



Australian Government

The Treasury

2013

File:

Mr Jason McNamara
Executive Director
Office of Best Practice Regulation
Department of Finance and Deregulation
John Gorton Building
King Edward Terrace
PARKES ACT 2600

Dear Mr McNamara

POST-IMPLEMENTATION REVIEW: ABOLISHING THE ENTREPRENEURS' TAX OFFSET

I am writing to you regarding the Australian Government requirement to undertake a Post-Implementation Review (PIR) of the abolition of the Entrepreneurs' Tax Offset (ETO).

The ETO was a non-refundable tax offset that was introduced in the 2005-06 Budget as additional assistance for very small, micro and home-based businesses in their early stages of development. It applied to assessments for income years commencing on or after 1 July 2005.

The attached PIR explains the ETO's policy objectives and the reasons for its abolition. In accordance with the Australian Government's Best Practice Regulation requirements the PIR assesses the actual impacts on stakeholders (such as the compliance costs) of abolishing the ETO.

The contact person for this matter in the Treasury is
or

who can be contacted on

Yours sincerely

Rob Heferen
Executive Director
Department of the Treasury

Post-Implementation Review: Entrepreneurs' Tax Offset

The Entrepreneurs' Tax Offset (ETO) provided a 25 per cent offset on the income tax liability attributable to the business income of small business entities with an annual turnover of \$75,000 or less. A business with an aggregated turnover of \$50,000 or less, would receive the full amount of the ETO on its business income. The ETO was phased out for businesses with an aggregated turnover between \$50,000 and \$75,000.

Example – how the offset worked

Jenny runs a physiotherapy practice from her home and she is a Simplified Tax System taxpayer for the income year commencing 1 July 2006. The net income from her practice is \$20,000 (i.e. \$30,000 turnover less \$10,000 business expenses). In addition, she has a part-time job as a shop assistant from which she receives salary and wages of \$25,000. Jenny's taxable income for year is \$45,000. In 2005-06, Jenny's total income tax liability was \$9,671.53 and 25 per cent of this tax liability is \$2,417.88. The ETO in 2005-06 was calculated under the Simplified Tax System based on the percentage of income attributable to the business, which is about 44 per cent of Jenny's income. Therefore, Jenny's Entrepreneurs' Tax Offset is \$1,074.51.

Problem and objectives

In its 2004 election policy statement *Promoting an Enterprise Culture*, the then Government announced a number of measures designed to foster the entrepreneurial spirit of small businesses. These measures included a tax offset for entrepreneurs to provide further incentive and encouragement to small businesses – particularly those that set up and operate from home and were eligible to participate in the Simplified Tax System (STS).

All types of small business entities were able to claim the ETO: individuals; companies; partners in a partnership; beneficiaries of a trust, where the beneficiary is liable to pay the tax; and trustees of a trust, where the trustee is liable to pay the tax.

Impact analysis

The low threshold for access to the ETO meant that it was only available to very small business entities (which accounted for around 20 per cent of all Australian small businesses in 2010-11¹). Many very small businesses in the start-up stage do not generate much, if any, profit and will have a corresponding nil or low tax liability. As the ETO was a non-refundable offset, many businesses could not benefit from it. There is no available data in respect of industries or businesses that actually claimed the ETO. However, the ATO has provided data which examines the number of ETO customers and the average amounts claimed.

The ETO was abolished by the *Tax Laws Amendment (Stronger, Fairer, Simpler and Other Measures) Act 2011* from 1 July 2012.

The costs and benefits of removing the offset are hard to quantify, to do so, would involve making various assumptions about business behaviour including changes to that behaviour which available data does not provide for. Nonetheless, the data provided by the ATO provides a history of taxpayers that claimed the ETO and details of income which allow tentative conclusions on the impact of the ETO.

¹ Small businesses have been defined as individuals, companies, partnerships and trusts with income above \$1 and below \$2 million. ATO *Taxation statistics 2010-11*

The benefits of abolishing the ETO include simplifying tax regulation by removing a poorly targeted law and a minor distortion between wage earners and those that derive business income. Reliance on the ETO could have become a potential barrier for growth of small business entities and potential loss of increased revenue to the government.

