

1 June 2005

MEMORANDUM FOR

From: Robert Conrad
Subject: Small Business Taxation

Small business taxes are described below. The Russia and Kyrgyz experience is discussed and recommendations for Ukraine are made.

1. Purpose of a Small Business Tax

One important justification for a small business tax is that compliance costs are decreased for small (and medium) sized businesses, however defined. The costs of maintaining complete accounting records on an accrued basis, combined with other regulatory and tax requirements, are large relative to net income for small businesses. These costs can place a small business at a competitive disadvantage relative to large enterprises, with the result that small business investment is lower than desired.

A second justification for a small business tax, often stated, is to encourage small business to move from the gray economy. While a desirable outcome, three points are noted about using a small business tax for this purpose. First, firms operate in the gray economy for a number of reasons, including compliance costs. The total costs of taxation include the tax payment, compliance costs and potential costs imposed by unscrupulous tax officials (or a general lack of regard by the government of taxpayer rights). Thus, one should not expect that small businesses will begin complying with the tax laws if only compliance costs are reduced, even significantly, by a small business tax. Second, large enterprises also operate in the gray economy or engage in transactions that reduce their exposure to the tax system. Thus, there is no reason to create a small business tax if the objective is to encourage market participation by all parties.

In general, the purpose of the small business tax is either to serve as a substitute for individuals paying business taxes as part of their individual income tax or to reduce the compliance cost for small entities paying the enterprise profits tax. This tax should not be designed as a tax incentive, however. That is, there should be minimal incentives for taxpayers to change organizational structure (to become a small business rather than employees or to become small corporate entities rather than large entities) in order to take advantage of lower taxes. To the extent possible, effective tax rates (both total and marginal) should be equal. The only purpose of the tax is to reduce accounting and compliance

costs. Thus, it is important to coordinate the small business tax with the enterprise profits and the personal income tax, as well as the VAT, in order to ensure that adverse incentives are minimized.

2. Types of Small Business Taxes

Three types of small business taxation are common.

a. Patents

A patent is a type of fixed fee per annum in lieu of some other taxes. A patent system could be designed as a required minimum tax, with additional income taxes levied if income is greater than a specified threshold. Alternatively, the taxpayer might be subject to only the patent with no attempt to enforce compliance beyond the simple payment.

Perceived simplicity is the primary advantage of this system. Taxpayers make a minimum contribution to the tax system and administrative costs are reduced for both the tax collector and the tax payer, at least in theory.

There are some disadvantages to the system.

i. Regressive Impact

The tax can be perceived as regressive. As long as the taxpayer qualifies for the patent, the same amount of tax is paid regardless of income level. The marginal tax rate is zero and the average rate falls as income increases. In addition, the taxpayer must pay the patent even if he has incurred losses.

ii. Discriminatory Treatment

The same tax is paid regardless of industry with a patent system. Thus, the tax can be discriminatory across sectors due to economic differences. Countries (such as the Kyrgyz Republic and Israel) have attempted to offset this type of discrimination (and the regressive impact to some extent) by creating sector-specific payments and payments that vary with some measure of activity. For instance, restaurants might pay one fee, small shops a different fee and petrol stations a third fee. In addition, small shops might be taxed on measured physical area of the facility, cafes on the number of tables and petrol stations on the size of their storage facility for example. This type of rate and base differentiation complicates administration. Tax administrators must be physically present in the establishment, monitor the measures to record changes and apply different standards depending on the facts and circumstances.

iii. Cumbersome Administration

A patent system is not easy to administer. The only administrative relief is the absence of income accounting. It is still necessary to measure turnover (or gross proceeds) if qualification is based on turnover, to register taxpayers, to monitor activities and to reduce evasion. In addition, there are incentives for large taxpayers to become small taxpayers if the patent is small relative to other payments. Anti-abuse rules are necessary and these rules must be enforced.

b. Gross Proceeds

A second small business tax base is a measure of gross proceeds (or turnover).¹ The tax is measured as a fixed proportion of gross proceeds and thus the tax level changes with that measure. Despite the benefit of taxes increasing with the measured base, a gross proceeds tax has similar drawbacks to the patent system. First, proceeds and profitability are not necessarily correlated and thus enterprises could be paying tax in periods when income is negative. A regressive impact could also result if costs are not proportional to proceeds.

