sole proprietor' is used to mean an *unincorporated* business conducted by a single individual. It is acknowledged that a partner in a general partnership could be a company or a trustee; however, for the purpose of this research it is assumed that the partner will be an individual.

[42] 'Individual Income Tax Rates for the 2022-23 Income Year' *Australian Taxation Office* (Web Page, 2023) <https://www.ato.gov.au/rates/individual-income-tax-rates>. The rates for 2022-23 are: (0–$18,200: Nil); ($18,201–$45,000: 19c for each $1 over $18,200); ($45,001–$120,000: $5,092 plus 32.5c for each $1 over $45,000; ($120,001–$180,000: $29,467 plus 37c for each $1 over $120,000); ($180,001 and over: $51 667 plus 45c for each $1 over $180,000). The Medicare levy of 2% (in most instances) is applied separately.

[43] *Income Tax Assessment Act 1997* (Cth) div 35.

[44] This share is determined by the partnership agreement; in the absence of an agreement, the relevant Partnership Act.

[45] *ITAA 1936* s 92(1).

[46] 'Changes to Company Tax Rates — Company Tax Rate' *Australian Taxation Office* (Web Page, 2022) <https://www.ato.gov.au/rates/changes-to-company-tax-rates>. This rate was applicable from 1 July 2021.

[47] *ITAA 1997* s 44. Pursuant to an imputation system, the corporation is still taxed separately on its income, although resident members in receipt of franked dividends from Australian resident corporations can obtain credit for a proportional amount of income tax paid by the corporation: *ITAA 1997* s 207-20.

[48] This includes corporate limited partnerships, except for the tightly regulated venture capital incorporated limited partnerships (*ITAA 1936* s 94D(2)) and public unit trusts.

[49] *ITAA 1997* s 207-20.

Trusts, including discretionary trusts, are subject to a partial tax flow-through system:[50] income can be assessed directly to members (beneficiaries), but losses are confined within the trust. Beneficiaries who are presently entitled to the income of the trust are taxed on their respective share of the trust's net income.[51] For a discretionary trust, the trustee can have the absolute discretion each year about which beneficiaries are to be presently entitled. Tax preferences may be able to flow through to beneficiaries, as a conduit principle may apply to distributions provided sufficient records are maintained.[52] This conduit principle means that trust receipts retain their character in the hands of the beneficiary,[53] thereby enabling beneficiaries to take advantage of concessional treatment applying to different receipts.[54] Note present entitlement is not the same as 'distribution' of income, and if there is an unpaid present entitlement ('UPE') to a corporate beneficiary there is some contention that Division 7A could apply to this.[55] Furthermore, if there is not full present entitlement to net income for beneficiaries, then the trustee is liable to be

[50] *ITAA 1936* div 6 provides the general framework to determine the tax liability for a trust estate, involving the key concepts of net income, present entitlement, and income of the trust. For taxation purposes, the initial step for each income year is to determine the taxable income of the trust estate, known as the 'net income': *ITAA 1936* s 95. Net income is essentially the assessable income of the trust estate less all allowable deductions, calculated as if the trustee was a resident individual.

[51] *ITAA 1936* s 97. In the circumstance where the beneficiary, although presently entitled, is under a legal disability, the trustee is taxable on the share of trust net income in a representative capacity. The trustee is also assessable in cases where the beneficiary is a non-resident.

[52] *Bamford v Commissioner of Taxation* (2010) 240 CLR 481; *Tax Laws Amendment Act (Measures No 5) 2011* (Cth) sch 2. Brett Freudenberg and Dale Boccabella, 'Streaming of Franking Credits Curtailed by Bamford-Induced Amendments – An Unintended Consequence?' (2019) 48(3) *Australian Tax Review* 190.

[53] For example, a capital gain realised by a trustee will be treated as a capital gain in the hands of a beneficiary presently entitled to it. For a discussion about the application of conduit theories to discretionary trusts see: Brett Freudenberg and Peter McDermott, 'The Forgotten CGT Events: Are Asset Revaluations Reserve Distributions by Trustees of Discretionary Trusts Taxable?' (2005) 34(2) *Australian Tax Review* 67.

[54] In some circumstances, the flow-through of tax preferences will be tax-free receipts for beneficiaries; for example, when accounting income exceeds taxable income: Brett Freudenberg, 'Are Asset Revaluation Reserve Distributions 'Ordinary Income' for Discretionary Beneficiaries?' (2005) 20(1) *Australian Tax Forum* 3. In comparison, for a beneficiary of a fixed (unit) trust, the receipt of a tax preference could result in the decrease of the cost base of their membership interest: *ITAA 1997* s 104-70.

[55] Division 7A can operate to ensure that a private company beneficiary is not financially accommodating the trust by allowing the trustee to retain the funds for use within the trust: ITAA 1936 div 7A, pt III. Division 7A may apply to private company beneficiaries' trust unpaid entitlements where the trust and private company beneficiary are related entities, the trust entitlements are used for the benefit of the private company's shareholder or their associate (for example, the trust). If the private company beneficiary provides financial accommodation to the entity that has use of the funds, it then may be treated as having made a loan to that entity. If Division 7A applies, the loan is deemed as an unfranked dividend, in the same way as a loan made directly from the company to the entity would be a deemed dividend: 'Trust entitlements: When Division 7A may apply' *Australian Taxation Office* (Web Page, 2022) <https://www.ato.gov.au/Business/Private-company-benefits---Division-7A-dividends/In-detail/Division-7A---trust-entitlements>. Board of Taxation, 'Post Implementation, Review of Division 7A of Part III of the Income Tax Assessment Act 1936: A Report to the Assistant Treasurer' (Report, 2014). However, the Commissioner's view that UPEs are loans for division 7A purposes has been recently held as incorrect: *Bendel v Commissioner of Taxation (Taxation)* [2023] AATA 3074.

assessed on that amount.[56] Generally, the trustee is taxed at the highest marginal rate plus Medicare levy,[57] although a lower tax rate can apply when the trust involved arises under a will, an intestacy, or bankruptcy.[58]

In addition to tax, another consideration might be compliance costs, which can consist of financial and non-financial costs, such as stress and time lost.[59] Compliance costs can be substantial for SMEs in any jurisdiction.[60] Concerns have been raised about the costs and the regressive nature of complying with tax obligations for businesses. This has influenced government policy makers to introduce legislation and tax concessions to try to address this issue. However, Evans et al argued that small business tax concessions may not be reducing tax compliance costs, as compliance costs remain regressively high, and the compliance burden disproportionately falls on smaller businesses.[61] A significant portion of compliance costs consists of the time and effort required to comply with tax obligations.[62] This can be a significant issue for SMEs when the owner has the responsibility for compliance activities. For this reason, compliance costs can reduce the economic efficiency of a business structure, especially if the compliance costs outweigh the benefit obtained.[63]

Succession planning is the process of identifying successors and training them so they can move to the leadership roles and/or ownership of the business.[64] The choice of business structure may influence the process of succession planning. Researchers have focused on the importance of succession planning in terms of ensuring the continuity of the business.[65] Despite its significance, many family-owned SMEs seem to have poor succession planning for their firm.[66] For instance, a family business survey conducted by KPMG in 2009 indicated that the majority of family businesses do not have a succession management plan, with only 15% reporting a formal succession plan in place and 31%

---

[56] *ITAA 1936* ss 99, 99A. This could occur in circumstances where the trustee had no power to appoint a particular entity as a beneficiary, and a default provision had not been triggered to entitle a default beneficiary, such as in the decision of *BRK (Bris) Pty Ltd v Federal Commissioner of Taxation* 2001 ATC 4111.

[57] Pursuant to *Medicare Levy Act 1986* (Cth) s 7 and *ITAA 1936* s99A. Robert Baxt et al, *Cases and Materials on Taxation* (Butterworths, 2nd ed, 1984) 749.

[58] *ITAA 1936* s 99A.

[59] Board of Taxation (n 37) 7.

[60] Alfons Weichenrieder, 'Survey on the Taxation of Small and Medium-Sized Enterprises: Draft Report on Responses to the Questionnaire' (Report, OECD, 2007) <http://www.oecd.org/dataoecd/52/25/39597756.pdf>.

[61] Chris Evans et al, 'Small Business and Tax Compliance Costs: A Cross-Country Study of Managerial Benefits and Tax Concessions' (2014) 12(2) *eJournal of Tax Research* 453.

[62] Phil Lignier and Chris Evans, 'The Rise and Rise of Tax Compliance Costs for the Small Business Sector in Australia' (2012) 27(3) *Australian Tax Forum* 615.

[63] Francis Chittenden, Saleema Kauser and Panikkos Poutziouris, 'Regulatory Burdens of Small Business: A Literature Review' *University of Manchester* (2000) 10.

[64] Christee Atwood, *Succession Planning Basics* (American Society for Training and Development, 2020).

[65] Roland Christensen, 'Management Succession in Small and Growing Businesses' (Report, Division of Research, Harvard Business School, 1953); Robert Brockhaus, 'Family Business Succession: Suggestions for Future Research' (2004) 17(2) *Family Business Review* 165; Jaideep Motwani et al, 'Succession Planning in SMEs: An Empirical Analysis' (2006) 24(5) *International Small Business Journal* 471.

[66] Anna Leon-Guerrero, Joseph McCann III and Jonathan Haley, 'A Study of Practice Utilization in Family Businesses, (1998) 11(2) *Family Business Review* 107.

were 'working' on one.[67] The reluctance to engage in succession planning might be explained by the emotional challenges of the process including: the challenge of facing one's mortality, the need to make emotional choices among family members, the inability of the owner to let go, and the need for change that may be confronting.[68]

Succession planning can be an emotional and a legal issue for SME owners. Special consideration should be given to the business structure of the enterprise and whether the structures are appropriate in facilitating an exit upon the permanent incapacity or death of key individuals. For business owners, costs such as CGT and stamp duty could impact the succession process, in particular the ability to structure the business to continue operating.[69] For instance it has been observed that family trusts can be a legitimate vehicle to circumvent CGT resulting from a succession event.[70]

Overall, these factors may be considered by advisors when recommending a business structure to their SME clients. It is these factors that form part of the evaluation matrix reported in Part IV which is used to evaluate the business structures recommended by professional advisors. There is a paucity of research in Australia about business structure choice, particularly the evaluation of business structures recommended. The following section discusses the findings of related research and explains how this study then builds upon this research to provide unique and deeper insights.

III FINDINGS OF RELATED STUDIES

In a related qualitative study, 48 professional advisors were provided with one of six SME business scenarios, and then were requested to provide their recommendation of a business structure for the scenarios described. With six different businesses (and variations in terms of industry, size, employee numbers etc), themes identified in the business structure advice could demonstrate the key motivations for advisors when recommending a business structure.[71] With these scenarios participants were either given a 'new' or 'established' SME client scenario. That is, with each of these six different businesses, participants could be either given a 'new proposed' business — that is, a business structure had yet to be adopted — or an 'established business' with a business structure already in place.[72] This meant a total of 12 scenarios were developed, with two sets (new or established) of six different SME business operations. The full details of the scenarios are detailed in Appendix A, and a short summary is provided in Table 13.

Through the qualitative analysis of the interviews with these SME advisors some insights were able to be put forward. An initial finding was that SME advisors largely

---

[67] KPMG and Family Business Australia, *KPMG and Family Business Australia Survey of Family Businesses* (Middle Market Advisory: Australia, 2009) 26.
[68] Isabelle Breton-Miller, Danny Miller and Lloyd Steier, 'Toward an Integrative Model of Effective FOB Succession' (2004) 28(4) *Entrepreneurship Theory and Practice* 305.
[69] Parliamentary Joint Committee on Corporations and Financial Services, 'Family Business in Australia — Different and Significant: Why They Shouldn't Be Overlooked' (Report, 2013).
[70] Parliamentary Joint Committee on Corporations and Financial Services (n 69).
[71] Trad et al (n 29).
[72] The detailed reasoning for this difference between new and established business structure is explained elsewhere: Barbara Trad et al, 'Business Structure Selection: A Mixed Methods Approach' *New Zealand Journal of Taxation Law and Policy* (forthcoming).

recommended a combination of business structures for the one enterprise, with only one advisor recommending a company in isolation.[73]

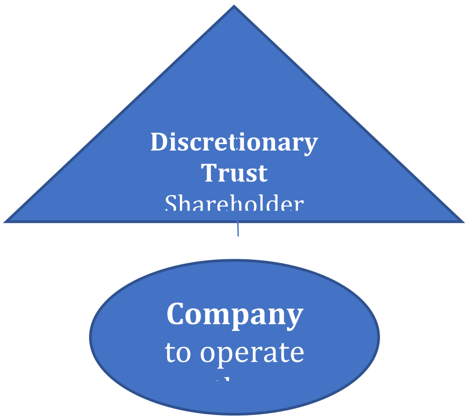
Table 13: SME Scenario overview

SME Scenario	Short overview of business	Established business structure
One	Involved an orthodontic and a dental business that has been operating as one business since 2000, with an annual turnover of $1.97 million, and 10 employees. The business is owned by a couple (an orthodontist and a dentist) who have three adult children. The children are not in receipt of any income. The couple are contemplating selling the business in 10 years' time prior to their retirement.	Family discretionary trust with a company trustee
Two	Involved a web design business with an annual turnover of nearly $1 million, with no employees. The owner is a 53-year-old man who is married to a stay-at-home mother. They have three children over the age of 18. Their children are university students who are not in receipt of any income.	Partnership
Three	Involved an electrical service business, with a turnover of $500, 000 and two employees. The owner is 35 years of age, and his wife is a stay-at-home mother. They have two children under the age of 18.	Sole proprietorship
Four	Was a medium-size business manufacturing human heart valves. Its turnover is $20 million, it has 80 employees, and a patent valued at $10 million. The owner is 45 years old, a heart surgeon, who lives with his partner, and has no children.	Trading company owned by asset-holding company, which is then owned by a family discretionary trust
Five	Was a small business with an annual turnover of $2.6 million, with 12 employees. The business involves importing and selling furniture. The owner is 60 years old, married, with two adult children. There is a potential for a divorce in the future.	Family discretionary trust
Six	Was a small bridal gown business, with an annual turnover of $6.1 million, and 25 employees. The owner is 55 years old, female, and single.	Company

