

ALL THINGS BEING EQUAL: SMALL BUSINESS STRUCTURE CHOICE

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ABSTRACT

In Australia there have been arguments about introducing new methodologies to tax small businesses. Recently Pitcher Partners submitted that a dual income tax (DIT) system should be introduced to achieve greater tax neutrality and to reduce complexity. However, what are the factors taken into account when a business structure is chosen for a small business, and how do these relate to the features of a DIT system? This article reports a pilot study that considered the factors for business structure choice, and whether a DIT system could provide such characteristics. It will be argued that for a DIT model to be successful in Australia it needs to address the taxation of retained business income and how it could apply to all business structures, including trusts.

Keywords: dual income tax, business structure, choice, small business, tax reform, Australia

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I INTRODUCTION

How to design a tax system is always a vexed question, as tax systems can be used not only to raise tax revenue but also for policy objectives.¹ A mooted design preference is to have a tax system that has minimal (or no) impact on decisions – known as tax neutrality.² However, the principle of tax neutrality can be ignored if there are clear policy objectives, such as deterring smoking. Kahn argues that complete tax neutrality is never possible as the existence of tax will inherently have the potential to influence taxpayers. Kahn pointed out that a tax system will influence taxpayer decisions regardless of the way the system is designed, even if the system is designed to be neutral to specific choices.³ For example, consider a sole proprietor with his or her income from business taxed at a marginal tax rate of 49 per cent: the government can be seen as a silent partner to this taxpayer, so that the government collects approximately half of the profit and bears approximately half of the business losses. This may have a great impact on the taxpayer's business choices when considering whether to incur a business expense or not. To this extent it is hard to eliminate tax influences, as they are an inadvertent cost of having a tax system.⁴

Part of a tax system design is how best to tax business activities. This can be a complex consideration when artificial legal structures are used, especially ones that allow for multiple equity members. There have been arguments that any business with legal personality should be taxed as such,⁵ where others have argued that the business's legal personality should be totally ignored with all business income and losses directly attributed to equity members.⁶ Alternatives at a mid-way point may be utilised with some tax at the entity level, and allow for this tax to be attributed to members on distribution, such as via an imputation or dividend deduction system.⁷ For example, Australia has utilised a spectrum of taxing methodologies for the corporation over the years, using the imputation system since 1987.⁸ However, the taxation of business structures in Australia is not consistent, as different taxing methodologies are utilised for each of the popular

¹ Adrian Sawyer, 'Complexity of Tax Simplification: A New Zealand Perspective' in Simon James, Adrian Sawyer and Tamer Budak (eds), *The Complexity of Tax Simplification – Experiences from Around the World* (Palgrave Macmillan, 2016) 111.

² Adam Smith, *An Inquiry into the Nature and Cause of the Wealth of Nations*, Book V of the Revenue of the Sovereign or Commonwealth (W Strahan and T Cadell, 1789) 645.

³ Douglas Kahn, 'The Two Faces of Tax Neutrality: Do They Interact or Are They Mutually Exclusive?' (1990) 18 *Northern Kentucky Law Review* 1–19.

⁴ *Ibid.*

⁵ Jeffrey A Maine, 'Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises' (2001) 62 *University of Pittsburgh Law Review* 223. For example, the classical tax system describes when the business structure is subject to an entity approach for tax purposes, with no recognition of this tax paid on subsequent distributions to members, nor concessional tax treatment on distribution, such as dividend deduction.

⁶ Jeffrey Kwall, *The Federal Income Taxation of Corporations, Partnerships, Limited Partnerships, Limited Liability Companies, and their Owners* (Foundation Press, 3rd ed, 2005).

⁷ Richard Vann, 'Australia's Policy on Entity Taxation' (2001) 16 *Australian Tax Forum* 33.

⁸ See Brett Freudenberg, *Tax Transparent Companies: Striving for Tax Neutrality? A Legal International Comparative Study of Tax Transparent Companies and Their Potential Application for Australian Closely Held Businesses* (PhD thesis, Griffith University, 2009) 3.

business structures of corporations, trusts, partnerships and sole proprietors.⁹ These different methodologies can mean that the level of tax imposed on a business can vary depending upon the business structure utilised, and as such this can be perceived as a breach of tax neutrality.

While for large businesses the corporation is the dominant structure, for small businesses there is utilisation of various structures, and there can actually be a concurrent utilisation of structures for the one business operation.¹⁰ It appears that a combination of business structures can be adopted by one business in order to achieve both desirable taxable and non-taxable attributes.¹¹ The reason for this has not been fully explored, but anecdotal factors include: the level of owner and advisor understanding; asset protection; limited liability; separate legal entity status; prestige; market preferences; and tax. A study by Freudenberg found that Australian advisors rated asset protection and tax planning as the top two attributes for consideration when recommending a business structure for their small business clients.¹² This would indicate that tax, while not the dominant factor, is a large consideration for choice of business structure, which is consistent with a number of overseas studies.¹³ Such a strong influence of tax could lead to economic costs, as the less efficient structure may be chosen, impacting on business productivity.¹⁴ Such breaches of tax neutrality for the taxation of business structures have been raised as a concern by various tax reviews in Australia.¹⁵

A tax methodology that has been introduced in a number of jurisdictions, especially in Nordic countries, is a dual income tax (DIT) system. A touted benefit of a DIT system is improved tax neutrality, and this was part of the reason that Pitcher Partners argued that a DIT should be introduced in Australia for small businesses, especially for closely held companies.¹⁶ The way that the tax system affects small businesses is seen as an important consideration given that small businesses contribute significantly to the economy. In 2013–14, there were 2 044 860 small businesses representing 97 per cent of businesses

⁹ Brett Freudenberg, 'Tax on my Mind: Advisors' Recommendations for Choice of Business Form' (2013) 42(1) *Australian Tax Review* 33.

