

THE IMPORTANCE OF TAXATION SYSTEMS FOR SME TAX COMPLIANCE

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ABSTRACT

SME tax systems need to be designed in such a way as to minimise compliance costs and maximize accessibility. The reforms of the SME tax system would then need to require compliance commensurate to capacity. Simplification of the income tax system for SMEs in a more comprehensive manner is strongly supported. This should take account the countries' past experiences, taxpayer views, specific suggestions on legislative detail and the lessons learnt from other tax regimes. These factors should provide a sound basis for tax policy decision-making in any country.

However, most SMEs see that the taxation system is not fair for them and that they pay the same amount as large enterprises. In this case, the system should apply differently to each one, and the large enterprise should pay more than the SME. Governments can simplify or make a new system that suits SMEs, which would remove the comparison with larger enterprises because SMEs would have a system of their own. In order to implement effective reform, governments and SMEs need to make an agreement to satisfy both parties. This would require both parties to compromise on the considerable benefits they are seeking.

KEYWORDS: *Reform, SME, tax,*

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1. INTRODUCTION

Government regulations particularly taxation regulations are a major concern of the business sector throughout the world. International experience demonstrates that regulatory burdens appear to fall disproportionately on small medium-sized enterprises. Businesses in whatever form, size or sector are required by law to comply with all relevant legislation including taxation.

This paper discusses the importance of creating taxation systems which promote SME tax compliance. Chapter 1 provides a background to the issues. Chapter 2 defines SMEs and Chapter 3 discusses the characteristics of SMEs. Chapter 5 discusses why it is difficult for SMEs to comply with taxes. Chapter 6 discusses the problem facing SME taxation. Chapter 7 outlines the prerequisites of effective tax reform. Chapters 8 and 9 discuss SME tax non-compliance and ways to reduce the compliance burden. Chapter 10 discusses the issue of favourable tax treatment of SMEs and Chapter 11 considers the negative impacts of SME taxes. At the end of the paper conclusions can be found.

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2. BACKGROUND

Taxes are a central parameter defining the business climate and are operating as a political accountability mechanism. One missing piece in the development of an effective tax system which promotes investment is the effective treatment of SME. A few countries have an effective SME tax system which is integrated fully into the general taxation system and which encourages compliance. Fixing the SME tax issue is critical to fixing the business climate in general. First, formal and informal SMEs constitute 80-90 percent of the workforce and over 50 percent of GDP on average in developed countries. Thus, the key source of economic growth from within is the SME sector. Second, one foundation of SME tax design is that it is a subset of the general taxation system. So, if the SME tax system involves streamlining both policy and administration, it will require streamlining the general tax system as well. Otherwise, there is a risk of large companies breaking up into SMEs. (Stern, 2007)

3. DEFINITION OF SMES

The classification of petty, small, and medium-sized enterprises and methods of allocating enterprises to individual categories is shown in Table 1. This is an example of SME classification from the Czech Ministry of Economy.

Table 1: Classification of SMEs

	Number of employees	Maximum total assets and turnover	
		Assets	Turnover
Medium-sized enterprise	< 250	€ 43 m	€ 50 m
Small-sized enterprise	< 50	€ 10m	€ 10 m
Petty enterprise	< 10	€ 2m	€ 2 m

Source: Ministry of Economy in Czech Republic

In the Ministry of Economy in Czech Republic guidelines, petty, small and medium sized enterprise are considered to be businesses:

- a. which employ fewer than 250 employees;
- b. whose assets in the balance sheet in CZ equivalent do not exceed **€43** mil or whose net turnover in the fiscal period does not exceed the CZ equivalent of **€ 50** mil.

A small business is considered to be one:

- a. which employs fewer than 50 employees;
- b. whose assets in the balance sheet or net turnover in the fiscal period does not exceed CZ equivalent of **€ 10** mil

A petty entrepreneur is considered to be one:

- a. who employs fewer than 10 employees;
- b. whose assets in the balance sheet or net turnover in the fiscal period does not exceed CZ equivalent of **€ 2** mil.