In terms of the most frequently recommended structure it was a trading company with shares held by a discretionary trust (recommended by 62.5% (30) of participants); which can be referred to as a 'trading company with holding trust': Figure 3. A trading company with holding trust was largely recommended in SME Scenarios One, Three, Five and Six.[74]

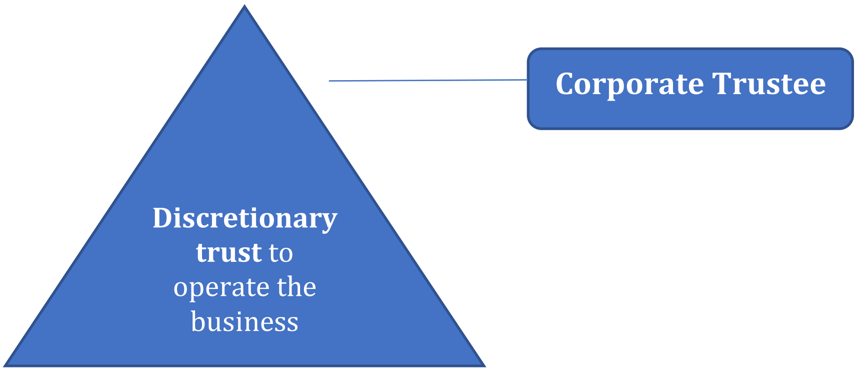
[73] Trad et al (n 29).
[74] For a more detailed discussion of the recommendations see ibid.

Figure 3: Trading company with holding trust



The second most recommended business structure was a trading discretionary trust with a corporate trustee; whereby the discretionary trust operates the business: Figure 4. This is referred to as a 'trading trust' in this article. A trading trust was recommended by 21% (10) of participants, and was recommended more in SME Scenarios One and Two, and occasionally in SME Scenarios Three, Four and Six.[75]

Figure 4: Trading Trust



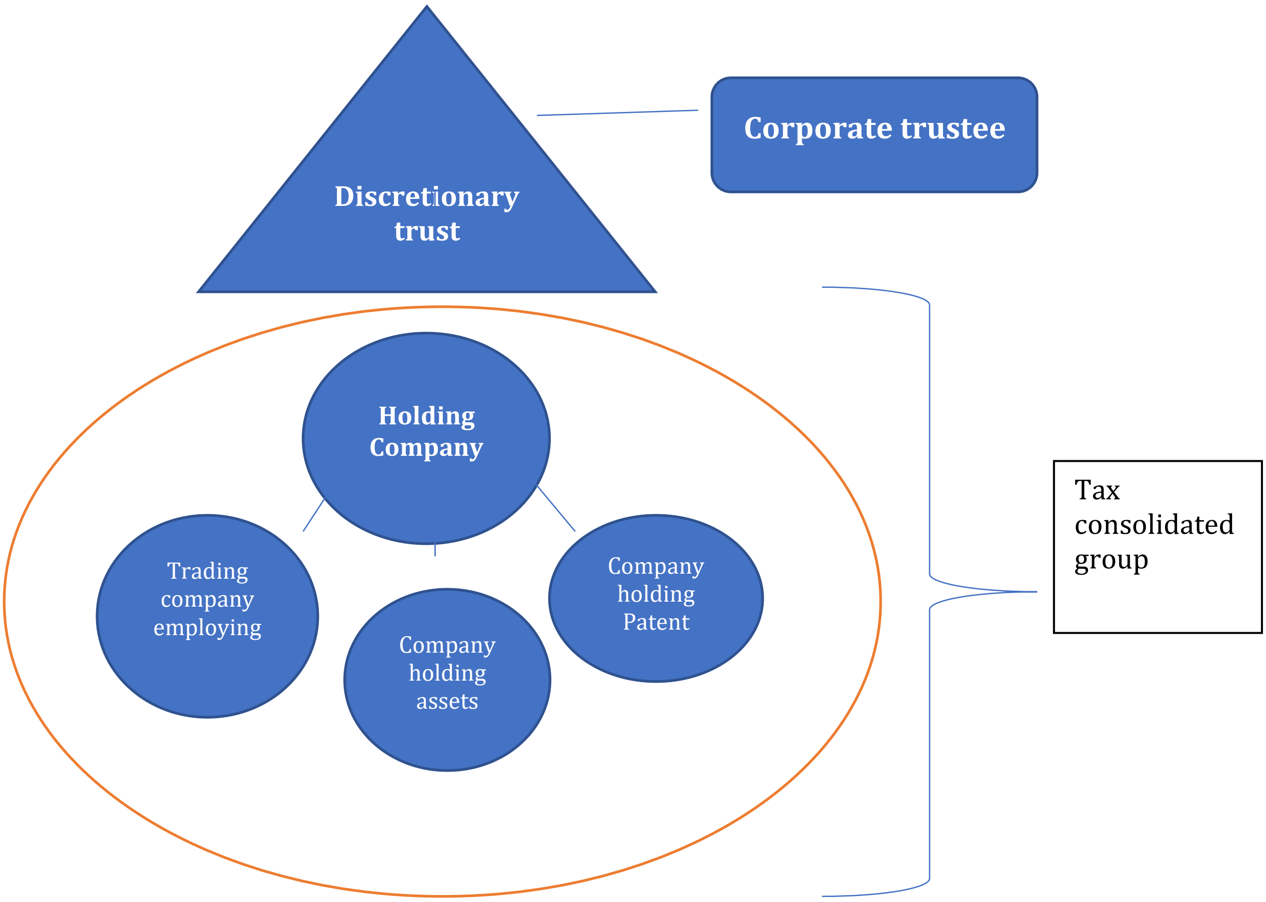
The third most recommended structure was a tax consolidated group with the shares held by a discretionary trust, referred to as 'tax consolidated group' in this article. Such a tax consolidated group was recommended by 14.5% (7) of participants and is illustrated in

Figure 5.[76] This tax consolidated group was mostly recommended for SME Scenario Four. This appeared to be influenced by the factual circumstances provided in Scenario Four, particularly the high-risk industry of heart valves, the value of intellectual property and the larger size of the business.

---

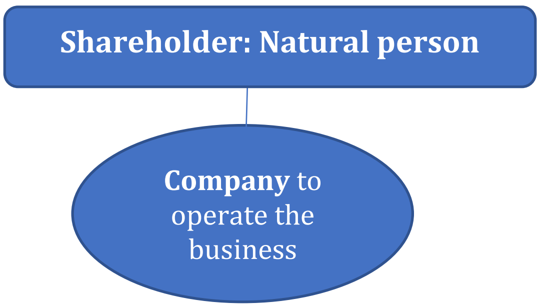
[75] For a more detailed discussion of the exact recommendations see: Trad et al (n 29).
[76] Just 2% recommended a single structure being a company.

Figure 5: Tax consolidated group



The fourth structure recommended was a trading company with shares held by an individual: Figure 6. This is referred to as a 'trading company' in this article and was only recommended by one advisor in relation to SME Scenario Six.

Figure 6: Company



The next stage of the research was a qualitative analysis of the interviews to explore the underlying reasons for business structure recommendations.[77] Through an analysis of the interview data a frequency table of factor mentions was created:

Table 14:[78] Frequency of factors for recommended business structure

Frequency band	Factors for recommended business structure
High Frequency (75%–100%)	• tax minimisation/tax rate, • complexity and compliance costs, • asset protection, • separation of assets from business risk, • income splitting/flexibility in distribution, • the requirement for working capital/ability to retain profits, and • small business concessions
Medium frequency (50%–75%)	• succession planning/exiting the business, • limited liability, and • industry
Low frequency (>50%)	• trends in structure over time and • superannuation

The factors that were mentioned on a 'high frequency', based on participant responses in the range of 75%–100%, were tax minimisation/tax rate, complexity and compliance costs, asset protection, separation of assets from business risk, income splitting/flexibility in distribution, the requirement for working capital/ability to retain profits, and small business concessions.[79] The medium frequency (50%–75%) factors were related to succession planning/exiting the business, limited liability, and industry. The low frequency (>50%) factors were trends in structure over time and superannuation.[80]

This prior analysis provides an initial understanding of what the advisors were trying to achieve with their recommended structures. However, qualitative analysis can have its limitations, so it was seen as important in terms of research validity to complement and triangulate this data with a survey. This survey tool allows us to consider to what extent

[77] Barbara Trad et al, 'Reasons behind SME Advisor Business Structure Recommendations' *Australian Tax Forum* (forthcoming).
[78] Ibid*.*
[79] Ibid*.*
[80] Ibid*.*

the advisors' motivations are consistent with attributes that prior research demonstrates as important factors for SMEs.

This article extends on these previous qualitative studies by testing the observed factors with quantitative measures. Advisors were asked to evaluate their recommended structure via a matrix of factors that prior research has indicated as important for SMEs. The survey research reported in this article provides important quantitative evidence about the recommended structures, including additional insights about recommended business structures that may be too focused on tax outcomes, resulting in a structure that is disadvantageous in respect of other factors.

Given that four structures were recommended by the advisors (see above) it is these four business structures that are analysed. By having advisors evaluate their recommended structures against a matrix of factors this may identify important differences between the structures not previously illuminated through the qualitative analysis, as well as demonstrate the perceived strengths and weaknesses of the recommended structures. The research methodology of this unique stage of this study is discussed in the next section.

IV RESEARCH METHODOLOGY

The research reported to date is based largely on the qualitative analysis of the interviews with the professional advisors when they considered one of the 12 SME business scenarios (Appendix A). Each scenario was considered by four participant advisors; for example, for Scenario One (an orthodontic business), four participant advisors considered the 'new' business, and four considered the 'established' business. With these four repetitions of each case study, 48 SME advisors were required. After receiving one of the allocated scenarios each advisor was interviewed approximately one week later to discuss the business structure they would recommend to the SME business.

Relevant to this article is that, in addition to the interviews, a short survey was administrated at the end of the interview. The survey was designed to complement the qualitative study and to triangulate the data.[81] Short surveys have been used in tax research. For example, Maciejovsky et al used short surveys to investigate how emotions affect tax ethics for SMEs;[82] and Wenzel used short surveys to evaluate an intervention to increase taxpayers' compliance.[83] The survey was completed by participants at the end of each interview, and participants were asked to evaluate their recommended structure in relation to the matrix of 23 listed factors. The advisors were asked to evaluate the factors on a Likert scale in terms of the question: *'On a scale of 1 to 10 (1 low/bad, 10 high/good) given your recommended structure what do you think it [the recommended structure] means for …'*.[84]

[81] Kathleen Eisenhardt, 'Building Theories from Case Study Research' (1989) 14(4) *Academy of Management Review* 532.

[82] Boris Maciejovsky, Herbert Schwarzenberger and Erich Kirchler, 'Rationality Versus Emotions: The Case of Tax Ethics and Compliance' (2012) 109(3) *Journal of Business Ethics* 339.

[83] Michael Wenzel, 'Misperceptions of Social Norms about Tax Compliance (2): A Field Experiment' (Working Paper no 8, Centre for Tax System Integrity, 2019).

[84] Scale was 1 to 10, with 10 being high/good and 1 being low/bad.

These 23 factors that formed the evaluation matrix were drawn from the existing literature (much of which was discussed in the earlier part of the article)[85] and the previous research about business structure choice.[86] While it is acknowledged that assessing the factors as low/bad to high/good is difficult, it was thought that the professional advisors through their experience could be able to assess this. Note that most participants had many years of industry experience (88% had over 10 years' experience: Table 16), which provides a level of comfort in their ability to evaluate. It was considered that having a comprehensive matrix of factors would allow a more nuanced evaluation of the recommended structure. This would include prompting advisors to consider factors that they may not have raised in the interviews and/or been conscientiously aware of. For example, past research has focussed on questions about 'tax benefits/savings'[87] motivating business structure choice. However, subsequent research has demonstrated that 'tax' is multi-faceted, so to allow for a more nuanced understanding of tax the survey contained nine factors that related to tax (such as: 'income splitting', 'retaining income at a lower tax rate', 'small business tax concessions' and 'access to research and development concessions').[88] By having this level of granularity, the survey instrument allowed for a more sophisticated understanding of how different business structures do or do not achieve the various tax attributes. Table 15 sets out the matrix of factors used to evaluate the recommended business structure. The evaluation matrix includes tax and non-tax attributes, as well as three overall arching themes of:

'Overall client satisfaction';
'Client understanding of the structure'; and
'Overall, an effective business structure for client'.