¹⁰ Brett Freudenberg, 'A Model Idea: Is the ICAA Proposal for a Tax Transparent Company the Ideal Model for Australia?' (2009) 38(3) *Australian Tax Review* 161, 221

¹¹ Freudenberg, above n 9.

¹² *Ibid.*

¹³ Andrew Hicks, Robert Drury and Jeff Smallcombe, 'Alternative Company Structures for the Small Business' (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).

¹⁴ Claire Crawford and Judith Freedman, 'Small Business Taxation: A Special Study of the Structural Issues Surrounding the Taxation of Business Profits of Owner Managed Firms' in Stuart Adam et al (eds), *The Mirrlees Review: Dimensions of Tax Design* (Institute for Fiscal Studies/Oxford University Press, 2010) vol 1.

¹⁵ For example: Government of Australia, 'Australia's Future Tax System' (Consultation Paper, Attorney-General's Department, 2008) 153.

¹⁶ Pitcher Partners, 'Re: Think Tax Discussion Paper: The Importance of the Middle Market' (Submission Letter, Pitcher Partners, 24 July 2015) <<https://cdn.tspace.gov.au/uploads/sites/52/2015/07/Pitcher-Partners-Submission-2.pdf>>.

in Australia.¹⁷ Though many small businesses are non-employing,¹⁸ they did account for approximately 43 per cent of non-financial private sector employment and approximately 33 per cent of gross domestic product (GDP) during 2012–13.¹⁹ While there are numerous measures of what is a ‘small’ business, for the purpose of this study a small business is one with an annual turnover of less than AU\$10 million and fewer than 20 employees.²⁰

To date there has been limited research in the Australian context analysing whether a DIT would assist small businesses. Particularly, this article will consider whether a DIT would provide the attributes desired by small businesses. In particular, this article will report a pilot study that explores the factors taken into account when choosing a business structure, and will consider how this could relate to a DIT system in Australia. It will also consider, all things being equal, what would be the business structure choice.

The remainder of this article is constructed as follows. Section 2 provides detailed literature on the role of tax neutrality. Section 3 reviews the current business structures utilised by Australian small businesses and the research that has considered whether tax influences this choice. Section 4 details the attributes of a DIT system. Section 5 discusses the research methodology, followed by the results in Section 6. Possible avenues for future research are discussed in Section 7.

II TAX NEUTRALITY

The importance of tax neutrality has been acknowledged by governments and discussed in many tax reviews, such as the Asprey Report in Australia.²¹ A key aspect of this principle is that it requires a tax system that should be neutral between business and consumption choices, and that should not influence taxpayer choices.²² Its importance was further emphasised by the Ralph Committee:

Ideally the business tax system should be neutral in its impacts and thus not be a consideration in business decision-making. Poorly designed tax systems can inhibit economic growth by distorting business decisions.²³

Any departure from the principle of neutrality in the tax system may result in adverse effects; this was highlighted more recently in the Henry Review. This noted the current breaches of tax neutrality across the range of business structures – there are significant

¹⁷ Australian Bureau of Statistics, ‘Counts of Australian Businesses, including Entries and Exits, Jun 2010 to Jun 2014’ (Data Release No 8165.0, Canberra, 2015).

¹⁸ Approximately 61 per cent of small businesses do not employ others: Australian Bureau of Statistics, above n 17.

¹⁹ *Ibid.*

²⁰ This is a combination of the measures used by the Australian Bureau of Statistics and the Australian Taxation Office.

²¹ Government of Australia, Taxation Review Committee and K W Asprey, *Taxation Review Committee: Full Report* (Australian Government Publishing Service, 1975) 16.

²² *Ibid.*

²³ Government of Australia, ‘Review of Business Taxation: A Tax System Redesigned’ (Report of the Ralph Committee, The Treasury, 1999) 105.

differences in the applicability of tax rates amongst them.²⁴ Such differences may result in inefficient outcomes that can impact on business productivity.²⁵ This point is of great importance, as tax distortions can arise when income derived from various business structures are taxed differently.