Second, there is discrimination across industries because profit margins vary. For instance, the profit margin for a small store could be 20% because of the need to maintain space and inventories whereas the margin for a translating service could be 80% because of its labor-intensive nature. The effective tax rate (on average) will thus be four times greater for the store relative to the translating service.

Finally, administration is still cumbersome with a gross proceeds tax. The only administrative benefit is the absence of a need to compute net profit. The tax administration must still audit turnover and undertake compliance activities.

c. Net Cash Flow

Net cash flow is an alternative to accrual accounting for income purposes. Double entry bookkeeping is not required. Simple cash accounting is sufficient and can be used to measure receipts and expenses.² The most efficient measure of net cash flow includes immediate expensing of all asset purchases (full depreciation in the period of payment), no accruals of any kind (deferred compensation, receivables or payables) and elimination of debt from the base. Debt can be eliminated in one of two ways: either interest expenses are

¹ The measure should be "gross proceeds", not turnover. Interest income and other payments other than repayment of capital should be included in the measure in order to avoid taxpayers either using a small business to shelter taxable income or to re-characterize sales as other types of income.

² This method is used in Poland, in the United States for individuals and some smaller enterprises, and in a number of other countries.

disallowed, or loan proceeds are included in income with loan repayments and interest expenses deducted. The first method is more commonly used because excluding loan proceeds and repayments is more in accord with standard income accounting.³

This method is neither regressive in impact nor discriminatory because the base is a measure of income. Thus, cash flow accounting is generally superior on economic grounds to either the gross proceeds base or the patent. The method is more complicated relative to the other methods, however, because costs must be measured and monitored. Thus, the administrative costs are greater.

d. Experience in Other Countries

A number of countries have implemented small business taxes, though none have been particularly successful with implementation. The experience of two CIS countries is noted here.

i. The Kyrgyz Republic

The Kyrgyz Republic used the patent system for the small business tax prior to 2005. The tax differed by industry. The system failed because the qualifications could not be monitored and the qualifications were too inclusive. For instance, all hotels paid patents. Thus, hotels paid a fixed fee and were exempt from all other taxes regardless of income levels. Patent proponents claimed that tax revenues from hotels increased because of this system. It is true that patent revenue increased, but revenues from the enterprise profits tax and the personal income tax fell, resulting, I believe, in a net revenue loss to the government. In addition, opponents claimed, with justification I believe, that corruption and discrimination in the system allowed large enterprises to qualify for patents.

ii. Russia

Russia uses a combined patent system (by regions) and a turnover tax (at the national level). The patents differ by industry (petrol stations taxed on proximity to major highways, small stores taxed on area and other measures). The gross proceeds tax is imposed depending on the size of firm. The tax on gross proceeds is 6%.

³ It is necessary to eliminate debt elements in cash flow accounting in order to ensure that the marginal effective tax rates are zero. Effective tax rates can be negative with leverage when cash flow is used because of the double counting for capital that is possible when assets are expensed and debt is used. In addition, the incentive for thin capitalization is reduced.

I believe the small business tax has been a failure. The patent has failed for reasons described above and there are a number of reasons for the failure of the gross proceeds tax.

1. Lack of Affiliation Rules

Russia has few anti-abuse rules. Thus, large corporations can own small businesses, wealthy individuals can split activities into a number of small businesses and partnerships can be created in order to split income among different activities.

2. Poor Coordination with Personal Income Tax

The personal income tax rate is 13% (like Ukraine's) but the gross proceeds tax is 6%. Individuals who are entrepreneurs are also exempt from the social tax. Thus, individuals have a strong incentive to switch from employment income by becoming independent contractors for their previous employers. In addition, there has been at least one case where the enterprise has encouraged employees to switch from employee status by offering higher overall compensation.

3. Administrative Burdens

Compliance is difficult because of the lack of anti-abuse rules, limited administrative resources and, perhaps, corruption. For instance, a store with multiple cash registers is treated as a number of small businesses with each cash register defined as a separate small business. Small businesses do not appear to be required to keep records necessary for determining qualifications. For instance, the patent system was based on a turnover level but there was no bookkeeping requirement so that it is not possible to determine (except by use of indicators) whether the business is qualified. These and other administrative burdens (such as registration and monitoring) have limited Russia's ability to target the tax in the manner intended.