The surveys were conducted between August 2020 and March 2021. Ethical clearance for the research was obtained and included such caveats as anonymity and the ability of participants to withdraw at any time.[89]

---

[85] Andrew Hicks, Robert Drury and Jeff Smallcombe, 'Alternative Company Structures for the Small Business' in *ACCA Research Report No 42* (Certified Accountants Educational Trust, 1995); Judith Freedman and Michael Godwin, 'Incorporating the Micro Business: Perceptions and Misperceptions' in A Hughes and D Storey (eds), *Finance and the Small Firm* (Routledge, 1994); Freudenberg (n 4); Giles Hertz, Fred Beasley and Rebecca White, 'Selecting a Legal Structure: Revisiting the strategic issues and views of small and micro business owners' (2009) 20(1) *Journal of Small Business Strategy* 101; Gregory A Porcaro, 'The Choice-of-Entity Maze (2007) 203(3) *Journal of Accountancy* 64; Rajendra Khandekar and John Young, 'Selecting a Legal Structure: A Strategic Decision' (1985) 23(1) *Journal of Small Business Management* 47 and Trad and Freudenberg (n 3).
[86] Trad et al (n 28).
[87] Brian Johns, Winston Dunlop and William Sheehan, *Taxation and the Small Firm in Australia: A Report to the Taxation Review Committee*, (University of Newcastle, 1974), 78: 'tax reason'; Freudenberg (n 4).
[88] Trad et al (n 28).
[89] Full Research Ethics Clearance: GU Ref No: 2020/555.

Table 15: Evaluation matrix of factors to assess recommended business structure

On a scale of 1 to 10 (1 low/bad, 10 high/good) given your recommended structure what do you think it means for …:	Scale of 1 to 10 (1 low/bad, 10 high/good)
Overall client satisfaction	
Client understanding of the structure	
Overall, an effective business structure for client	
Simplicity	
Regulatory compliance cost (non-tax)	
Tax compliance cost	
Good tax rate	
Asset protection	
Limited liability	
Flow-through of tax concessions	
Income splitting (Flexibility in distributions)	
Providing for family members	
Small business CGT concessions – Div 152	
CGT discount	
Small business tax concessions (non-CGT)	
Retaining income at a lower tax rate	
Succession planning (exiting)	
Raising equity	
Control for owner	
Overseas business operations	
Business expansion in Australia	
Utilisation of tax losses	
Access to research and development concessions	

Data obtained from the survey were analysed in Excel which was then used to generate averages, tables and graphs to illustrate the findings. Graphs were used to illustrate the highest and the lowest averages for each of the recommended combinations of business structures; then, these factors were compared amongst the different recommended structures using tables.

A *Participants*

This research involved 48 professional advisors (accountants or lawyers) who advise and engage with SMEs. Criteria for selecting the participants included that they must be knowledgeable with the SME sector, have at least five years' experience, and be aware of the issues that challenge SME businesses. To recruit participants, convenience and snowballing sampling were used. The convenience sampling involved the professional and personal contacts of the research team being contacted by email and LinkedIn. Snowball sampling describes that these initial contacts being encouraged to share the invitation to participate in the research with their own networks. Participants were also recruited by contacting representatives of professional bodies for potential participants. There was also a mass email distribution seeking potential participants sent to various accounting and law firms using their website contacts.

An overview of each participant's current profession, number of years in their profession, the state where they lived, current position, clients' business size, frequency of advice per year, and area of practice is presented in Table 16. The participants consisted of 29 accountants, 15 lawyers, two tax advisors and two business consultants. Thirty three of the 48 participants had over 15 years' experience in their profession, nine participants had 10 to 15 years of experience, and six participants had five to 10 years of experience. There were 31 advisors (65% of participants) who lived in Queensland, and five participants from each of Victoria, New South Wales, and Western Australia. Of the remaining participants, one was from Tasmania, and one from South Australia.

Participants indicated that they engage with a range of business sizes. Four participants indicated that their clients include micro-to-medium size businesses ($500,000–<$100m), nine participants indicated that their clients are micro-businesses ($500,000–<$2m), one participant services micro to small businesses ($500,000–<$5m 17 participants service small businesses ($2m–<$5m), two participants service small to medium businesses ($2m–<$100m), and 15 participants indicated that they provide services to medium businesses ($10m –<$100m). When the participants were asked how regularly they provide business structure advice per year, the majority (27 participants) commented that they provide advice more than 20 times a year, 4 participants give advice 11 to 20 times, 6 participants give advice 6 to 10 times, 6 participants advise 2 to 5 times, and 5 participants give advice once a year. Over three-quarters of those participants (78%) who reported giving advice more than 20 times a year advised SMEs. Overall, it is argued the demographics of SME advisors gives assurance as to the wealth of experience and expertise of the participants to evaluate their recommended business structures against the matrix of factors.

Table 16: Demographics of SME advisors

Code	Scenario	Occupation	Advisor Years	State	Current position	Clients' business size ($)	Freq of advice /year	Area of practice
1	One est.	Accountant	>15	Victoria	Partner/Principal	10m–<100m	>20	Specialist tax consultant
2	One est.	Accountant	>15	Queensland	Partner	500,000–<2m	2–5	Taxation and business advisory services
3	One new	Accountant	10–15	Queensland	Director	500,000–<2m	>20	Tax advice
4	One new	Lawyer	>15	Victoria	Partner/Principal	10m–<100m	6–10	Privately taxation and succession
5	Two est.	Lawyer	>15	Queensland	Principal	2m–<5m	1	Tax advice/tax disputes
6	Two est.	Accountant	>15	Queensland	Partner	10m–<100m	>20	Income tax, FBT and superannuation
7	Two new	Lawyer	>15	Queensland	Partner	10m– <100m	>20	Tax restructuring
8	Two new	Lawyer	>15	Queensland	Partner	5m–<10m	11–20	Commercial transaction
9	Three est.	Accountant	>15	Queensland	Partner	10m– <100m	>20	Corporate tax
10	Three est.	Lawyer	10–15	Queensland	Partner	500,000–<2m	>20	Commercial litigation and insolvency
11	Three new	Accountant	>15	Queensland	Principal	500,000–<2m	>20	Specialist tax advisor
12	Three new	Accountant	>15	Queensland	Partner	2m–<5m	>20	Business and taxation advisor
13	Four est.	Accountant	10–15	Queensland	Partner	10m–<100m	6–10	Tax advisor
14	Four est.	Accountant	5–10	Queensland	Senior	500,000–<2m	2–5	Accounting for small businesses
15	Four new	Accountant	>15	Queensland	Principal	10m–<100m	>20	SME structuring
16	Four new	Accountant	>15	Queensland	Partner	10m–<100m	>20	Corporate and international tax
17	Five est.	Lawyer	>15	Queensland	Partner	10m–<100m	>20	Taxation and restructuring of SMEs
18	Five est.	Accountant	>15	Queensland	Partner	500,000–<100m	>20	SME tax advisor
19	Five new	Accountant	>15	Queensland	Partner	10m–<100m	6–10	Business advice tax strategy
20	Five new	Accountant	>15	Queensland	Partner	2m–<5m	2–5	Tax advisor
21	Six est.	Lawyer	10–15	Western Aust.	Partner	5m–<10m	>20	Tax lawyer
22	Six est.	Accountant	5–10	Queensland	Senior	5m–<10m	1	Tax and business advisory
23	Six new	Lawyer	>15	Queensland	Partner	5m–<10m	>20	Tax advisory, structuring, commercial
24	Six new	Accountant	10–15	Western Aust.	Principal	500,000–<5m	2–5	Tax and business advisor
25	One est.	Lawyer	>15	Qld (all states)	Sole Practitioner	2m–<5m	>20	Family/SME business structuring
26	One est.	Tax advisor	5–10	Western Aust.	Manager	5m–<10m	11–20	Tax consulting on transactions
27	One new	Accountant	>15	Victoria	Partner	500 k to <100m	1	Accounting and taxation
28	One new	Accountant	>15	Victoria	Partner	10m–<100m	>20	Tax technical area
29	Two est.	Lawyer	>15	NSW	Special Counsel	10m–<100m	>20	Taxation and Superannuation
30	Two est.	Lawyer	>15	NSW	Partner	10m–<100m	6–10	Corporate taxation (including disputes)
31	Two new	Accountant	>15	Queensland	Director	500,000–<2m	>20	Taxation and financial statements
32	Two new	Accountant	>15	Queensland	Partner	500,000–<2m	>20	Taxation and small business advisory
33	Three est.	Accountant	5–10	Queensland	Manager	500,000–<100m	2–5	Business service and tax
34	Three est.	Accountant	>15	Tasmania	Sole Practitioner	500,000–<2m	2–5	Small business tax
35	Three new	Lawyer	>15	Western Aust.	Principal	2m–<5m	6–10	Succession planning

36	Three new	Lawyer	>15	Queensland	Principal Director	5m–<100m	>20	Tax specialist
37	Four est.	Advisor	10–15	South Australia	Sub-contractor	2m–<5m	1	Business effectiveness and marketing
38	Four est.	Accountant	10–15	Victoria	Manager	2m–<5m	>20	Tax advice
39	Four new	Lawyer	>15	Queensland	Partner	5m–<10m	>20	Wholistic estate and succession planning
40	Four new	Lawyer	>15	Queensland	Partner	10m–<100m	11–20	Legal structuring, tax, asset protection
41	Five est.	Accountant	>15	NSW	Partner	2m–<100m	6–10	Business structures and cost cutting
42	Five est.	Accountant	10–15	Queensland	Partner	500,000–<2m	>20	SME strategy, risk and governance
43	Five new	Accountant	>15	Western Aust.	Partner	5m–<10m	>20	Tax and accounting consultant
44	Five new	Accountant	5–10	NSW	Manager	500,000–<100m	11–20	Income tax for private clients
45	Six est.	Consultant	5–10	Queensland	Self-employed	2m–<5m	1	Domestic and international tax
46	Six est.	Accountant	>15	Queensland	Manager	2m–<5m	>20	Tax and business advisory
47	Six new	Consultant	>15	Queensland	Consultant	5m–<10m	>20	Consulting services to CFOs
48	Six new	Accountant	10–15	NSW	Manager	10m–<100m	>20	Income tax specialist

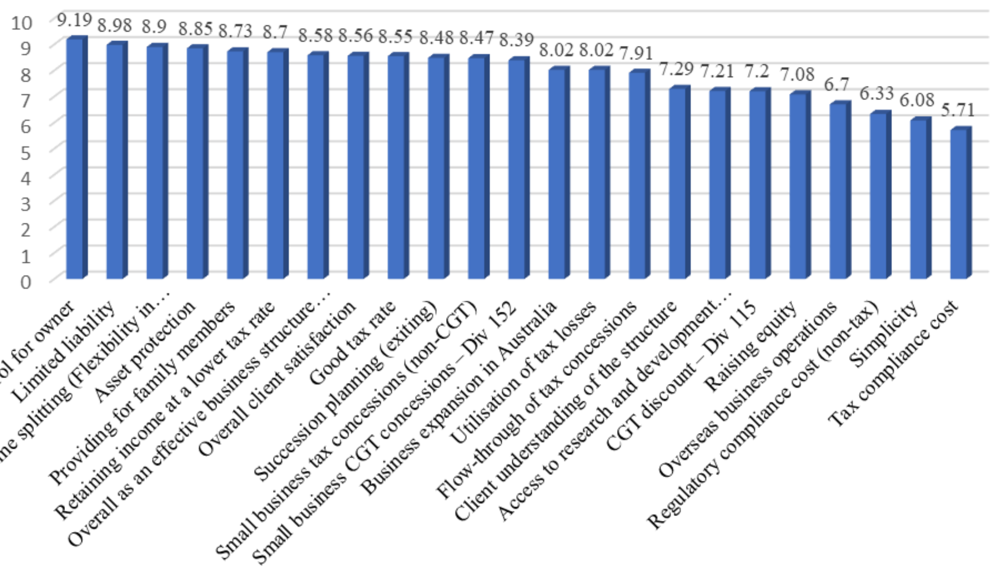
V RESULTS

This section of the article presents analysis of the data obtained from the survey questions. It first presents the evaluation of the factors for all scenarios and is then followed by a discussion about each of the four main recommended structures.[1]

A *Factors for All Scenarios*

When considering all the scenarios in aggregate the overall results of the weighted average[2] as evaluated by advisors in terms of *their recommended structure what they think it [the recommended structure] means for …* is illustrated in Figure 7 with the factors ranked from highest to lowest.