It is perceived that if a tax system has a potential to distort economic decisions then tax may adversely affect investment decisions and result in inefficient economic decisions. The concept of 'tax neutrality' refers to a system that does not influence personal and financial choices and does not create a bias for taxpayers in choosing one investment over another.²⁶ In this context, the basic conception for tax neutrality is that decisions are based on their economic virtues and not on tax motives.²⁷

The literature has emphasised the importance of an ideal neutral tax system, and research into tax neutrality has a long history. Johansson discussed the issue of neutrality in corporate taxation.²⁸ Recently, researchers have shown an increased interest in tax neutrality in the light of tax policy uncertainty, such as the effects of different uncertain tax factors on investment behaviour.²⁹ Dixit et al found that uncertainty in tax policy can complicate and depress investment.³⁰ However, this view was rejected by Niemann, who argued that in some cases tax policy uncertainty might in fact encourage real investment.³¹

In general, the tax system should strive to be neutral, but in some circumstances, it is impossible to achieve this goal without certain levels of distortion influencing taxpayer decisions.³² In theory, tax neutrality is a broadly accepted concept, and a foundation for any canonical aim of tax reform. However, in practice, trade-offs between tax neutrality and different goals may not be easily resolved.³³ For example, the notion of equity can be a stronger policy motivator than neutrality when it comes to a tax system being politically acceptable.³⁴

From a neutrality perspective, similar activities should be treated in similar ways under a neutral tax system. For example, a neutral system taxes all consumption equally,

²⁴ Government of Australia, 'Australia's Future Tax System' (Report to the Treasury, 2009).

²⁵ Ibid.

²⁶ Kahn, above n 4.

²⁷ Jason Furman, 'The Concept of Neutrality in Tax Policy' (testimony at 'Tax: Fundamentals in Advance of Reform', before the US Senate Committee on Finance Hearing, 15 April 2008).

²⁸ Sven-Erik Johansson, 'Income Taxes and Investment Decisions' (1969) 71(2) *The Swedish Journal of Economics* 104.

²⁹ Avinash Dixit and Robert Pindyck, *Investment under Uncertainty* (Princeton University Press, 1994); Rainer Niemann, 'Neutral Taxation under Uncertainty – A Real Options Approach' (1999) *FinanzArchiv/Public Finance Analysis* 51; Caren Sureth, 'Partially Irreversible Investment Decisions and Taxation under Uncertainty: A Real Option Approach' (2002) 3(2) *German Economic Review* 185.

³⁰ Dixit and Pindyck, above n 29.

³¹ Rainer Niemann, 'Tax Rate Uncertainty, Investment Decisions, and Tax Neutrality' (2004) 11(3) *International Tax and Public Finance* 265.

³² Furman, above n 27.

³³ Ibid.

³⁴ Simon James, 'The Complexity of Tax Simplification: The UK Experience' in Simon James, Adrian Sawyer and Tamer Budak (eds), *The Complexity of Tax Simplification – Experiences from Around the World* (Palgrave Macmillan, 2016) 231.

minimising the distortion in people's choices. However, neutrality in the tax system is not always appropriate: for example, it can be argued that a lack of neutrality is valuable in some cases, such as in the consumption of undesirable products.³⁵ Taxes (or tax concessions) have also been used to support certain activities, such as encouraging research and development activities and childcare. It has been argued that such non-neutralities should be introduced only after other approaches have been shown to be ineffective.³⁶

In Australia it has been observed that the taxation of business structures is far from neutral, as discussed in the next section.

III SMALL BUSINESS AND STRUCTURE CHOICE

Small businesses range across all sectors of the economy, but are concentrated in construction, agriculture and professional services.³⁷ In considering the business structures used by small businesses, it is of great importance to gain an understanding about the utilisation of different business structures. In terms of size, for taxpayers with annual business income less than \$2 million (known as 'micro' businesses) the sole proprietor structure is the most popular (48 per cent), followed by corporations (29 per cent), with trusts and partnerships at approximately 13 and 11 per cent respectively. When considering the business structures for those businesses with annual income from \$2 million to \$10 million, then it is evident the corporation is the most popular structure, accounting for 64 per cent of businesses, followed by trusts at 25 per cent, then partnerships at 8 per cent and sole proprietors at 3 per cent (see Table 1). Consequently, it can be appreciated that there are a variety of business structures being used by small businesses, with more sophisticated structures being utilised as the business turnover increases, although this is not always the case.

Table 1: Number of entities by business type and size in 2014–15 tax year

Business structure	Loss (<\$0)	Nil (= 0)	Micro (>0 but <\$2M)	Small (>\$2M but <\$10M)	Medium (>\$10 but <\$100M)	Large (>\$100M but <\$250 M)	Very large (>\$250 M)
Sole proprietors	1022	12 050 273	1 159 231	2996	289	2	1
Partnerships	160	65 737	255 963	7638	1018	61	43
Trusts	600	481 883	312 392	24 145	4212	166	50
Corporations	1567	125 936	706 860	61 173	16 497	1345	1130
Total	3349	12 723 829	2 434 446	95 952	22 016	1574	1224

Source: *Taxation statistics 2014–15*, Australian Taxation Office <<https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2014-15>>.

³⁵ James Mirrlees and Stuart Adam, *The Mirrlees Review: Tax by Design* (Oxford University Press, 2011) vol 2.

³⁶ Government of Australia, above n 23, 105.

³⁷ Australian Bureau of Statistics, above n 17.