4. CHARACTERISTICS OF SMES

The characteristics of SMEs in OECD countries include the sector (e.g. manufacturing, industrial, service sectors), size (micro, small and medium sized companies), the contribution of the SME to employment, unincorporated versus incorporated firms, and the distribution of the numbers of firms by taxable profit and business form. These data are provided as background information relevant to policy analysis in this area and, they highlight the importance of the SME population while encouraging policy makers to consider the diversity of SMEs in terms of their size, risk characteristics, growth potential and market and framework conditions under which they operate. (Malcom, 2007)

A simple yet striking fact from the data is that most firms are SMEs (whether looking at industrial, manufacturing or service sectors), with the smallest of firms (micro-firms) generally the most common. Perhaps then, not surprisingly, SMEs typically also account for the bulk of employment. The predominance of SMEs serves to heighten interest in ensuring that tax rules do not place SMEs at a competitive disadvantage with regard to the tax burden on other firms, taking into account not only taxes paid to government (tax liabilities), but also resources involved with the “compliance burden” of preparing, documenting and filling tax returns.

The prevalence of firms in a tax-loss position is also shown to be an important consideration, although the data does not provide a breakdown of loss-making firms that are small, medium-size and large. While this detail is needed for a thorough assessment of SMEs most affected by tax-loss offset provisions, it is recognized that the development of certain SMEs involves long gestation periods with limited revenue from sales but significant start-up costs – implying business losses for one or more years. This fact, combined with data showing a prevalence of firms in a tax loss position, serves to encourage policy makers to ensure that tax-loss offset rules are not impeding the risky investment in young, innovative firms. (Stevenson & Lundstrom, 2001)

The data also shows that incorporation is increasingly common for firms of larger size. In particular, for small firms that begin as unincorporated businesses, growth to a significant size (e.g., 10-50 employees and up) is likely to involve incorporation. One possible reason is that SMEs may need to issue equity shares to raise sufficient capital to grow, with investors possibly attracted by the continuity of business life that incorporation can provide.

Another possible reason is that incorporation may provide investors with more limited liability than an unincorporated business. Where governments aim to avoid policy-related impediments to growth, it follows that tax rules should aim to find a balance to not discourage (or encourage) incorporation, where relevant considerations include scope for double taxation of corporate profits, while recognizing at the same time that incorporation generally involves application of relatively low corporate income tax rates on reinvested profits of growth-oriented firms.

5. CHARACTERISTICS OF A GOOD TAX SYSTEM FOR SME

The following characteristics should apply in designing any tax system for SMEs:

1. Simplicity – The tax system should be easy to administer and comply with;
2. Proportionality – The tax compliance burden should not be disproportionate to the businesses sizes, SME should have correspondingly small and medium compliance burden;
3. Certainty – in tax liability is important for SMEs that sometimes need to make seat of the pants decision;
4. Trade-offs should favor compliance friendliness – In designing any compliance-friendly tax environment, the decision paths invariably meet at the intersection of accuracy, tax base protectionism and simplicity; for SMEs, the trade-offs need to favor simplicity.

5. Tax neutrality – Overall, the intention is not to change how much is paid. However, simplicity does not equal less tax. In some cases, more tax will be paid, and in some cases less tax will be paid.
6. Fairness – Taxes and compliance burdens should always be seen to adhere to the principle of fairness, that is, all other things being equal. (Jousten, 2007)

6. WHY IS IT SO HARD FOR SMES TO COMPLY WITH TAXES?

There are many reasons for why it is hard for SMEs to comply with taxes:

1. Taxes are numerous
2. Little revenue yields
3. It is easy not comply
 - cash based
 - low audit probability
 - low cost to evade
 - fewer tax handles
4. Imposing higher compliance comes at a cost to both taxpayers and tax administrations
5. Poor tax education
6. Poor tax morale.