Figure 7: Evaluation of structure advice: All scenarios



[Results of advisor survey in response to the question 'On a scale of 1 to 10 (1 low/bad, 10 high/good) given your recommended structure what do you think it *[the recommended structure]* means for …']

The highest five factors (in descending order) are: 'control for owner' (9.19), 'limited liability' (8.98), 'income splitting/flexibility in distributions' (8.9), 'asset protection' (8.85), and 'providing for family members' (8.73). According to the survey, 'control for the owner' appears to be an important attribute; an insight from the survey that was not discussed in the qualitative interviews.[3] While absent in the interviews other research confirms that the notion of 'control' is an important factor for SMEs,[4] particularly those

[1] Preliminary analysis was conducted in relation to the 'new' and 'established' business scenarios; however, this analysis did not provide any specific insights. It was decided not to include this analysis in the article.
[2] A weighted average method was used with 'low/bad' taking the value of '1', and 'high/good' taking the value of '10'.
[3] Trad et al (n 77).
[4] Freedman and Godwin (n 85) 111.

not publicly listed. It appears that advisors considered that their recommended structure would facilitate owner control but did not articulate this in their discussion, perhaps as they thought it was so fundamental to the business structure that it went without saying. Next the related notions of 'limited liability' and 'asset protection' are both ranked in the highest five, and this reinforces other research which indicates that the ability to protect personal and business assets is an important characteristic of a recommended structure.[5] The tax concept of 'income splitting/flexibility in distributions' rates highly, as does the related notion of 'retaining income at a lower level' (6^{th}: 8.7). The prominence of 'income splitting/flexibility in distributions' could explain why discretionary trusts featured prominently in 99% of the business structures recommended, as the wide discretion that a trustee has with a discretionary trust is widely recognised.[6]

In terms of the three overarching themes, in aggregate, advisors considered their recommended structure was 'overall as an effective business structure for client' (8.58), with high 'overall client satisfaction' (8.56); although lower was 'client understanding of the structure' (7.29). This lower client understanding could be related to the fact that in most instances the recommended business structure involved a combination of structures, which poses additional regulatory and tax complexity. The result is a clear acknowledgement that their SMEs clients may struggle to understand the combination of business structures recommended. This might be due to the client needing to understand two bodies of laws and/or regulations applying to the different structures, as well as the interaction between these rules. This is supported by the fact that the three lowest ranked factors by advisors are 'tax compliance cost' (5.71), 'simplicity' (6.08) and 'regulatory compliance cost (non-tax)' (6.33). Two other low-ranking factors were 'overseas business operations' (6.7) and 'raising equity' (7.08). Apart from 'control for owner', these survey results are largely consistent with the analysis of the qualitative data from the SME advisor interviews, which provides some assurance as to the integrity of the findings.[7]

Given that there were four major types of business structures recommended, a relevant question is – do the evaluations differ according to the type of business structure(s) recommended for SMEs? As discussed above, the recommended structures are a trading company with holding trust, a trading trust with a corporate trustee, a tax consolidated group with holding trust, and a trading company. Each of these structures are discussed below in terms of the advisors' evaluations.

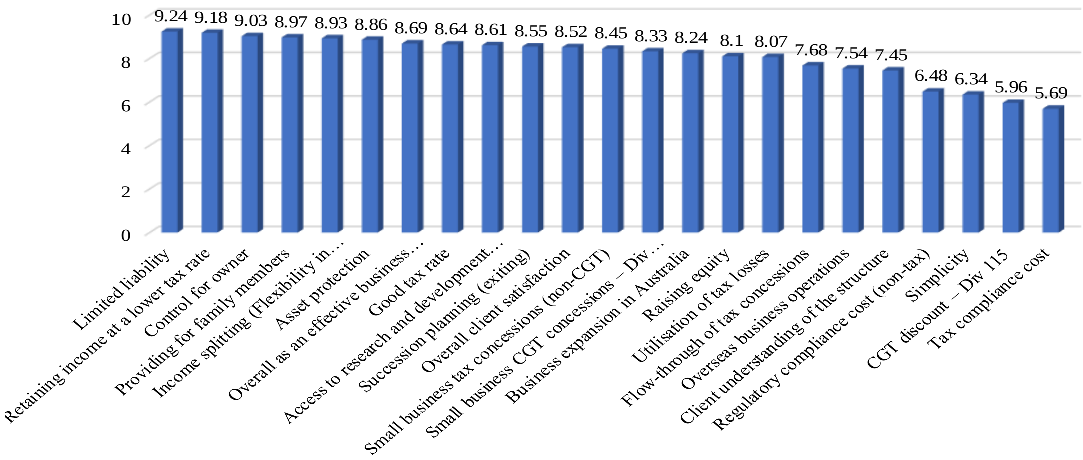
B *Highest Five Factors for a Trading Company with Holding Trust*

As discussed previously, the most frequently recommended structure was a trading company with holding discretionary trust. When considering advisors who recommended this structure, the highest five ranked factors are: 'limited liability' (9.24), 'retaining income at a lower tax rate' (9.18), 'control for owner' (9.03), 'providing for family members' (8.97), and 'income splitting/flexibility in distributions' (8.93). The

[5] Freudenberg (n 4).
[6] Brett Freudenberg and Bradley T Borden, 'Contribution and Distribution Flexibility and Tax Pass-Through Entities' (2019) 23(1) *Florida Tax Review* 349.
[7] Trad et al (n 77) and Trad et al (n 72).

lowest ranked five factors consist of: 'tax compliance cost' (5.69), 'CGT discount – Division 115' (5.96), 'simplicity' (6.34), 'regulatory compliance cost (non-tax)' (6.48), and 'client understanding of the structure' (7.45). Figure 8 illustrates the evaluation of all 23 factors for a trading company with holding trust from highest to lowest.

Figure 8: Evaluation of structure advice: Trading company with holding trust



[Results of advisor survey in response to the question 'On a scale of 1 to 10 (1 low/bad, 10 high/good) given your recommended structure what do you think it *[the recommended structure]* means for …']

In terms of the three overarching themes, when compared to 'all scenarios' the weighted average for advisors recommending the 'trading company with holding trust' produced a similar result in terms of being 'an effective business structure' (8.69 *cf* 8.58) and 'overall client satisfaction' (8.52 *cf* 8.56). However, the 'client understanding of structure' is slightly higher (7.45 *cf* 7.29). Also, advisors appear more assured that there will be better 'limited liability' protection offered by a trading company with holding trust (9.24 *cf* 9.19), as well as 'retaining income at a lower rate' (9.18 *cf* 8.7), although 'control for the owner' is slightly lower (9.03 cf 9.19). Given that a company can meet both related objectives (limited liability and a low tax rate), it infers from the findings that perhaps there could be additional advantages offered by a holding trust that could justify the advisors' recommendations. It appears that the primary reasons for such combination are for the tax benefit obtained from the low corporate tax rate, and then the ability to stream and income split the dividends and franking credits (through the discretionary trust) to the beneficiaries.[8]

C *Highest Five Factors for a Trading Trust with Corporate Trustee*

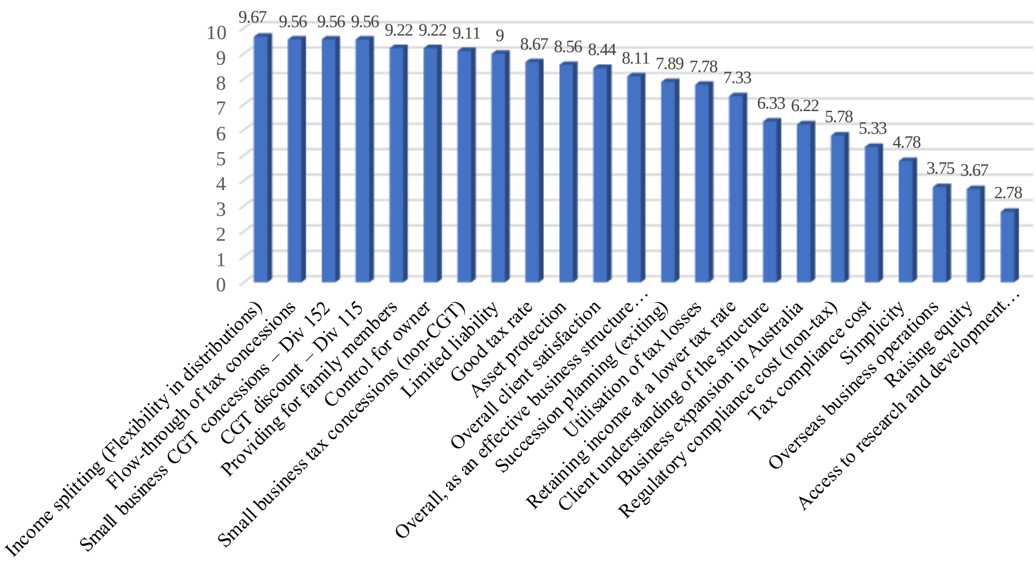
The second most frequently recommended business structure was a trading trust (with a corporate trustee) (recommended by 21% of participants). When considering advisors who recommended this structure, the highest five ranked factors are: 'income

[8] Trad et al (n 77).

splitting/flexibility in distributions' (9.67), 'flow-through of tax concessions' (9.56), 'small business CGT concessions – Division 152' (9.56), 'CGT discount – Division 115' (9.56), 'providing for family members' (9.22) and 'control for owner' (9.22).[9] The lowest five factors are: 'access to R&D tax incentive' (2.78), 'raising equity' (3.67), 'overseas business operations' (3.75), 'simplicity' (4.78), and 'tax compliance cost' (5.33). Figure 9 illustrates the results from highest to lowest of all 23 factors for the trading trust with corporate trustee.

For the three overarching themes, when compared to 'all scenarios', the weighted average for advisors recommending the trading trust is lower as an 'effective business structure' (8.11 *cf* 8.58), as is the 'overall client satisfaction' (8.44 *cf* 8.56). The 'client understanding of structure' is also lower (6.33 *cf* 7.29). This would seem to suggest clients will struggle to understand the trading trust, which could then lead to unintentional non-compliance. This may be attributed to the complex case law that applies to trusts, whereas statute (*Corporations Act 2001 (Cth)*) is the primary source of law for companies. Additionally, the interaction of the tax laws (including tax integrity measures) can complicate matters further for a trading trust. However, advisors appear more assured that a trading trust will offer better tax outcomes in terms of 'income splitting' (9.67 *cf* 8.93), as well as 'flow-through of tax concessions' (9.56 *cf* 7.91), and access to important CGT concessions such as 'small business CGT concessions – Div 152 (9.56 *cf* 8.39) and CGT Discount – Div 115 (9.56 *cf* 7.2), although control for the owner is similar (9.22 *cf* 9.19).

Figure 9: Evaluation of structure advice: Trading trust with corporate trustee



[Results of advisor survey in response to the question 'On a scale of 1 to 10 (1 low/bad, 10 high/good) given your recommended structure what do you think it *[the recommended structure]* means for …']

[9] Note there are more than five factors listed due to there being the same weighting for some factors.

The results provide evidence that the use of discretionary trusts could be due, in part, to advantageous tax treatments. Discretionary trusts may offer favourable attributes to SMEs which are not available in other alternative business structures. These attributes, which motivated SME advisors to recommend a discretionary trust within a combination of structures, included tax benefits (income splitting/flexibility of distribution of income, flow-through of tax concessions, small business CGT concessions, and access to the 50% CGT discount) together with non-tax attribute of control for owner.[10]

D *Comparison between Trading Company with Holding Trust and Trading Trust with Corporate Trustee*

The advisors' weighted evaluations reveal key differences between the two most recommended structures: trading company with holding trust, and the trading trust with corporate trustee.

'Overall client satisfaction' is slightly higher for the trading company with holding trust compared to the trading trust (8.52 *cf* 8.44), as is 'overall an effective business structure' (8.69 *cf* 8.11). It appears also that advisors consider the trading company with holding trust will have greater 'client understanding' compared to the trading trust (7.45 *cf* 6.33). It could be due to these perceived advantages that more advisors recommended the trading company with holding trust (62.5% of participants).

Another observation is that the evaluations of factors for the trading trust is slightly more skewed (both positively and negatively) compared to the trading company with holding trust. For the trading trust, there are higher weighted average evaluations at the positive end (more averages over 9.5 where the trading company with holding trust has none at this level). However, at the other end of the scale, the trading trust has more averages at the lower end (averages lower than 5.5 whereas trading company with holding trust has none at this level). Overall, the trading company with holding trust has weighted averages with a tighter distribution (closer band). This could indicate there are more extreme positive and negative attributes of the trading trust. That is there are some great advantages, but there are also some severe disadvantages that are experienced with a trading trust.

In terms of the five highest evaluated factors for the trading trust, 'income splitting/flexibility in distributions' is the highest. This result is consistent with the legal principle that a discretionary trust provides the trustee with greater discretion in terms of amount and type of income distributed to beneficiaries, than the director of a company with a holding trust as shareholder (9.67 *cf* 8.93). The next three highest evaluations of the trading trust with corporate trustee relate to tax concessions, which are all higher than that achieved through a trading company with holding trust, being: 'flow-through of tax concessions' (9.56 *cf* 7.68), 'small business CGT' (9.56 *cf* 8.33), and 'CGT discount' (9.56 *cf* 5.96). This clearly demonstrates that a trading trust, as perceived by advisors, has a greater advantage in relation to these generous tax concessions. Such evaluations would also re-enforce concerns that the use of discretionary trusts, especially as a trading

[10] Trad et al (n 77).

trust, appears to be tax driven.[11] The fifth highest factor is 'providing for family members' which is also highly ranked for the trading company with holding trust (9.22 *cf* 8.97).