In terms of these business structures a variety of taxing methods apply.³⁸ For example, tax flow-through applies for sole proprietors and general partnerships, with equity member(s) being assessed directly on the business income and losses. For trusts, such as discretionary and unit trusts, a partial income flow-through applies, with beneficiaries (members) assessed on income if they are presently entitled, although losses are trapped within the trust. For corporations and limited partnerships an imputation system applies, with the corporation initially assessed on the business income with distributions to members able to have imputation credits attached. Losses for a corporation are trapped at the corporate level and carried forward. Consequently, the varieties of tax methodologies mean that the level of tax on business income can vary depending upon the business structure chosen.

Given the variety of tax treatments, characteristics and regularity requirements, what are the considerations in the choice of business structure? In particular, do breaches in tax neutrality between different business structures influence the taxpayer's choice of business structure?

Numerous studies have demonstrated that there is a potential influence by tax arbitrages for taxpayers when considering the choice of a business structure. In the US, research by Scholes and Wolfson, and by Gordon and MacKie-Mason, has considered the effect on business structure choice due to the 1986 Tax Reforms.³⁹ However, the findings from an earlier US study conducted by Ayers et al found that non-tax factors such the size and the age of the business, the ownership structure and the business risk are all important considerations in choosing the business structure.⁴⁰

In the UK, Hicks et al investigated the reasons behind the small business choice to incorporate, and found that tax consideration was the second most important factor, from the advisors' point of view, whereas limited liability was the dominant reason to incorporate.⁴¹ Also in the UK, Freedman and Goodwin found that, while tax was not the dominant reason for the choice of business structure, it did in fact play a role, as close to 40 per cent of participant choice was based on tax.⁴²

Two Australian studies particularly explore the tax influence on business structure choice. Holub, who analysed the use of public trusts in relation to their tax treatment, found that the initial choice to utilise the public unit trust before the tax amendments could be based on tax considerations.⁴³ This conclusion was reached as it was found that

³⁸ For a more detailed discussion of the different tax methodologies of Australian business structures see: Freudenberg, above n 9.

³⁹ Myron Scholes and Mark Wolfson, 'Issues in the Theory of Optimal Capital Structure' in Sudipto Bhattacharya and George M 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' (NBER Working Paper No 3222, National Bureau of Economic Research, 1990).

⁴⁰ Ben Ayers, Bryan Cloyd and John Robinson, 'Organizational Form and Taxes: An Empirical Analysis of Small Businesses' (1996) 18 *The Journal of the American Taxation Association* 49.

⁴¹ Hicks, Drury and Smallcombe, above n 13.

⁴² Freedman and Godwin, above n 13.

⁴³ Mark Holub, *Taxes and the Choice of Organisational Form in Australia* (University of Western Australia, 2001).

after reforms that fundamentally altered the tax impost of public unit trusts, nearly all studied businesses changed their business structure. This would suggest that, all things being equal, the initial choice of a unit trust was based on the tax imposed and not on other commercial implications. Holub also suggested that the high percentage of conversions to corporations (seven out of eight) meant that the non-tax advantages of the corporate form were greater than for unit trusts.⁴⁴

In a more recent Australian study, Freudenberg explored the considerations regarding the formation of businesses in a survey of 81 advisors.⁴⁵ In Freudenberg's study advisors were asked what were the most important factors when advising a client about business structure. Respondents were asked to rank 10 factors from most important to least important.⁴⁶ These rankings were then averaged out of 10, with 10 being the most important and 1 being the least important.

Freudenberg's study found that on average the most important factor was considered to be asset protection (8.26 on a 10 point scale), 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). Freudenberg observed that:

the notion of asset protection appears to be more important than limited liability, which may highlight an understanding that the notion of limited liability can be undermined by various circumstances (such as personal guarantees and regulatory obligations) ... What may be more important at the end of the day is protecting valuable assets rather than shielding a person from liability exposure.⁴⁷

The ability for the business structure to allow for expansion was the 3rd most important factor (5.98), with capital gains tax (CGT) concessions at 6th (5.68) and succession planning at 7th (5.47). A limitation of Freudenberg's study is that it only provided advisors with 10 factors to consider. It is likely that more factors are potentially relevant and the concept of 'tax planning' has a number of subtle nuances – consequently a number of additional factors could be developed.

Freudenberg's study also explored in more detail the role that tax benefits may play in the choice of business structure, with advisors asked to rank each business structure on which gave the greatest tax benefits/savings (ignoring tax compliance cost). In response to this, discretionary trusts were seen as providing the greatest benefit, with an average of 3.81 (on a 5 point scale). Companies (3.3) and unit trusts (3.16) were considered the 2nd and 3rd best. Such evidence could support assertions that the use of discretionary trusts could be largely due to tax and not their commercial factors.

⁴⁴ Ibid, 328

⁴⁵ Freudenberg, above n 9.

⁴⁶ For reporting purposes 10 is used as most important and 1 as least important. Note on the survey instrument itself 1 was 'most important' and 10 was 'least important'; as it was considered the use of '1' would indicate that it was of the upmost importance. However, for reporting purposes the scale was reversed to give a greater logical representation in the diagram with the largest column symbolising the greatest importance.