7. WHAT IS THE PROBLEM FACING SMES TAX?

The main problems facing SME taxation is non-compliance and the search for a simple tax regime that is suitable for SMEs. In general, there are two types of situations:

- 1 In some countries, literacy and numeracy are nearly universal, there is a good access to technology, good access to professional advice and the social norms stigmatise substantial tax evasion. In such circumstances, even relatively small taxpayers can be expected to maintain complete and accurate books. Compliance costs for any given set of tax rules are likely to be relatively low with most non-compliance likely to take the form of misreporting rather than wholesale concealment of economic activities.
- 2 Some countries have the opposite features and hence relatively high compliance costs. In particular, small or medium taxpayers may have difficulty keeping books of any sophistication. The concealment of such books is widespread, informality is extensive and many enterprises may simply be ghosts operating without any effort at tax compliance (even though they might in some cases be compliant with basic registration requirements).

8. PREREQUISITES OF EFFECTIVE TAX REFORM

Taxpayers who may have previously found the hurdles and frustrations of paying tax on incomes to be a barrier to compliance will be able to declare income and know that once the tax is paid that is the end of the matter, thus, people who have earned income under the table in the past may well be encouraged to pay the taxes to contribute their part to the schools, roads and hospitals their taxes pay for. However, they might be worried about taxes on income earned in prior years.

If they start paying tax under the new rules then the tax administrator may well ask about prior years. For this reason, tax reforms should be implemented with transitional measures. For example, if the tax administrator has not previously identified undeclared income from the sources to which the businesses activities relate they will be statutorily precluded from chasing prior years' income from these sources.

That is a form of amnesty for undeclared earnings for prior years provided the tax is paid going forward. Without such a rule, taxpayers may be dissuaded from entering the reformed tax system. A transitional approach provides an incentive for people to start paying tax and legitimize their earning.

Other important elements to consider in tax reform for SMEs include (Stern, 2007):

- Unifying the taxation system for various enterprises
- Abolishing some tax incentive policies
- Absolving the double taxation problem
- Creating public-private dialogue
- Delivering taxpayer services
- Creating a political vision on the importance of SMEs for political stability and sustainable growth.

9. WHAT IS SME TAX NON-COMPLIANCE?

SME non-compliance or “tax evasion” is motivated by the perception that the tax burden is too high. Non-compliance undermines the tax system’s equity and efficiency and impedes sustained economic development. This situation requires solutions that reduce the compliance burden, increase tax revenue and avoid unintended distortions. Ensuring tax compliance is difficult for SMEs which have a relatively high compliance burden and therefore have a stronger incentive to evade. In addition, it is costly to audit the SME population. (Aires, 2007)

Tax evasion by SMEs may be curbed by reducing the compliance burden on SMEs. For example:

- Simplifying taxes
- Increasing the fines for non-compliance and increasing the probability of detection “audits”.

Adjustment of the tax system is not easy or straightforward. Relaxing reporting requirements for financial accounts or relaxing auditing requirements (to reduce compliance costs) may also reduce compliance. A lower statutory burden may feed the perception that taxes on employment are too high. One unintended consequence of reforms might be the creation of SMEs with the primary goal to avoid tax. Structural features facilitating evasion may be desirable. (Rawling, June 2005)

Overall, there is a general preference for reducing the compliance burden as a means to discourage evasion. Surveys show that small companies don’t have the capacity or the information to comply with SME tax regime and thus decide it’s easier to remain informal than to comply with the law. (Loeprick, 2007) Table 2 shows what SME compliance could look like.

Table 2: SME tax compliance

Firm size	Thresholds	Applied taxes
Large	All firms administered by large taxpayer unit	General tax system
Medium	Firms below LTU but above VAT thresholds (+ opt ins)	General system (with some simplifications, e.g. less frequent VAT payments)

Firm size	Thresholds	Applied taxes
Small	Turnover below VAT threshold	A single presumptive tax based on turnover, replacing all other fiscal levies
Micro	Profit below income tax exemption	One-time fee per year (option for several instalments?)