The Australia's Future Tax System (AFTS) recommended the abolition of the ETO noting that its removal would reduce compliance and administration costs and provide a more equitable and neutral treatment between self-employment and employment income. ATO data indicates that the administration and compliance cost of the ETO was not high and was considered business as usual within the administration of the ATO.

The ETO may have acted as a disincentive for very small business entities to expand beyond the \$75,000 threshold because once reached the threshold they would no longer be eligible for the offset, especially in the case of businesses run as a secondary source of income. However, due to the limitation of the data and because the decision to expand a business is based on a number of factors such as the current economic environment and capacity of the business owner to expand the business, it is hard to assess to what extent this tax offset would be taken into account in business decisions.

There were also some gains in revenue in abolishing the ETO. The 2011-12 Budget stated that over four years it would increase revenue by \$365 million. This allowed for funding of competing priorities.

The abolition of the ETO has affected a range of taxpayers that claimed the offset. This included:

- approximately 215,000 sole traders and 45,000 partnerships in 2005-06 and 335,000 sole traders and 45,000 partnerships in 2011-12 income years that claimed the ETO; and
- on average, ETO claimants lost around \$500 for sole traders and \$300 for partners in a partnership in 2011-12.

The number of business entities that were eligible to claim the ETO increased from 2005-06 to 2009-10, there was a slight decrease in the number of businesses eligible to claim from 2009-10 to 2011-12, possibly due to the imposition of an income test as an additional eligibility criteria. However, the total number of business entities that were eligible to claim was higher in 2011-12 than in 2005-06, despite the income test being introduced in 2009-10.

Many ETO claimants had other means to support themselves through wage income. 150,000 sole traders and 20,000 partnerships in 2011-12 had wage and salary income and were claiming the ETO.

These very low levels of net business income suggest that the business may not be the primary source of income for the claimants. The average net business income for ETO claimants in 2011-12 was \$18,000 and the average aggregated turnover was around \$32,500.

Abolishing the ETO removes assistance for smaller business entities that were starting out and therefore potentially discouraging some small enterprises from starting up. 55,000 small business entities were claiming the maximum amount of the ETO they were eligible for.

Other government measures

There is a range of other government measures that could help small business entities. These include a range of State and Federal grant programs, and generous concessions in the tax system. Comparing with the limited access of the ETO, these initiatives are available to more small business entities that have aggregated turnover of up to \$2 million. However, many of the above measures are not specifically targeted at micro business entities like the ETO and are aimed at helping small business entities more broadly.

In the 2011-12 Budget, the then Government announced a range of tax measures that provided tax concessions for small businesses by increasing instant asset write off thresholds. However, these changes are being unwound with the repeal of the Mineral Rent Resource Tax and Clean Energy package.

Capital gains tax (CGT) concessions are also available to businesses with a turnover under \$2 million. There are four CGT concessions available to small businesses; (1) the retirement exemption; (2) the 15-year exemption; (3) the active assets 50 per cent reduction; and (4) the small business rollover.

Also, government websites such as business.gov.au provide comprehensive and up to date information for small businesses on a range of essential topics such as employment, grants and assistance and taxation.

Consultation

On 8 May 2011, as part of the small business tax reform package in the 2011-12 Budget, the Government announced that it would abolish the ETO from the 2012-13 income year. Preliminary to this budget announcement, it is understood that there was some targeted consultation with relevant stakeholders.

Conclusion

In conclusion, abolishing the ETO had a small but direct impact, namely the loss of \$500 in average income for 380,000 business entities in the 2011-12 income year who claimed the ETO. However, the Government continues to assist small business entities by providing tax concessions and grants.

Abolishing the ETO has resulted in the removal of a minor distortion in the tax system and an increase to revenue. Other than the impact to revenue, the benefits of the ETO are very hard to quantify because the ETO was a small offset and the benefits are based on a range of behavioural assumptions which are inherently hard to verify.