⁴⁷ Freudenberg, above n 9.

Together, these studies indicate that there is some evidence to support the argument that tax arbitrages can influence taxpayer choice of business structure, although factors such as asset protection and liability are also critical influences. It can be argued, based on the analysis provided, that the taxpayer's investment decisions may be distorted by breaches of tax neutrality in business structures. A mooted tax system to address breaches of tax neutrality is a DIT system, which is discussed and explored further in the next section.

IV DUAL INCOME TAX SYSTEM

Denmark was the first to implement the DIT system, in 1987.⁴⁸ In the early 1990s, the DIT system proliferated throughout other Nordic countries: Sweden in 1991; Norway in 1992;⁴⁹ and Finland in 1993.⁵⁰ Several other countries outside the Nordic region have now implemented, or have introduced elements of, a DIT system.⁵¹

Under the DIT system, capital income is taxed separately from other sources of income.⁵² The Nordic DIT system is a particular form of schedular income tax that applies a separate low proportional tax rate to capital income and progressive tax rates to labour income.⁵³ 'Capital income' is defined as the imputed return on the business assets, and 'labour income' is classified as the difference between total business income and the imputed capital return.⁵⁴ Business assets could be defined as the recorded book value of the firm's depreciable assets plus acquired goodwill and other intangible assets.⁵⁵ Capital income is taxed at a single flat rate that is equivalent to the lowest marginal tax rate on non-capital income. In the pure version of the system, the capital income tax rate is aligned with the corporate tax rate and with the lowest marginal tax rate on labour income.⁵⁶ Under the DIT system, the flat capital income tax base should be as broad as possible in order to achieve homogeneity and neutrality in capital income taxation. Therefore, capital income from all sources would include capital gains, interest, dividends, royalties, rental income, imputed returns on owner-occupied housing and imputed returns on

⁴⁸ Peter Birch Sørensen, 'From the Global Income Tax to the Dual Income Tax: Recent Tax Reforms in the Nordic Countries' (1994) 1(1) *International Tax and Public Finance* 57.

⁴⁹ Jonas Agell, Peter Englund and Jan Sodersten, *Incentives and Redistribution in the Welfare State: The Swedish Tax Reform* (MacMillan, 1998).

⁵⁰ Bernd Genser and Andreas Reutter, 'Moving Towards Dual Income Taxation in Europe' (2007) 63(3) *FinanzArchiv: Public Finance Analysis* 436.

⁵¹ In Europe, a DIT system has been described as an important blueprint for income tax reforms: Genser and Reutter, above n 50. Austria, Belgium, Portugal, Czech Republic, Lithuania and Poland introduced a final withholding tax on interest and dividend incomes rather than a full-fledged DIT. In 1996, Italy introduced a DIT, primarily for corporate earnings, that provided large tax cuts for companies reinvesting profits or issuing new equity on the stock market for the first time: G Forlani, 'Italy: Dual Corporate Income Tax System' (1997) *World Tax Report* 185.

⁵² Sørensen, above n 48.

⁵³ Peter Birch Sørensen, 'The Nordic Dual Income Tax: Principles, Practices, and Relevance for Canada' (2007) 55(3) *Canadian Tax Journal* 557.

⁵⁴ Bernd Genser, 'The Dual Income Tax: Implementation and Experience in European Countries' (2006) 57(3-4) *Ekonomski pregled* 271.

⁵⁵ Rachel Griffith, James Hines and Peter Birch Sørensen, 'International Capital Taxation' in *The Mirrlees Review: Dimensions of Tax Design* (Institute for Fiscal Studies/Oxford University Press, 2010) vol 1, 914.

⁵⁶ Peter Birch Sørensen, 'Dual Income Taxation: Why and How?' (2005) 61(4) *FinanzArchiv/Public Finance Analysis* 559.

capital invested in non-corporate firms.⁵⁷ The component for non-capital income includes labour income from employment and self-employment, wages and salaries, non-monetary fringe benefits, private and public pensions, and government transfers.⁵⁸

In summary, a DIT system in its purest form has the following characteristics:

- A flat uniform personal tax rate that applies to all forms of capital income, equalling the corporate income tax rate;
- The lowest marginal tax rate on labour income, aligned with both the capital and the corporate tax rates;
- No double taxation on corporate equity income (no double taxation on dividends: shareholders receiving dividends are given full credit for taxes paid at the corporate level); and
- A broad tax base for capital income (as outlined above).⁵⁹

The Nordic countries have introduced splitting rules to address these issues. These splitting rules apply to all unincorporated firms and closely held or unlisted companies. The fundamental role of these rules is to define the capital income (for tax purposes) as an imputed return on the firm's assets and to treat the residual part as labour income.⁶⁰ The following paragraph demonstrates how small business income is taxed under a DIT system.