From the five highest evaluations for the trading company with holding trust, the weighted evaluations are similar for three factors when compared to the trading trust: 'limited liability' (9.24 *cf* 9); 'control for the owner' (9.03 *cf* 9.22); 'provide for family members' (8.97 *cf* 9.22). However, the trading company with holding trust is lower than trading trusts in relation to 'income splitting/flexibility in distributions' (8.93 *cf* 9.67). Conversely, there is a clear perceived advantage of the trading company with holding trust in 'retaining income at a lower rate' compared to the trading trust (9.18 *cf* 7.33). It is this feature that may explain why trading company with holding trust was the most frequently recommended structure by SME advisors in the qualitative study.[12] As discussed previously, access to finance can be an issue for SMEs. It appears that the trading company with holding trust minimises the concerns around Division 7A and facilitates access to finance through the retention of income by the trading company at the company tax rate.[13]

When considering the low-evaluated factors, some clear observations can also be made. The five lowest evaluated factors for the trading trust with a corporate trustee are all lower than the weighted average equivalent for the trading company with holding trust, with the lowest factor being 'access to research and development' (2.78 *cf* 8.61). This result is consistent with legislation around research and development concessions, which are only available to companies and not other business structures.[14] Similarly, 'raising equity' (3.67 *cf* 8.1) and 'overseas business operations' (3.75 *cf* 7.54) rate lower for the trading trust. This result is consistent with observations made in the qualitative study of SME advisors, namely that discretionary trusts cannot issue membership rights (such as shares) to raise equity, and that trading trusts are not well understood in overseas jurisdictions which can lead to reluctance for overseas parties to deal with them.[15] Even for the two lowest evaluated factors for both structures, the trading trust is ranked lower than the trading company with holding trust: 'simplicity' (4.78 *cf* 6.34) and 'tax compliance costs' (5.33 *cf* 5.69). Clearly both combinations of business structures are perceived by advisors not to be simple and can lead to greater tax compliance costs, but more so for the trading trust.

In addition to the two factors discussed above ('simplicity' and 'tax compliance costs') the other three lowest evaluated factors for the trading company with holding trust are 'CGT discount' (5.96 *cf* 9.56), 'regulatory compliance cost' (6.48 *cf* 5.78) and 'client understanding' (7.45 *cf* 6.33). In particular, the trading company with holding trust is

---

[11] Dale Boccabella, 'Family Trusts often Cause more Harm than Good' *The Conversation* (Blog Post, 26 July 2017) <https://theconversation.com/family-trusts-often-cause-more-harm-than-good-81551>. Compared to $1.2 billion (no indication on the year of the study) in Australian Taxation Office, 'Current Issues with Trusts and the Tax System — Focusing on Trusts Used to Deliberately Avoid Tax' (Taskforce Report, January 2019).
[12] Trad et al (n 29).
[13] Trad et al (n 77).
[14] *ITAA 1997* s 355-210.
[15] Trad et al (n 77).

perceived as not advantageous in terms of accessing the CGT discount, whereas the trading trust ranked much higher (5.96 *cf* 9.56). This provides further evidence as to how the trading trust is seen as having greater ability to access generous tax concessions, which is due to eligibility for the concessions, combined with the conduit nature of trusts.

The above comparisons of the weighted average of the evaluations provide some candid insights into the advantages and disadvantages between these two combinations of business structures and gives some indication of when they are likely to be more appropriate for the SME client. Additionally, there is triangulation of the data from the survey research with the qualitative data, being the interviews with SME advisors about their recommended business structures, giving some greater validation and insights to the findings.[16]

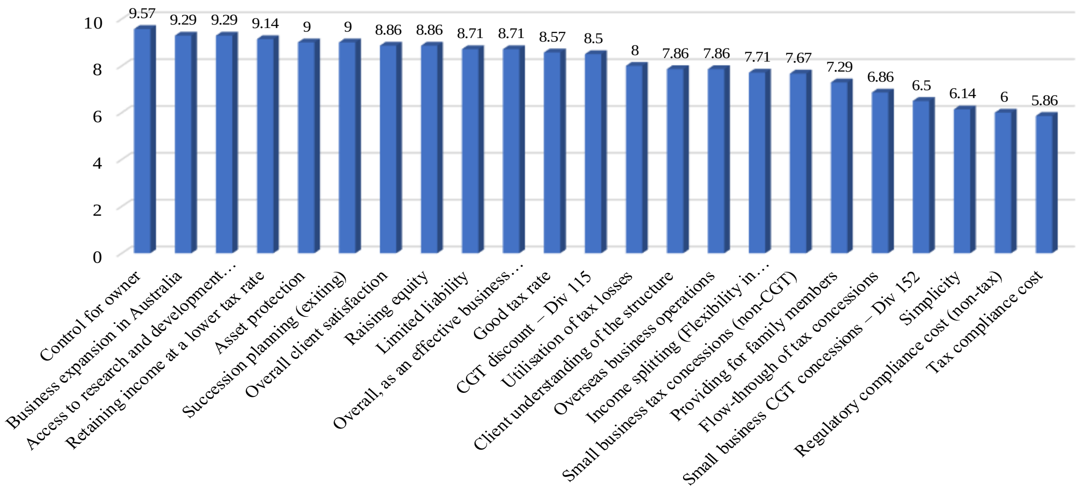
E *Highest Five Factors for a Tax Consolidated Group with Holding Trust*

While the tax consolidated group with holding discretionary trust was the third most recommended structure it related mostly to the client circumstance in SME Scenario Four, when it was recommended by 75% (6 out of the 8) of the advisors who considered that scenario. Otherwise, the tax consolidated group was only recommended once in the other SME scenarios.[17] Given the scale of the business, value of intellectual property and overseas expansion, advisors in SME Scenario Four recommended what they considered to be a more sophisticated structure of the tax consolidated group, with the shares in the holding company held by a discretionary trust. The sophistication included separate companies being set-up to: (a) employ staff and operate the business, (b) hold real property of the business, (c) hold the patent.

The evaluations of factors for this type of business structure provides some insights into the perceived advantages and disadvantages of a tax consolidated group. 'Overall client satisfaction' is 8.86 (which is slightly higher than for the trading company with holding trust (8.52) and trading trust (8.44)). The factor 'overall as an effective business structure' is also higher (8.71) than the other two structures (8.69; 8.11). Advisors appear to consider that the tax consolidated group will have greater 'client understanding' (7.86) compared to the trading company with holding trust (7.45) and trading trust (6.33). Figure 8 illustrates the evaluation results of the factors from highest to lowest for the tax consolidated group with holding trust. Overall, this would suggest that such a tax consolidated group could be a highly effective business structure for SMEs. Given that tax consolidation groups were not more broadly recommended by SME advisors for all of the scenarios it may be that advisors only recommend this business structure to more larger businesses with valuable assets, operating in a risky industry with significant international trade.[18]

[16] Ibid and Trad et al (n 72).
[17] Trad et al (n 29).
[18] Many of the other scenarios involved enterprises with a lower turnover and/or greater reliance on domestic trade. See Appendix A.

Figure 10: Factors for a tax consolidated group with holding trust



[Results of advisor survey in response to the question 'On a scale of 1 to 10 (1 low/bad, 10 high/good) given your recommended structure what do you think it *[the recommended structure]* means for …']

The five highest factors for the tax consolidated group were 'control for owner' (9.57), 'business expansion in Australia' (9.29), 'access to R&D tax incentive' (9.29), 'retaining income at a lower tax rate' (9.14), 'asset protection' and 'succession planning/exiting' (9). The lowest five factors were 'tax compliance cost' (5.86), 'regulatory compliance cost (non-tax)' (6), 'simplicity' (6.14), 'small business CGT concessions — Division 152' (6.5), and 'flow-through of tax concessions' (6.86). The multiple companies used (together with a holding discretionary trust) is clearly seen by advisors as adding compliance costs (whether it be regulatory or tax), also the results indicate that advisors do not see it as a simple structure. The reason for the low ranking of the Division 152 concessions could be due to the size of the client in Scenario Four ($20m turnover), as the client would be unlikely to satisfy the required 'small' business threshold.[19] Additionally, the use of companies for asset holdings and trading activity would mean that a conduit principle would generally not apply to distributions from the companies to shareholders. These results support the qualitative data obtained from the advisor interviews,[20] and these results are also supported by the literature, in that when a business employs a combination of structures, complexity and compliance costs could increase.[21]

F *Highest Five Factors for a Company*

Only one advisor recommended a company in which the shares are owned by a natural person. Consequently, it is difficult to make observations and comparisons from the

[19] *ITAA 1997* s 152-10(1AA): < $2m.
[20] Trad et al (n 77).
[21] Alexis Kokkinos and Theo Sakell, 'The Importance of the Middle Market' (Tax Discussion Paper, Pitcher Partners Advisor Proprietary, 24 July 2015).

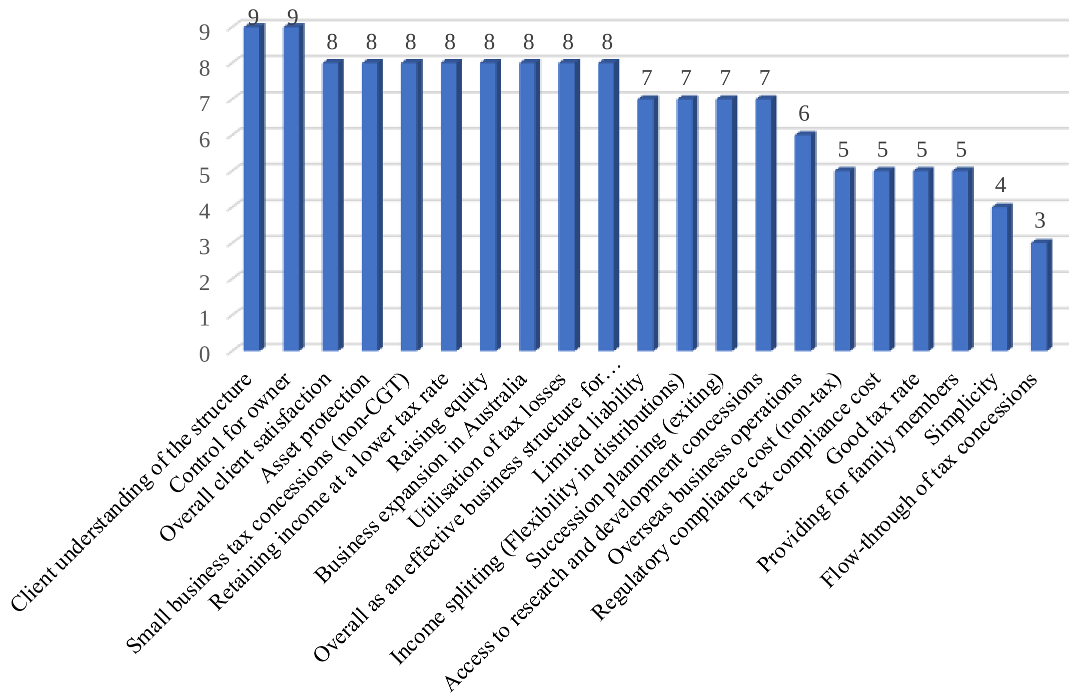
evaluations given that they originate from only one advisor. However, for completeness some of the factors are briefly discussed.

The company had the lowest 'overall client satisfaction' evaluation (8) from the four structures (tax consolidated group with holding trust (8.86), trading company with holding trust (8.52), and trading trust (8.44)), and the lowest evaluation (8) for 'overall as an effective business structure' (tax consolidated group with holding trust (8.71), trading company with holding trust (8.69), trading trust (8.11)). However, it appears that the advisor considered that the company will garner greater 'client understanding' (9) compared to a tax consolidated group with holding trust (7.86), trading company with holding trust (7.45), and trading trust (6.33). This greater understanding makes sense, as there is only one business structure being recommended compared to the others that involved a combination of business structures for the one enterprise. Overall, this provides further evidence that the combination of business structures is seen by advisors as resulting in lower client understanding. Such a lower client understanding could be problematic as it may lead to unintentional mistakes, which then could have adverse consequences, such as to comprise liability protection or result in tax penalties.

The highest five factors obtained from the survey for a company are: 'client understanding of the structure' (9), 'control for owner' (9), 'overall client satisfaction' (8), 'asset protection' (8) and 'small business tax concessions (non-CGT)' (8). The lowest five factors are: 'flow-through of tax concessions' (3), 'simplicity' (4), 'providing for family members' (5), 'good tax rate' (5), and 'tax compliance cost, regulatory compliance cost — non-tax' (5). The low evaluation of 'good tax rate' may initially appear unexpected as companies are taxed at either 30% or 25%. However, this headline tax rate is not the only aspect of understanding how tax is affected by business structure choice. Indeed, the overall tax impost can be reduced by other items such as CGT concessions, income splitting and flow-through of tax concessions, all features of a discretionary trust. This finding reinforces the importance of identifying and assessing multiple tax factors when recommending a business structure. Figure 11 illustrates the evaluation results from highest to lowest factors for a company.

Figure 11: Factors for a company

[Results of advisor survey in response to the question 'On a scale of 1 to 10 (1 low/bad, 10 high/good) given your recommended



structure what do you think it *[the recommended structure]* means for …']

Overall, the analysis of the survey results combined with the prior interviews with SME advisors,[22] provide compelling evidence that discretionary trusts are used to gain tax advantages in Australia. The relevant tax advantages relate to 'income splitting/flexibility of distributions', 'flow-through of tax concessions', 'small business CGT concessions – Div 152', 'CGT Discount – Div 115' and other 'small business concessions (non-CGT)'. Such tax advantages are some of the unique characteristics of discretionary trusts and appear to be a significant reason why advisors are recommending them for SMEs. However, an acknowledged problem with discretionary trusts is the retention of income issue (which could result in the highest marginal tax rate applying if there are no presently entitled beneficiaries, or Division 7A issues in the event of an UPE to a company beneficiary).[23] It appears that this factor (with others) is part of the reason for advisors recommending more frequently the trading company with holding trust. However, given that the shares of the trading company are held by a discretionary trust it does mean that some of the flexibility and advantages of discretionary trusts are retained, despite less ability in relation to the flow-through of tax concessions (although the ability to flow-through franking credits could be retained).

[22] Trad et al (n 77).