Source: Multi-Donor Investment Climate Advisory Service of the World Bank Group

While compliance cost is difficult to measure, business tax compliance costs tend to be higher for large firms as a percentage of sales and are significantly higher for SME. By reducing tax compliance costs and thereby lowering the overall tax burden on small business, SMEs may thus find paying taxes especially burdensome. (Clark, 2007) Meanwhile, the tax authorities are likely to find it especially unrewarding to collect it from them. There is considerable evidence that the cost of compliance, relative to firm size, is greater for small companies. This has been widely documented for higher income countries. (European Commission, 2010)

10. REDUCING THE COMPLIANCE BURDEN

The heavy burdens that many companies continue to face in terms of the time and expense involved in meeting their tax obligations were documented in *Paying Taxes 2016: the Global Picture* (World Bank Group and PwC, 2015). Simplifying these requirements can result in significant benefits to both SME taxpayers and the tax administration. Key aspects include simplifying the procedures to register, make and deal with enquiries, file and submit returns, pay taxes, complete an audit, and solve tax disputes. Given the limitation on SME compliance capacities, tax administrations should streamline procedures in accordance with the following four principles:

1. Don't request more information than will be processed and used for the tax administration purposes
2. Do provide simple and clear information on what, how, where, and by when actions should be completed, and do clearly delineate the record-keeping requirement
3. Do standardize procedures nationwide in order to avoid different treatments across different offices
4. Do operate with transparency and public accountability.

11. FAVOURABLE TAX TREATMENT FOR SMES

There are several arguments for tax measures that are favorable to SMEs. First, there may be market failures that affect SMEs such as asymmetric information or product monopolies. The power of large companies might make entry into the market difficult for an SME, or an SME may have difficulties in raising finance. These may be used as justification for general tax relief or for special schemes to promote investment in SMEs. (Shi, 2007)

Second, it may be important to counter the disadvantages of being small by special measures, as in the case of the regressive nature of burden on business compliance costs. Various countries have established the regressive nature of taxes and other burdens on SME business and this is widely accepted as being a problem that may be legitimately by addressed by reliefs and exemptions and by removing certain reporting and disclosure requirements from SMEs.

Third, losses bear more heavily on SMEs than on other businesses. Rather than being required to pay tax immediately, the tax authority may have to wait until the business generates sufficient taxable profit to absorb past accumulated loss.

Successful tax administration means not simply increasing revenue but also increasing voluntary compliance. Solutions need to be created that are well suited for developed and advanced transition economies, and the critical issues will vary from country to country and even within a country over time. (James, 2008)

12. NEGATIVE IMPACTS OF SME TAXES

The provision of tax reliefs and exemptions for SMEs run against the key principle of neutrality. It may distort the choice of business organization, commercial decisions about forms of expenditure timing, and methods of transfer into other hands. Reliefs may even result in barriers to growth at the margins if restricted to businesses below certain thresholds. It is arguable that a simple and neutral system of business taxes could be more important to SMEs than many special provisions which create complexity. In addition, tax incentives and reliefs for SMEs may interfere in the market and result in economic inefficiency. This would result in the allocation of resources to SMEs that are less efficient (Freedman and Crawford, 2009).

13. CONCLUSIONS

SME tax systems need to be designed in such a way as to minimise compliance costs and maximize accessibility. The reforms of the SME tax system would then need to require compliance commensurate to capacity. Simplification of the income tax system for SMEs in a more comprehensive manner is strongly supported. This should take account the countries' past experiences, taxpayer views, specific suggestions on legislative detail and the lessons learnt from other tax regimes. These factors should provide a sound basis for tax policy decision-making in any country. (Pope and Jabbar, 2008)

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