The DIT can apply to small business owners who are self-employed, to sole proprietors and to partnerships,⁶¹ as well as to closely held companies if the owner is active (works in the business) and owns more than two-thirds of the company.⁶² In general, the owners of small businesses work in their own business; therefore part of their income is regarded as labour income. Similarly, the owners have also invested some or all of their savings in their business; therefore the other part of their income is regarded as a return on their business assets and is treated as capital income.⁶³ When the income return derives as a single aggregated amount, it can be a concern that business income is not split into capital and labour incomes: if the aggregated business income were to be treated as labour income at progressive rates, this would result in overtaxing owners' capital income, compared to other types of capital income, especially as many owners of small businesses are active in their business; on the other hand, if all business income were to be treated as capital income, this would result in the business owners avoiding the progressivity of tax rates on labour income.⁶⁴ To avoid such a discrepancy in tax treatment, it is necessary to divide business income into two categories: capital income and labour income. In

⁵⁷ Peter Birch Sørensen, 'Dual Income Taxes: A Nordic Tax System' in Iris Claus, Norman Gemmill, Michelle Harding and David White (eds), *Tax Reform in Open Economies: International and Country Perspectives* (Edward Elgar, 2010) 78.

⁵⁸ Robin Boadway, 'Income Tax Reform for a Globalized World: The Case for a Dual Income Tax' (2005) 16(6) *Journal of Asian Economics* 910.

⁵⁹ Sørensen, above n 56.

⁶⁰ Seppo Kari and Hanna Karikallio, 'Tax Treatment of Dividends and Capital Gains and the Dividend Decision under Dual Income Tax' (2007) 14(4) *International Tax and Public Finance* 427.

⁶¹ Sørensen, above n 56.

⁶² Genser, above n 54.

⁶³ Sørensen, above n 56.

⁶⁴ *Ibid.*

practice, the number of working hours contributed to firms by business owners is seen as subjective, as it is determined by the owner, and it can be difficult to prove to tax authorities. In comparison, business assets are seen as more objective. From this perspective, in splitting business income the rule is to first calculate the imputed return on business assets, regarded as capital income, and then to treat the remainder of the business profit as labour income. The imputed rate of return can be set in accordance with the applicable interest rate on average government bonds plus the risk premium.⁶⁵

The two major splitting methods to calculate the imputed return on business assets are the gross-asset method and the net-asset method. In Sweden and Finland, the splitting method is based on net assets, whereas in Norway a gross-asset method is used.⁶⁶ Under the gross-asset method, the firm's net financial liabilities are not deducted from the asset base. To calculate the labour income of the business owner, the imputed return on gross business assets is calculated first (capital income), which is then deducted from the gross profits (profit before interest) of the firm (classified as labour income). The taxable net capital income is calculated as the imputed return to the gross assets less the interest expenses.⁶⁷

There has been detailed analysis of whether the DIT system has been successful or not in the Nordic countries. For example, the reforms are said to have improved horizontal equity.⁶⁸ This is in part because income is taxed on the basis of its economic substance, regardless of the legal structure or label.⁶⁹ In theory, this may eliminate tax rate biases that exist due to different business structures.⁷⁰ However, this view was contradicted by de Mooij and Nicodeme, who observed that lower corporate tax rates have resulted in income shifting from personal to corporate income in several European countries.⁷¹ Pirttila and Selin argued that a lower tax rate on capital income may reduce the incentives for tax avoidance through profit shifting and other schemes, and may reduce the benefit of tax arbitrage obtained from leveraging.⁷²

In terms of the potential implications of a DIT system in Australia, analysis by Trad and Freudenberg has considered a DIT impact in terms of understanding, complexity, compliance cost and finance.⁷³ This analysis found that the experts considered that while there could be some benefits from a DIT, negative impacts on small businesses could

⁶⁵ Ibid.

⁶⁶ Tobias Lindhe, Jan Sodersten and Ann Oberg, 'Economic Effects of Taxing Different Organizational Forms under the Nordic Dual Income Tax' (2004) 11(4) *International Tax and Public Finance* 469.

⁶⁷ Sørensen, above n 56.

⁶⁸ Erlend E Bo, Peter J Lambert and Thor Thoresen, 'Horizontal Inequity under a Dual Income Tax System: Principles and Measurement' (2012) 19(5) *International Tax and Public Finance* 625. This was in relation to the reform to the DIT in Norway with the introduction of the shareholder income tax in 2006.

⁶⁹ Richard M Bird and Eric M Zolt, 'Dual Income Taxation and Developing Countries' (2010) 1 *Columbia Journal of Tax Law* 174.

⁷⁰ Pitcher Partners, above n 16.

⁷¹ Ruud A de Mooij and Gaëtan Nicodeme, 'How Corporate Tax Competition Reduces Personal Tax Revenue' (2008) *CESifo DICE Report* 27.

⁷² Jukka Pirttila and Håkan Selin, 'Income Shifting within a Dual Income Tax System: Evidence from the Finnish Tax Reform of 1993' (2011) 113(1) *The Scandinavian Journal of Economics* 120.