[23] However, the Commissioner's view that UPEs are loans for Division 7A purposes has been recently held as incorrect: *Bendel v Commissioner of Taxation (Taxation)* [2023] AATA 3074.

For more sophisticated and larger scale businesses, the tax consolidated group with a holding discretionary trust appears to be a highly regarded business structure. However, given the tax consolidated group with holding trust involves a multitude of additional structures, it appears that advisors only recommended it in specific circumstances. The implications of adopting a tax consolidated group with holding trust are owner control, business expansion in Australia, access to the R&D tax incentive, income retention at a lower tax rate, and asset protection. Overall, the survey findings support the qualitative findings from the SME advisor interviews[24] by quantifying the weighting of various factors which influenced SME advisors' recommendations for their business structure.

VI RECOMMENDATIONS

This section provides recommendations for tax policy reform drawn from the survey findings.

A *Aligning the Taxation of Trusts and Companies*

While discretionary trusts featured in all business structures recommended by advisors (with one exception), there is clearly an issue with retention of income. A well-recognised disadvantage of a trading trust is the inability to retain business income in a tax effective manner. The weighted average for 'retaining income at a lower tax rate' was only 7.33 for the trading trust, compared to 9.18 for the trading company with holding trust. The survey findings support the concerns raised by advisors during the interviews about the inability to retain income in trusts at a lower tax rate compared to companies.[25] A corporate structure can retain income and cap such income at a lower tax rate, and then reinvest the profit back into the business. The potential for a high tax rate for a trust on retained profits can be detrimental for SMEs wanting to grow, as retained profits are an important source of capital for a business.[26] These results are consistent with previous research conducted in South Australia, in which Division 7A was highlighted as a major issue, and participants in the study identified that billions of dollars were sitting in bucket companies (company beneficiaries), and subject to paying a 'locked up tax'.[27] For tax reasons, such funds may sit idle with company beneficiaries instead of being used for business growth. The rationale for the taxation of retained trust income at the highest marginal rate is unclear.[28] It may be that these rules were introduced at a time when there

[24] Trad et al (n 77).

[25] Trad et al (n 77). For example, participants in the interviews expressed concerns about the potential for Division 7A to apply when reinvesting the retained profit from the corporate beneficiary into the trusts. It was also mentioned by participants that clients and/or advisors may not fully understand Division 7A, and this could create an issue, because if Division 7A applies such funds can be regarded as unfranked dividends and are taxed at the highest rate (45%) plus 2% Medicare levy.

[26] *ITAA 1936* ss 99, 99A. This could occur in circumstances where the trustee had no power to appoint a particular entity as a beneficiary, and a default provision had not been triggered to entitle a default beneficiary, such as in the decision of *BRK (Bris)Pty Ltd v Federal Commissioner of Taxation* 2001 ATC 4111.

[27] Giancaspro, Villios and Graves (n 22) 69.

[28] Originally under *ITAA 1915* s 26(1) a trust was taxed at the trustee level as a separate taxpayer, with a deduction system applying for any distributions to beneficiaries. This was then slightly altered in 1918, before the essentially the current regime was introduced in 1936. See Ann Kayis-Kumar and C John Taylor, 'The application of capital gains tax to trusts: conceptual, technical and practical issues, and a proposal for reform' (2019) School of Taxation and Business law, Business School, University of New South Wales.

was concern about sheltering income in structures to avoid high marginal tax rates for individuals. For example, prior to the imputation system private companies could be subject to additional tax if there were undistributed profits.[29] It is argued that regardless of the historical reasons, applying a similar imputation system to trusts would provide greater tax neutrality to the tax system, as well as facilitate the government collecting tax revenue at the business structure level. Given the extent to which discretionary trusts feature prominently in business structure advice, it is important to consider if their taxation treatment can be enhanced, particularly whether greater tax neutrality can be achieved. Taxation models from other jurisdictions may be worthy of further consideration. Most of the developed common law countries have modernised and codified trust law, including the United Kingdom, the United States of America, Hong Kong, Singapore, Ireland and New Zealand.[30] There could be merit in allowing trusts to retain profit and be taxed at a comparable rate to companies. For instance, it could be useful for Australia to consider the approach adopted in New Zealand. In New Zealand, the trustee pays tax on behalf of the beneficiaries for income allocated to beneficiaries. The beneficiaries then claim a tax credit for the tax paid on their behalf.[31] It is the trustee that is the entity taxed;[32] income may also be taxed at the hands of beneficiaries if distributed.[33] Thus, the trustee can elect to retain received income in the trust or to distribute part or all of the income to beneficiaries, where beneficiaries are taxed at the marginal tax rate for the distributed income.

It is also recommended that *ITAA 1936* s 99A be amended to provide that trustees of trusts are taxed at 30% on trust income to which no beneficiary is presently entitled. This could be limited to trusts that have made a 'family trust election', as such an election effectively reduces the ability to split income to non-family members (as defined).[34] This would allow family trusts to retain income to fund business operations. Later distributions from such taxed retained income could be franked. Extending the scope of trusts to accumulate profits and retain such profits at a comparable tax rate to a company may assist businesses to develop internal capital necessary for business development. There would be less of a need to use a corporate beneficiary to retain income, and this may lead to fewer issues under Division 7A, and it may lessen complexity and compliance

---

[29] Brian Johns, Winston Dunlop and William Sheehan, *Small Business in Australia: Problems and Prospects* (Allen and Unwin, 3rd ed, 1989) 182: 'In 1973 private companies paid undistributed profits tax at a rate of 50 cents in the dollar on those after-tax profits retained by the business in excess of 50 per cent of the after-tax total profits.'

[30] David Chaikin and Eve Brown, 'Submission to Productivity Commission, Inquiry into Barriers to Growth in Services Exports' (Report, 2015) 13.

[31] Inland Revenue Department, 'Trusts and Estates Income Tax Rules' (Report, 2020) <https://www.ird.govt.nz/-/media/project/ir/home/documents/forms-and-guides/ir200---ir299/ir288/ir288-2020.pdf?modified=20210329201228&modified=20210329201228>.

[32] *Income Tax Act 2007* (NZ) subpt HC 2 (Trusts). The income tax obligations of calculating a trust's taxable income and providing a tax return fall squarely on the trustee under s HC 2.

[33] Trustee pays tax at 33% rate for income retained in the trust. Inland Revenue, New Zealand Government, *Income Tax, Trusts and the Australian–New Zealand Double Tax Agreement* (A Tax Counsel Office Discussion Document, 18 December 2020); Inland Revenue Department, Tax Rates for Businesses (Web Page, 2021) <https://www.ird.govt.nz/income-tax/income-tax-for-businesses-and-organisations/tax-rates-for-businesses>. Any income trust earns is taxed at 33%; Inland Revenue Department (n 120).

[34] *ITAA 1936* sch 2 F, s 272-80.

costs for the SME sector overall. Furthermore, the recommended tax treatment on UPEs may achieve greater tax neutrality and less distortion between the choice of business structures.

The CGT tax concessions also raise issues of tax neutrality in respect of trust and company structures. For example, the 50% CGT discount in Division 115[35] is available to individuals and trusts, but not to companies. The findings from this research indicate that this disparity could result in complex business structuring involving combinations of companies and trusts, for one enterprise, for the purpose of accessing the 50% discount.[36] This involves the trust owning the business and/or any assets that are disposed of. Trusts pose additional complexity and compliance costs compared to other business structures, and this was supported by the interviews with SME advisors.[37] Complexity, compliance, and administrative costs increased when multiple structures were adopted for one enterprise.[38] To combat this issue, and to complement the above recommendation, a bold reform could be to either remove access to the 50% CGT discount that flows through discretionary trusts to beneficiaries or, alternatively, to allow companies to access the CGT discount. However, it is unlikely that access to 50% CGT discount by companies can be justified, as companies have already been favoured with lower tax rates of 25% or 30%.

The 50% CGT discount is a significant tax expenditure, with an annual forgone revenue cost exceeding $23 billion.[39] In this context, it is likely that the removal of the CGT discount for trusts would be politically acceptable. This could improve tax system neutrality and reduce the complexity associated with implementing a combination of structures for one enterprise. A potential political impediment to this being adopted is that governments may prefer to be seen to be 'doing something' for SMEs, even if good intentions can lead to less than perfect outcomes.[40] Moreover, there has been a recognition of the need to reform CGT concessions, including the small business CGT concessions in Division 152.[41] Given the need for the reform of CGT concessions, a more appropriate tax policy recommendation might be to remove the discount and to re-introduce indexation for capital gains for individuals and across all business structures.[42] The arguments for recommending such tax policy are to achieve greater tax neutrality amongst different business structures; to promote horizontal equity among individuals

[35] *ITAA 1997* div 115 (50% CGT discount).
[36] Trad et al (n 77).
[37] Ibid.
[38] Ibid.
[39] Commonwealth of Australia (2023) *Tax Expenditures and Insights Statement*, February. <https://treasury.gov.au/sites/default/files/2023-02/p2023-370286-teis.pdf>.
[40] Mark Burton, 'Australian Small Business Tax Concessions – Public Choice, Public Interest or Public Folly' (2006) 21 (1) *Australian Tax Forum* 71.
[41] Board of Taxation, 'Review of Small Business Tax Concession' (Report, March 2019): <https://taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2019/12/RSBTC-report.pdf>.
[42] The indexation of asset cost base was part of the CGT regime, as introduced in September 1985, and it was referred to in: Australian Government, 'Reform of the Australian Tax System: Draft White Paper' (1985) 85.

and the different types of business structures; and to reduce administration and compliance costs.[43]

VII LIMITATIONS OF RESEARCH AND FUTURE RESEARCH

A limitation of the research is that the interview sample was skewed towards SME advisors based in Queensland — 31 out of 48 participants (65%) lived in Queensland.

Another limitation was that due to COVID-19 restrictions, each of the interviews was conducted online (via Microsoft Teams or Zoom) instead of in-person. Despite the necessity of interviewing online, this is not considered to have had any significant impact on the data collection. The online interview environment may be considered to have aided the conduct of the research, in that it reduced costs while maintaining a rich sample of advisors.

A further limitation is that advisors self-reported their evaluation of the factors, which can be problematic, and at times inaccurate, as it is based on their own perceptions rather than objective test results or measurements. However, the SME advisors' experience, as well as the comparisons made by triangulating the qualitative (interview) and quantitative (survey) data, minimised the risks pertaining to self-reporting.

Future research could extend and further develop this study by surveying SME operators. Such research could explore the SME operators' perceptions of the use of alternative business structures, in particular discretionary trusts, and whether SME operators are satisfied with their current business structures. This could include a comparison between these factors and those of the advisors reported in this study to see if they are consistent or not.

VIII CONCLUSION

It is a complex task to recommend an appropriate business structure. This is because there are a range of available structures, which have varying implications for an enterprise in the way it operates, including legal obligations and how tax is imposed.

This article reported the results of a survey about how 48 SME advisors evaluated their own recommended business structure against a matrix of 23 factors that research has previously demonstrated important for SMEs. These results indicate that a trading company with holding trust appears to be good for SMEs in terms of limiting the owner's liability, retaining income at a lower tax rate, owner control of the business, providing for family members, income splitting/flexibility in distributions, asset protection, a good tax rate, and access to the R&D tax incentive. In comparison, the implications of adopting a trading trust (with a corporate trustee) appears to be good for income splitting/flexibility in distributions, flow-through of tax concessions, small business CGT concessions – Division 152, and CGT discount – Division 115. However, this structure was identified as

[43] John Freebairn, 'Indexation and Australian capital gains taxation' (2001) *International evidence on capital gains taxes* 123. It has been argued that administration and compliance costs of indexing capital gains in Australia were insignificant.

not preferable for accessing the R&D tax incentive, for overseas business operations, and for raising equity.

This study contributes to a greater understanding of how advisors evaluate the recommended business structure in relation to the tax and non-tax factors, as well as the perceived client understanding and satisfaction of the recommended structure. It is with such an informed view that the prospective consequences of the choice of implementing alternative business structures can be understood. It is hoped that this improved understanding and knowledge can promote tax policy development in Australia. Future development of SME taxation policy should strive to achieve greater tax neutrality between alternative business structures and minimise complexity. Such reform may encourage and enhance SMEs' performance and allow this sector to remain a strong contributor to the Australian economy.