3. Policy Elements of a Small Business Tax

A small business tax, regardless of the base (patent, gross proceeds or net cash flow) should have a number of elements.

a. Definition of Small Business

i. Gross Proceeds

Qualification should generally be based on gross proceeds. Gross proceeds should be broadly defined to include all cash receipts except capital contributions and repayments. Qualification should not be based on the number

of employees because of administrative reasons (it is difficult to define and to monitor any definition of full time equivalent employees)

ii. No Related Parties

A small business should not be owned by either a large business, a group of large businesses, a wealthy individual, a group of wealthy individuals or any combination of such persons. In addition, a group of small businesses should not be related by common ownership (or control). For instance, a husband and wife should not be allowed to treat two separate stores as separate small business. There need to be clear (and somewhat arbitrary) aggregation requirements and rules to ensure that the small business tax is not used as a tax shelter, that operations are not split into multiple organizations and that large taxpayers (either individual or corporate) cannot own small businesses.

iii. Activities

Qualifications should be further restricted. The following persons should not qualify for the small business tax:

1. Producers of excisable goods,
2. Producers of certain services (electricity and financial services for instance),
3. Persons with large charter capital (or capital listed on stock exchanges) or large assets (such as a manufacturing plant), and
4. Persons engaged in certain activities (insurance, recipients of foreign exchange from export, professionals such as doctors, lawyers, architects, engineers or those engaged in other specified activities).⁴

b. Bookkeeping Requirement

Books of account should be maintained and should be sufficient for determining eligibility (both initial and continuing). The books should include asset values, ownership information and gross receipts, among other information.

⁴ It might be beneficial, as a draft strategy, to list only those sectors and enterprise types that are to be eligible for the small business tax.

c. Registration

All small business taxpayers should be registered and issued taxpayer numbers. Information sufficient for monitoring should be required, including ownership structure, address, addresses of owners, type of organization and other statutory information.

d. Coordination with Other Taxes and Tax Provisions

It is important that the small business tax be coordinated with other taxes in order to reduce arbitrage incentives and to reduce administrative costs. Some particular elements of coordination are noted here.

i. Definition of Employee

The definition of employee should be in the income tax law, not in the small business tax law. The definition of an employee is important for determining requirements for withholding and such the payment of social taxes. Employees should not be eligible for small business taxation.⁵

ii. Definition of Related Party

The same definitions for related parties that are used for determining transfer pricing and other rules should be applied to small businesses.

iii. Rates

Tax rates should be coordinated to the extent possible to reduce arbitrage incentives. For instance, the enterprise profits tax rate and the small business tax rate should be the same, assuming the cash flow tax is employed. Coordinating rates is more difficult if the small business tax base is gross proceeds, but some rate approximating the rate on net income is desirable.

iv. Turnover Levels

The gross proceeds level and the exemption levels for certain taxes should be coordinated in order to provide consistent signals, to reduce complexity and to provide a more comprehensive view of a small business. For instance, the gross proceeds level should be equal to the turnover level necessary for mandatory VAT registration. Thus, a small business would automatically be exempt from VAT.

⁵The definition of an employee is difficult and all countries, including the United States, have significant problems determining whether a physical person is an employee. I believe the definition should be clear and based on objective standards in Ukraine in order to encourage compliance.

v. Provision for a Tax Credit

One objective of income tax policy as it evolves is to create a unified tax system. In cases where a person has other income sources, a credit might be appropriate. For instance, an individual might have wage income and small business income measured on cash flow. It might be reasonable to combine both income sources into a measure of the comprehensive base and to allow a credit for the small business tax paid against total taxes due.

e. Optional Registration

Registration for a small business should be optional. Persons should have the right to be taxed under the normal system. Such a provision will ensure that persons with legitimate losses are not unduly harmed by the small business tax and that persons have the option to become VAT taxpayers. A minimum duration (three years, for instance) is required for optional registration, however. This is necessary in order to keep taxpayers from coming into (or out of) the system based on current circumstances.

f. Exempt Taxes

Small business taxpayers should be exempt from other income taxes on small business income (either profit tax or personal income tax) and VAT. Small business taxpayers should not be exempt from property tax, other sales taxes or fees. Small business taxpayers also should be required to pay withholding and other taxes on behalf of employees. It is not clear how to treat the social taxes of a small business owner, however. Some countries exempt small business tax owners from social tax. A powerful incentive is created to arbitrage the tax system in this case, particularly when the exempt person qualifies for benefits. Thus, policymakers must decide whether to exempt social taxes and, if they do, they must set the small business tax rates relative to the combined rates of the exempt taxes.