⁷³ Barbara Trad and Brett Freudenberg, 'A Dual Income Tax System for Australian Small Business: The Experts' Verdict' (forthcoming) *Australian Tax Review*.

include the complexity in splitting business income and the anti-avoidance rules for income shifting between labour and capital income. Concerns were also expressed about a re-education process on how the system works and the costs due to changes in accounting systems. Also there was uncertainty of the impact of a DIT on finances for Australian small businesses.⁷⁴ In a related study that focused on the potential for a DIT to improve tax neutrality for Australian small businesses, it was concluded that while the DIT model could step towards improved tax neutrality, it is incorrect that a DIT removes all the possibilities of tax influencing taxpayers' decisions. For example, clearly the different tax rates applying to capital and labour income are a breach of tax neutrality and require integrity rules to ensure that they are not abused.⁷⁵ However, the lower tax rate on capital income was seen as having the potential to decrease tax arbitrages and planning. Consequently, while there could be some benefit from the introduction of a DIT in Australia, there are some concerns about how it might interact with the current tax system, and the current methodologies of taxing business structures.

With this understanding the research question and methodology is outlined in the next section.

V RESEARCH METHODOLOGY

The primary research question for this article is: *What are the factors taken into account when choosing a business structure for an Australian small business?* In analysing these factors, to what extent would a DIT address these factors?

A Delphi Technique

A modified Delphi technique was adopted to gain a detailed understanding of and insight into whether Australian small businesses are likely to benefit from the introduction of DIT. As small business owners are not currently using a DIT system and therefore potentially have little or no practical understanding of the DIT and its implication for their businesses, the Delphi technique of surveying and interviewing experts in the small business field was chosen. By interviewing experts in Australian small business issues, it was thought they could critically provide insight into business structures in Australia. Delphi is a widely employed research method in many disciplines including economics and social science.⁷⁶ It has been considered a reliable qualitative method ideally utilised in situations of uncertainty; it is also widely used for forecasting, gaining information for a decision-making process, or obtaining strategic views.⁷⁷

Delphi technique is identified by Dalkey and Helmer, and by Okoli and Pawlowski, as a process in which the greatest reliable consensus is obtained via the knowledge,

⁷⁴ Ibid.

⁷⁵ Barbara Trad and Brett Freudenberg, 'A Dual Income Tax System for Australian Small Business: Achieving Greater Tax Neutrality?' (forthcoming).

⁷⁶ Marcin Kozak and Olesia Iefremova, 'Implementation of the Delphi Technique in Finance' (2014) 10(4) *eFinanse* 36.

⁷⁷ Ibid.

experience and opinion of a group of experts.⁷⁸ Practically, this technique allows the inclusion in the study of contributions from participants who are geographically spread.⁷⁹ This method is a robust approach for investigating an issue or phenomenon where there is incomplete knowledge.⁸⁰ Rowe and Wright suggest that the Delphi method is most appropriate when the aim is to create a better understanding of problems, prospects and solutions, or to make predictions.⁸¹ In particular, it can be applied to problems that are uneasily examined by other specific methodical techniques, but which could benefit from the opinion of the subjective judgements of interacting groups of experts.⁸² Thus, the focus of the intelligence of the entire group is drawn to the problem being investigated.⁸³

The Delphi method has been used in various research fields. Although it has been predominantly utilised in science and technology,⁸⁴ there is increasing utility for this method in education, legal and other studies. For instance, El Dahshoury employed the Delphi method to explore the obstacles facing the development of the Physical Education curriculum in the Arab Republic of Egypt.⁸⁵ In the taxation field, Stoianoff and Walpole utilised the Delphi method to develop a tax policy analysis framework that can be employed to assess the effectiveness of environmental tax measures.⁸⁶ It has also been successfully utilised by Evans to investigate options for personal tax reform in Australia.⁸⁷ Guglyuvatyy and Stoianoff employed the Delphi method to assist in prioritising the criteria used in comparing a carbon tax with an emissions trading scheme for the purpose of reaching climate change mitigation.⁸⁸ It is argued that the Delphi method can be a beneficial means in legal study for the development of law and policy, and thus, the Delphi method can contribute to enhanced real world law-making and its application can offer a basis for a balanced law-making model useful in the context of policy-making and legal research.⁸⁹

⁷⁸ Norman Dalkey and Olaf Helmer, 'An Experimental Application of the Delphi Method to the Use of Experts' (1963) 9(3) *Management Science* 458; Chitu Okoli and Suzanne Pawlowski, 'The Delphi Method as a Research Tool: An Example, Design Considerations and Applications' (2004) 42(1) *Information & Management* 15.

⁷⁹ Gene Rowe and George Wright, 'The Delphi Technique as a Forecasting Tool: Issues and Analysis' (1999) 15(4) *International Journal of Forecasting* 353.

⁸⁰ Kathy Franklin and Jan Hart, 'Idea Generation and Exploration: Benefits and Limitations of the Policy Delphi Research Method' (2007) 31 *Innovative Higher Education* 237.

⁸¹ Rowe and Wright, above n 79.

⁸² Michael Adler and Erio Ziglio, *Gazing into the Oracle: The Delphi Method and its Application to Social Policy and Public Health* (Kingsley, 1996).

⁸³ Harold A Linstone and Murray Turoff, 'Introduction' in Harold A Linstone and Murray Turoff (eds), *The Delphi Method: Techniques and Applications* (Addison-Wesley Publishing Company, 1975) 3.