BIBLIOGRAPHY

A *Articles/Books/Reports*

Atwood, Christee, *Succession Planning Basics* (American Society for Training and Development, 2020)

Board of Taxation, 'Review of Small Business Tax Concession' (Report, March 2019) <https://taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2019/12/RSBTC-report.pdf>

Treasury, 'Family Businesses in Australia – Different and Significant: Why They Shouldn't Be Overlooked' (Report, October 2014)

Australian Small Business and Family Enterprise Ombudsman, 'Affordable capital for SME growth' (Report, 2018) <https://www.asbfeo.gov.au/sites/default/files/2021-11/ASBFEO-affordable-capital-for-SME-growth.pdf>

Australian Taxation Office, Australian Government, Current Issues with Trusts and the Tax System — Focusing on Trusts Used to Deliberately Avoid Tax (Report, January 2019)

Ayers, Benjamin, Bryan Cloyd, and John Robinson, 'Organizational Form and Taxes: An Empirical Analysis of Small Businesses' (1996) 18 *Journal of the American Taxation Association* 49

Baxt, Robert et al, Cases and Materials on Taxation (Butterworths, 2nd ed, 1984)

Blackburn, Robert and Robin Jarvis, 'The Role of Small and Medium Practices in Providing Business Support to Small-and Medium-Sized Enterprises' (2010) *International Federation of Accountants* 1

Boccabella, Dale, 'Family Trusts often Cause more Harm than Good' The Conversation (Blog Post, 26 July 2017) <https://theconversation.com/family-trusts-often-cause-more-harm-than-good-81551>

Board of Taxation, 'Post Implementation, Review of Division 7A of Part III of the Income Tax Assessment Act 1936: A Report to the Assistant Treasurer' (Report, 2014)

Board of Taxation, 'Scoping Study of Small Business Tax Compliance Costs: A Report to the Treasurer' (Report, 2007)

Breton-Miller, Isabelle, Danny Miller and Lloyd Steier, 'Toward an Integrative Model of Effective FOB Succession' (2004) 28(4) *Entrepreneurship Theory and Practice* 305

Brockhaus, Robert, 'Family Business Succession: Suggestions for Future Research' (2004) 17(2) *Family Business Review* 165

Burton, Mark, 'Australian Small Business Tax Concessions-Public Choice, Public Interest or Public Folly' (2006) 21 (1) *Australian Tax Forum* 71

Chittenden, Francis, Saleema Kauser and Panikkos Poutziouris, 'Regulatory Burdens of Small Business: A Literature Review' *University of Manchester* (2000)

Roland Christensen, 'Management Succession in Small and Growing Businesses' (Report, Division of Research, Harvard Business School, 1953)

Crusto, Mitchell, 'Unconscious Classism: Entity Equality for Sole Proprietors' (2008) 11(2) *Journal of Constitutional Law* 215

Davidsson, Per, Paul Steffens and Scott Gordon, *Comprehensive Australian Study of Entrepreneurial Emergence (CAUSEE): Design, Data Collection and Descriptive Results* (Handbook of Research on New Venture Creation, 2011)

Eisenhardt, Kathleen, 'Building Theories from Case Study Research' (1989) 14(4) *Academy of Management Review* 532

Evans, Alex C, 'Why We Use Private Trusts in Australia: The income tax dimension explained' (2019) 41(2) *Sydney Law Review* 217

Fida, Bashir, 'The Role of Small and Medium Enterprises (SMEs) in Economic Development' (2008) *Enterprise Development, Free Online Library*

Freebairn, John, 'Indexation and Australian capital gains taxation' (2001) *International evidence on capital gains taxes* 123

Freedman, Judith, 'Small Business Taxation: Policy Issues and the UK' in *Taxing Small Business: Developing Good Tax Policies* (Conference Series) (Australian Tax Research Foundation, 2003)

Freedman, Judith and Michael Godwin, 'Incorporating the Micro Business: Perceptions and Misperceptions' in A Hughes and Storey D (eds), *Finance and the Small Firm* (Routledge, 1994)

Freudenberg, Brett, 'Advisors' Understanding of Tax Compliance for Choice of Business Form' (2013) 4(1) *Global Review of Accounting and Finance* 1

Freudenberg, Brett, 'Tax on my Mind: Advisors' Recommendations for Choice of Business Form' (2013) 42(1) *Australian Tax Review* 33

Freudenberg, Brett, 'Fact or Fiction? A sustainable tax transparent form for closely held businesses in Australia' (2009) 24(3) *Australian Tax Forum* 375

Freudenberg, Brett, 'Are Asset Revaluation Reserve Distributions 'Ordinary Income' for Discretionary Beneficiaries?' (2005) 20(1) *Australian Tax Forum* 3

Freudenberg, Brett and Bradley T Borden, 'Contribution and Distribution Flexibility and Tax Pass-Through Entities' (2019) 23(1) *Florida Tax Review* 349

Freudenberg, Brett and Dale Boccabella, 'Changing Use of Business Structures: Have University Business Law Teachers Failed to Reflect this in Their Teaching?' (2014) 9(1) *Journal of the Australasian Tax Teachers Association* 180

Freudenberg, Brett and Dale Boccabella, 'Streaming of Franking Credits Curtailed by Bamford-Induced Amendments – An Unintended Consequence?' (2019) 48(3) *Australian Tax Review* 190

Freudenberg, Brett and Peter McDermott, 'The Forgotten CGT Events: Are Asset Revaluations Reserve Distributions by Trustees of Discretionary Trusts Taxable?' (2005) 34(2) *Australian Tax Review* 67

Freudenberg, Brett and Scott Sargent, 'Not so Guaranteed: Superannuation Guarantee and Australian Small Businesses' (2015) 30(1) *Australian Tax Forum* 90

Evans, Chris et al, 'Small Business and Tax Compliance Costs: A Cross-Country Study of Managerial Benefits and Tax Concessions' (2014) 12(2) *eJournal of Tax Research* 453

Giancaspro, Mark, Sylvia Villios and Chris Graves, 'The Use of Family Trusts in Small Business and Family Enterprise, ASBFEO Final Report' (Report, 2019)

Gordon, Roger and Jeffrey Mackie-Mason, *Effects of the Tax Reform Act of 1986 on Corporate Financial Policy and Organizational Form* (National Bureau of Economic Research No w3222, 1990)

Hansford, Ann, John Hasseldine and Carole Howorth, 'Factors Affecting the Costs of UK VAT Compliance for Small and Medium-Sized Enterprises' (2003) 21(4) *Environment and Planning C: Government and Policy* 479

Hertz, Giles, Fred Beasley and Rebecca White, 'Selecting a Legal Structure: Revisiting the strategic issues and views of small and micro business owners' (2009) 20(1) *Journal of Small Business Strategy* 101

Hicks, Andrew, Robert Drury and Jeff Smallcombe, 'Alternative Company Structures for the Small Business' in *ACCA Research Report No 42* (Certified Accountants Educational Trust, 1995)

Holmes, Scott and Brian Gibson, *Definition of Small Business* (University of Newcastle, 2001)

Inland Revenue Department, 'Income Tax, Trusts and the Australian–New Zealand Double Tax Agreement' (Report, 18 December 2020)

Inland Revenue, 'Trusts and Estates Income Tax Rules' (Web Page, 2020) <https://www.ird.govt.nz/-/media/project/ir/home/documents/forms-and-guides/ir200---ir299/ir288/ir288-2020.pdf?modified=20210329201228&modified=20210329201228>

Inspector-General of Taxation, 'Review into the ATO's Administration of the Superannuation Guarantee Charge' (Report, 2010)

Kayis-Kumar, Ann and C John Taylor, 'The application of capital gains tax to trusts: conceptual, technical and practical issues, and a proposal for reform' (2019) School of Taxation and Business law, Business School, University of New South Wales.

Johns, Brian, Winston Dunlop and William Sheehan, 'Taxation and the Small Firm in Australia: A Report to the Taxation Review Committee' (Report, 1974)

Johns, Brian, Winston Dunlop and William Sheehan, *Small Business in Australia: Problems and Prospects* (Allen and Unwin, 3rd ed, 1989)

Jousten, Alain, 'SMEs and the Tax System: What Is so Different about them?' (2007) 8(2) *CESifo Forum* 14

Khandekar, Rajendra and John Young, 'Selecting a Legal Structure: A Strategic Decision' (1985) 23(1) *Journal of Small Business Management* 47

Kokkinos, Alexis and Theo Sakell, 'The Importance of the Middle Market' (Tax Discussion Paper, Pitcher Partners Advisor Proprietary, 24 July 2015)

KPMG and Family Business Australia, *KPMG and Family Business Australia Survey of Family Businesses* (Middle Market Advisory: Australia, 2009)

Leon-Guerrero, Ann,a Joseph McCann III and Jonathan Haley, 'A Study of Practice Utilization in Family Businesses, (1998) 11(2) *Family Business Review* 107

Lignier, Phil and Chris Evans, 'The Rise and Rise of Tax Compliance Costs for the Small Business Sector in Australia' (2012) 27(3) *Australian Tax Forum* 615

Maciejovsky, Boris, Herbert Schwarzenberger and Erich Kirchler, 'Rationality Versus Emotions: The Case of Tax Ethics and Compliance' (2012) 109(3) *Journal of Business Ethics* 339

Motwani, Jaideep et al, 'Succession Planning in SMEs: An Empirical Analysis' (2006) 24(5) *International Small Business Journal* 471

Pandya, Viral, *Comparative Analysis of Development of SMEs in Developed and Developing Countries* (International Conference on Business and Management, Thailand, 6- 7 September 2012) 426

Parliamentary Joint Committee on Corporations and Financial Services, *Family Business in Australia — Different and Significant: Why They Shouldn't Be Overlooked* (2013)

Pizzacalla, Mark, 'Developing a Better Regime for the Preferential Taxation of Small Business' (PhD thesis, Monash University, 2014)

Porcaro, Gregory A, 'The Choice-of-Entity Maze (2007) 203(3) *Journal of Accountancy* 64

Reform of the Australian Tax System: Draft White Paper (Report, 1985)

Reserve Bank of Australia, 'Submission to the Inquiry into Access for Small and Medium Business to Finance' (Submission No 3, Feb 2011)

Scholes, Myron and Mark Wolfson, 'Issues in the Theory of Optimal Capital Structure' in Sudipto Bhattacharya and George Constantinides (eds), *Frontiers of Modern Financial Theory* (Rowman and Littlefield, 1989)

Scholes¸ Myron and Mark Wolfson, 'Taxes and business strategy: A planning approach' (Prentice-Hall, 1992)

Trad, Barbara and Brett Freudenberg, 'All Things Being Equal: Small Business Structure Choice' (2017) 12(1) *Journal of Australasian Tax Teachers Association* 136

Trad, Barbara et al, 'Not in Isolation: The Rationale for a Combination of Business Structures in Australia' (2023) 51(3) *Australian Business Law Review* 16

Trad, Barbara et al, 'Reasons behind SME Advisor Business Structure Recommendations' *Australian Tax Forum* (forthcoming)

Trad, Barbara et al, 'Business Structure Selection: A Mixed Methods Approach' *New Zealand Journal of Taxation Law and Policy* (forthcoming)

Trad, Barbara et al, 'Choice of Australian Business Structures in the SME Sector: What Do Advisors Recommend?' (2023) 52(3) *Australian Tax Review* 177

Valadkhani, Abbas, George Chen and Bernice Kotey, 'Asymmetric Changes in Australia's Small Business Loan Rate' (2014) 43(4) *Small Business Economics* 945

Weichenrieder, Alfons, 'Survey on the Taxation of Small and Medium-Sized Enterprises: Draft Report on Responses to the Questionnaire' *Organization for Economic Co-operation and Development* (Report, 2007) <http://www.oecd. org/dataoecd/52/25/39597756. pdf>

Wenzel, Michael, 'Misperceptions of Social Norms about Tax Compliance (2): A Field Experiment' Working Paper no 8 (Centre for Tax System Integrity, 2019)

B *Cases*

Bamford v Commissioner of Taxation (2010) 240 CLR 481

Bendel v Commissioner of Taxation (Taxation) [2023] AATA 3074.

BRK (Bris) Pty Ltd v Federal Commissioner of Taxation 2001 ATC 4111

Donoghue v Stevenson [1932] AC 562

C *Legislation*

Income Tax Act 2007 (NZ)

Income Tax Assessment Act 1936 (Cth)

Income Tax Assessment Act 1997 (Cth)

Medicare Levy Act 1986 (Cth)

Partnership Act 1891 (Qld)

Tax Laws Amendment Act (Measures No 5) 2011 (Cth)

D *Other*

Australian Bureau of Statistics, *Counts of Australian Businesses, Including Entries and Exits, June 2017 to June 2021, 8165.0, Table 10* (2021)

Australian Small Business and Family Enterprise Ombudsman, Australian Government, *Inquiry into Small Business Loans* (December 2016) <https://www.asbfeo.gov.au/policy-advocacy/policy-insights/small-business-loans-inquiry-2016>

Australian Taxation Office, Australian Government, *Individual Income Tax Rates for the 2022-23 Income Year* (2023) <https://www.ato.gov.au/rates/individual-income-tax-rates>

Australian Taxation Office, *Changes to Company Tax Rates — Company Tax Rate* (2022) <https://www.ato.gov.au/rates/changes-to-company-tax-rates>

Australian Taxation Office, Australian Government, *Division 7A - trust entitlements: When Division 7A may apply* (2022) <https://www.ato.gov.au/Business/Private-company-benefits---Division-7A-dividends/In-detail/Division-7A---trust-entitlements>

Australian Taxation Office, *Taxation Statistics: A Summary of Tax Returns for the 1990–91 to 2018–19 Income Year* (2021) <https://data.gov.au/data/dataset/taxation-statistics-2018-19/resource/d6f6266c-7ad2-461a9552f5736cc0d30f?inner_span=True>

Australian Taxation Office, *Taxation Statistics: A Summary of Tax Returns for the 2018–19 Income Year*, *Number of Entities by Size* (2021)

Australian Taxation Office, *Taxation Statistics: A summary of Tax Returns for the 1990–91 to 2018–19 Income Year - Entity Size Classification* (2021)

David Chaikin and Eve Brown, *Submission to Productivity Commission, Inquiry into Barriers to Growth in Services Exports* (2015)

Inland Revenue, New Zealand Government, *Business and Organisations, Tax Rates for Businesses* (2021)

Parliament of Australia, *Parliamentary Joint Committee on Corporations and Financial Services: Access for Small and Medium Business to Finance* (2011) <https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Service>

Appendix A

Scenario One – Established Business

Please ignore any Covid-19 economic conditions and government support.