4. Recommendations for Ukraine

One recommendation for Ukraine is provided below. This proposal is provided in order to generate discussion about how to proceed in Ukraine given the unique circumstances of the country. I believe, however, that a variant of this system can work in Ukraine if care is taken in developing the law and regulations. Specific drafting instructions and technical matters can be developed once policy decisions are made

a. A Two-Tiered Tax

I propose a combined patent system – net cash flow tax. Only qualified physical persons would be eligible for the patent system. All qualified legal entities and other individuals would be required to use net cash flow.

i. Qualifications

1. Individuals

- a. Individual entrepreneurs with gross proceeds below the income threshold for the personal income tax⁶, with assets below a specified threshold and who have no employees, however defined, would qualify for a patent system.⁷
- b. All individual entrepreneurs with gross proceeds below the VAT threshold would qualify for cash flow accounting.

2. Legal Persons

All legal persons with gross proceeds below the VAT threshold would qualify for cash flow accounting.

3. Affiliation and Aggregation

a. Affiliation

A legal entity that is a “large” business may not have an economic interest, either direct or indirect, in any small business if that small business is to qualify for the small business tax.

- i. A small business or small business owner may not have an economic

⁶ It would be helpful (and efficient I believe) to increase the threshold for the personal income tax so that the majority of Ukrainian individuals would be exempt from the personal income tax. Such an increase would improve the perceived progressivity of the tax, reduce the administrative burden by reducing the number of taxpayers and increase the overall elasticity of the tax system. The share of total taxes collected by the personal income tax would thus increase through time with the growth of per capita income.

⁷ Individuals with significant assets (houses, cars and equities for instance) should not be allowed to own small businesses.

interest, either direct or indirect, in another small business if any of the small businesses so connected are to qualify for the small business tax.⁸

b. Aggregation

Qualification for small business status is based on the aggregation of all business interests of the taxpayer. For physical persons, aggregation means the total of all gross income except wages and passive income (including interest and dividends), regardless of geographical location or type of activity. For legal entities, aggregation of business interests includes proceeds from economic activities (including interest and dividends) regardless of geographical location or type of activity.

4. Excluded Activities

The following activities would not be eligible for small business taxation:

- a. Financial services,
- b. Professional services including legal, medical, engineering or other services where advanced education is generally a prerequisite or expected,
- c. Transportation services,
- d. Production of excisable goods, and
- e. Services provided by employees.

⁸ There is the additional issue about individuals with significant relationships to large legal entities. For instance, a board member might establish a small business to sell services to the legal entity. This type of issue might be addressed by law or regulation.

b. Exempt Taxes

i. Individuals Who Pay Patent

Patent taxpayers would be exempt from VAT, personal income tax and social tax.

ii. Legal Entities and Individuals Paying Cash Flow Tax

Small business entities or individuals paying the cash flow tax would be exempt from either profits tax or personal income tax and from VAT. Individual entrepreneurs would pay social tax based on measured net cash flow.

c. Base

i. Patent

The patent would be a fixed fee adjusted each year for inflation and payable quarterly. The fee would be identical for all activities.

ii. Cash Flow

Net cash flow would be defined as gross proceeds less all ordinary and necessary costs (except wages paid to the entrepreneurs and any relatives). Assets would be immediately expensed and deductions would not be allowed for interest expenses.

d. Rates

i. Patent: Amount to be determined

ii. Net Cash Flow⁹

1. Individual entrepreneurs: The personal income tax rate.

2. Legal entities: The enterprise profits tax rate.

⁹ It would be beneficial for both policy and administrative reasons to equalize the profits tax and personal income tax rates.

e. Other Provisions

i. Tax Credit

Individuals would be able to take a credit for the small business tax measured on net cash flow against the aggregate personal income tax liability.

No credit would be allowed for legal entities.

ii. Optional Registration

Any person would be able to choose to be taxed under the normal tax system. Such election would be binding for a minimum of three years.

iii. Bookkeeping

All small business taxpayers should maintain cash flow accounts, receipts and other information sufficient to validate qualifications.

In summary, a small business tax is neither a simple tax to administer nor a panacea for the problems inherent in developing a small business sector. Thus, care must be taken to design a system that meets the policy objective with minimal incentives to corrupt the system and to satisfy administrative requirements.

I hope this information is helpful and look forward to our discussions. I will be pleased to supply additional material and comment as deemed necessary.

Thank you