'Shiny Teeth' is a successful orthodontic business that has been operating since 2000. The business is run by its owner Peter Johnson, who is an orthodontist. The business is conducted from a building which was purchased ten years ago. Part of this building is used by Peter to run his orthodontic practice, while the rest of the building is used by his wife Debbie to run her dentistry practice, which operates under the business name 'Healthy Teeth'.

Peter is in his mid-fifties, married with two children Ben and Sarah aged 20 and 18 years. Both children are university students and are not in receipt of any income. Peter and his wife Debbie live in a large house situated on acreage, which he inherited from his grandfather in June 1995 (current value $2.5 million). Peter and Debbie plan to retire in ten years from now, as they love to travel around the world. Since none of their children are interested in the business, both Peter and Debbie are considering selling the businesses just prior to their retirement.

'Shiny Teeth' and 'Healthy Teeth' have been operating through a discretionary trust (the Johnson Trust) since its commencement in 2000. Ortho Co Pty Ltd is the trustee of the family trust, in which Peter and Debbie each own one share. Peter, Debbie, their two children Ben and Sarah, and a corporate beneficiary P & D Pty Ltd (shares held by Peter and Debbie) are the 'primary beneficiaries' (discretionary objects) of the trust. The trustee, Ortho Co Pty Ltd owns the building (valued at $1.9 million). Trustee of the Johnson Family Discretionary Trust carries on business for both Peter and Debbie. Additional relevant information is set out in the Table.

Factors	Descriptions
Current Business Structure	Family Discretionary Trust with a company trustee
Gross Annual Turnover of Business	$1,974,000
Number of Employees	10
Business Asset Value (current market value)	Building: $1.9 million; plant and equipment: $1.7 million
Personal Asset Value (current market value)	House and land owned jointly by Peter and Debbie: $2.5 million; cars: $125,000
Business creditors	Bank: loan on building: $920,000
Personal creditors	Bank: loan on house: $615,000; cars: $62,000
Industry	Dentistry
Marital Status	Married
Family/non-Family	Two adult children

Succession and Estate Planning	Sale of the business, with both children to inherit equally the wealth after the death of both parents.
Future Plans	Husband and wife to retire in 10 years from now.
Plans for Growth	Happy with the steady growth of the business
Education Level	Postgraduate degree
Client's prior Business Experience	None
Superannuation Fund - Balance	Peter: $310,000; Debbie $210,000
Frequency of use of Advisor	Too focussed on business – reliance on the accountant
Annual Cash Flow	Service revenue: $1,974,000; total payments: $1,004,000
Owner's annual income requirement	Peter: $150,000; Debbie:110,000
Need for new equity	Not needed
Need for Self-finance	Business can grow and develop using the profit, without the need to borrow money.
Need for unrelated investors	No intention of introducing new investors
Client's level of business knowledge	Sound knowledge
Client's level of understanding of different business structures and tax	Little knowledge
Client's need for Control	Strong need to control

Scenario Two – Established Business

Please ignore any Covid-19 economic conditions and government support.

Charlie is a web designer; after having been employed for over 20 years, Charlie started a web design business from a leased building. Charlie used his savings of $35,000 to purchase computers and software and other equipment needed for the business. The business generates around $500,000 per annum in profit.
Charlie is 53 years old and is happily married to Jane, who is 51 years old, a stay-at-home mother. Jane owns the family house solely in her name.
Children: Peter, Jade and Ashley are full-time students at university. Peter and Jade are twins aged 20, and Ashley is 18. None of the three children are in receipt of any income.
Charlie operates his business through a general partnership with his wife Jane with a 50: 50 split of income, after Charlie is paid the first $120,000. For additional information see table below:

Factors	Descriptions
Current Business Structure	Partnership with Charlie and Jane
Gross Annual Turnover of Business	$950,000
Number of Employees	0
Business Asset Value (current market value)	Plant and equipment: $35,000
Personal Asset Value (current market value)	Charlie: car $45,000; Jane: house $850,000, car $40,000
Business creditors	Landlords: $2,000 monthly lease (12-month lease)
Personal creditors	Car and home loan of $590,000
Industry	Service
Marital Status	Married
Family/non-Family	Three adult children
Succession and Estate Planning	Selling the business in 10 years from now
Future Plans	His children Peter and Jade to work in the business after their graduation
Plans for Growth	Build up his business in order to sell it
Education Level	Undergraduate degree
Client’s prior Business Experience	None
Superannuation Fund - Balance	$110,000 each for husband and wife
Frequency of use of Advisor	Once a month
Annual Cash Flow	Service revenue: $950,000; payments: $450,000

Owner’s annual income requirement	$120,000
Need for new equity	Not needed
Need for Self-finance	No need to finance
Need for unrelated investors	Charlie prefers to be the sole controller of the business
Client’s level of business knowledge	Medium level of knowledge
Client’s level of understanding of different business structures and tax	Basic knowledge
Client’s need for Control	Strong need to control

Scenario Three – Established Business

Please ignore any Covid-19 economic conditions and government support.

Paul is an electrician who started his own business ten years ago as a sole proprietor. Paul owns a van and all the tools and equipment needed for his business, which he purchased using his saving of $20,000 and a business loan of $25,000 from the bank. Over the last few years, Paul has been very busy and now his business is generating an annual net profit of over $200,000.

Paul is 35 years old, married to Lynnette who is 31 years old. Lynnette does not work, and she is a stay-at-home mother for their two little children, Abraham (6 years old) and Sasha (4 years old). In order to protect the family house from the risks of business, before Paul commenced his business, both he and Lynnette decided that the family house would be solely in Lynnette's name.

For additional information, see the Table below:

Factors	Descriptions
Current Business Structure	Sole proprietorship
Gross Annual Turnover of Business	$533,500
Number of Employees	2
Business Asset Value (current market value)	Plant and equipment $45,000
Personal Asset Value (current market value)	Paul: car & boat $85,000; Lynette house & car $660,000
Business creditors	Banks- business loan $25,000
Personal creditors	Paul personal loan $35,000; Lynette home loan $420,000
Industry	Electrical services
Marital Status	Married
Family/non-Family	Two children
Succession and Estate Planning	Selling to 3rd party if possible
Future Plans	Employing more workers, undertaking contract works with government
Plans for Growth	Grow the business from 2 to 10 employees.
Education Level	Diploma from TAFE, electrical fitter
Client's prior Business Experience	None
Superannuation Fund - Balance	$90,000 for Paul and Lynette $40,000
Frequency of use of Advisor	Four times a year
Annual Cash Flow	Service revenue: 533,500; Total payments: 330,000

Owner's annual income requirement	$100,000
Need for new equity	Not required
Need for Self-finance	Profits from business can be reinvested back into business
Need for unrelated investors	Not preferred
Client's level of business knowledge	Basic level of knowledge
Client's level of understanding of different business structures and tax	No real understanding (leaves everything to the accountant)
Client's need for Control	Strong need to control

Scenario Four – Established Business

Please ignore any Covid-19 economic conditions and government support.

Dr Nigel is a leading heart surgeon with an annual salary of $520,000 (from working in hospital). Dr Nigel through his medical research has invented a valve which derives from a bull's heart that is compatible to replace valves in human heart, and has it patented. He obtained finance to have the item produced, and he employed several employees for marketing, sales, and distribution. During the first few years the business did not generate any profits as substantial overhead costs had resulted in losses.

Dr Nigel is 45 years old, and he lives with his partner Sue aged 45 in a large house which they own as joint tenants.

Dr Nigel operates his business through a trading company Cardiac Biological Valve Pty Ltd which is owned by a holding company 'Happy Heart Pty Ltd'. Happy Heart Pty Ltd then holds the assets for the business, and the shares in Happy Heart Pty Ltd are owned by the Cardio Family Discretionary Trust. Dr Nigel and his partner Sue are the beneficiaries of this trust. For additional information see table below:

Factors	Descriptions
Current Business Structure	Trading company owned by asset-holding company, which is then owned by a family discretionary trust
Gross Annual Turnover of Business	$20,000,000
Number of Employees	80
Business Asset Value (current market value)	Intangible asset: patent $10,000,000; plant and equipment: $6,000,000
Personal Asset Value (current market value)	House: $950,000 (as joint tenants); car: $95,000
Business creditors	Bank loan: $6,000,000
Personal creditors	Bank loan: house: $205,000; car: $40,000
Industry	Medical manufacturing
Marital Status	De-facto relationship
Family/non-Family	No children
Succession and Estate Planning	Sale of the business in 15 years
Future Plans	Interest to export to some European countries
Plans for Growth	Interest in expanding the business overseas in future
Education Level	Doctoral Degree
Client's prior Business Experience	None
Superannuation Fund - Balance	Dr Nigel: $160,000; Sue: $95,000

Frequency of use of Advisor	Total reliance on advisor
Annual Cash Flow	Sales revenue: $20,000,000; total payments: $15,500,000
Owner’s annual income requirement	$150,000
Need for new equity	Potential for two private investors in two years
Need for Self-finance	Yes
Need for unrelated investors	Potential need for more public investors
Client’s level of business knowledge	Medium
Client’s level of understanding of different business structures and tax	Minimal
Client’s need for Control	Yes - initially

Scenario Five – Established Business

Please ignore any Covid-19 economic conditions and government support.

John operates a furniture business importing furniture from China. John conducts his business from a warehouse which he purchased for $1m five years ago. To finance the warehouse, John used $250,000 from his saving account and the rest of the cost was a secured loan from the bank. A part of this warehouse is used as a showroom to display furniture and the rest of the warehouse is used as a storage for the furniture. The business had a net income of $410,000 at the end of the last financial year.

John is 60 years old and has been married to Lucy who is 54 years old for 25 years. John and Lucy's relationship has encountered some difficulties and John may terminate their relationship. Lucy owns the family house and works occasionally to assist John in running the business when needed. John and Lucy have two children: Jade aged 26 and Mathieu aged 24. Jade works as a teacher at a local school and Mathieu works full-time in the family business.

John operates his furniture business through a family discretionary trust structure, the J & L Family Discretionary Trust. John is the trustee of the trust, and the 'primary beneficiaries' (discretionary objects) are: John, Lucy, their children Jade and Mathieu, and a corporate beneficiary Comfy Plus Pty Ltd (shares held by John and Lucy). For additional information see table below:

Factors	Descriptions
Current Business Structure	Family discretionary trust structure
Gross Annual Turnover	$2.6m
Number of Employees	12
Business Asset Value (current market value)	Warehouse: $1.3m; plant and equipment: $70,000; inventory: $650,000
Personal Asset Value (current market value)	Boat: $60,000. house owned by Lucy worth $850,000
Business creditors	Bank: $750,000; suppliers: $900,000
Personal creditors	Bank loan: $43,000
Industry	Retail
Marital Status	Married (potential for divorce)
Family/non-Family	Two adult children
Succession and Estate Planning	When retired in 5 years, intention to pass the business to his son Mathieu
Future Plans	Expand furniture importing to Europe
Plans for Growth	To open another branch to be operated by his son Mathieu
Education Level	Business Diploma from TAFE

Client's prior Business Experience	Operated a coffee shop for 10 years
Superannuation Fund - Balance	John: $120,000; Lucy: $140,000
Frequency of use of Advisor	On average 5 times a year
Annual Cash Flow	Sales revenue: $2.6m; total payments: $2,190,000
Owner's annual income requirement	$140,000
Need for new equity	His son Mathieu to have some equity in the business
Need for Self-finance	Yes
Need for unrelated investors	No
Client's level of business knowledge	Sound knowledge
Client's level of understanding of different business structures and tax	Basic knowledge
Client's need for Control	Strong need to control

Scenario Six– Established Business

Please ignore any Covid-19 economic conditions and government support.

Mary is a famous fashion designer and operates a bridal gown business. Mary has branched out into fashion designing after receiving a prestigious fashion design award. Mary's business has grown significantly, and her fashion business now generates much larger profits of $1.9m. Mary runs her business from a building that she owns personally, which has a market value of $1.5 million and a cost base of $500,000.

Mary holds several other investments which generate income of over $180,000 per year. Mary is 55 years old, single, and plans to sell the business and retire in 10 years from now.

Mary operates her business through a company, the Happy Moment Pty Ltd, Mary is the sole shareholder of Happy Moment Pty Ltd. For additional information see table below:

Factors	Descriptions
Current Business Structure	Company
Gross Annual Turnover	$6.1m
Number of Employees	25
Business Asset Value (current market value)	Goods: $900,000; machinery: $400,000
Personal Asset Value (current market value)	Building $1.5m; house and car: $750,000
Business creditors	Bank loan: $950,000; Suppliers: $250,000
Personal creditors	Bank loan: $400,000
Industry	Manufacturing (fashion)
Marital Status	Single
Family/non-Family	No family
Succession and Estate Planning	Not considered
Future Plans	Adding evening gown fashion to her business
Plans for Growth	Branching out into different states
Education Level	Undergraduate degree
Client's prior Business Experience	Making and selling garments online
Superannuation Fund - Balance	$700,000
Frequency of use of Advisor	12 times per year
Annual Cash Flow	Sales revenue: $6.1m; total payments: $4.2m

Owner’s annual income requirement	$90,000
Need for new equity	Most likely in the future
Need for Self-finance	Need to reinvest profits back into business
Need for unrelated investors	Potential need for investors in the future
Client’s level of business knowledge	Good knowledge
Client’s level of understanding of different business structures and tax	No knowledge
Client’s need for Control	Initially some control