⁸⁴ Adler and Ziglio, above n 82.

⁸⁵ Marwa El Dahshoury, 'The Obstacles which Facing the Development of Physical Education Curriculum in the Arab Republic of Egypt – Delphi Method' (2015) XV(2) *Science, Movement and Health* 425.

⁸⁶ Natalie Stoianoff and Michael Walpole, 'Tax and the Environment: An Evaluation Framework for Tax Policy Reform – Group Delphi Study' (2016) 31 *Australian Tax Forum* 693.

⁸⁷ Chris Evans, 'Unravelling the Mysteries of the Oracle: Using the Delphi Methodology to Inform the Personal Tax Reform Debate in Australia' (2007) 5 *eJournal of Tax Research* 105.

⁸⁸ Evgeny Guglyuvatyy and Natalie Stoianoff, 'Applying the Delphi Method as a Research Technique in Tax Law and Policy' (2015) 30 *Australian Tax Forum* 179.

⁸⁹ *Ibid.*

Like any other research method, the Delphi method has strengths and weaknesses. Despite its effectiveness in many legal research and decision-making contexts, there have been some criticisms of this method relating to the soundness, reliability and credibility of its application. For example, Sackman criticised the Delphi method and described it as unscientific and inherently misleading, arguing that anonymity of expert participants may lead to a lack of accountability.⁹⁰ Another criticism relates to the selection of experts: their origin, their individual bias, the number of experts, and the skill of the researcher in defining who is an expert in the field being investigated.⁹¹ On the other hand, the Delphi method has been supported by several studies: in their study, Basu and Schroeder reported that the Delphi forecasts were 10–15 per cent more precise than quantitative methods of forecasting.⁹² Goodman reported that one of the advantages of the Delphi method is the aggregated contribution of each participant; and that the anonymity in the response can encourage bias-free ideas thereby improving accuracy in the study.⁹³ Perhaps the advantages of the Delphi techniques can be summarised by Snyder-Halpern as: flexibility to data collection strategies from various sources; reduced peer pressure; and the simplicity of summarising ideas of varied experts into a few particular concepts that relate to the subject being investigated⁹⁴

In order to explore what expert participants perceived as important in business structure choice for small businesses, a survey and semi-structured interviews with open-ended questions were used as data sources.

B Participants

For this project 14 participants were selected from a broad background, 3 tax professionals (accountants), 3 from the Australian Taxation Office (ATO), 2 lawyers, 4 tax academics, and 2 Treasury officials. Criteria for selecting the subjects were as follows:

- All participants must be engaged with (or knowledgeable about) small businesses,⁹⁵ with diverse characteristics from various industries;
- All participants must have at least five years' experience with small businesses; and
- All participants must be aware of issues challenging small businesses.

⁹⁰ Harold Sackman, *Delphi Critique: Expert Opinion, Forecasting, and Group Process* (Lexington Books, 1975).

⁹¹ Olaf Helmer, 'Problems in Futures Research: Delphi and Causal Cross-Impact Analysis' (1977) 9 *Problems in Futures Research* 17.

⁹² Shankar Basu and Roger G Schroeder, 'Incorporating Judgments in Sales Forecasts: Application of the Delphi Method at American Hoist and Derrick' (1977) 7 *Interfaces* 18.

⁹³ Claire M Goodman, 'The Delphi Technique: A Critique' (1987) 12 *Journal of Advanced Nursing* 729.

⁹⁴ Rita Snyder-Halpern, 'Indicators of Organizational Readiness for Clinical Information Technology/Systems Innovation: A Delphi Study' (2002) 63 *International Journal of Medical Informatics* 179.

⁹⁵ The small business definition was with accordance to a turnover of less than \$10 million and fewer than 20 employees. Australian Bureau of Statistics, above n 17; *Table 1: Definitions of the Terms Used to Explain Small Business Entity Concessions*, Australian Taxation Office <<https://www.ato.gov.au/Business/Small-business-entity-concessions/Eligibility/Definitions>>.

The selection of participants was important for the final outcome of the research project, as the study is based on their opinion and expertise.⁹⁶ According to Kozak and Iefremova, in a Delphi study the number of experts can vary from a few to thousands, depending upon the available experts in the given topic.⁹⁷ Recently, the number of experts to be included has been debated, with suggestions that as few as 4 and up to 50 experts is acceptable, however recent research suggests there should be between 10 and 20 experts included in the research.⁹⁸ Consequently it was felt that, given the participants' expertise, 14 experts was sufficient to provide for an investigation into the issues at hand. This number exceeds that in the Guglyuvatyy and Stoianoff study where they selected 11 experts, while it is slightly fewer than the study by Stoianoff and Walpole of 29 experts; it is substantially fewer than Marwa El Dahshoury's study of 70 experts.

An overview of each participant's gender, current profession or position, number of years in their profession, and engagement with small businesses is presented in Table 2. Of the 14 participants: 8 were males and 6 were females; 13 had over 10 years' experience in their profession and 1 had 5 years' experience; 12 were engaged with small businesses and 2 academics had excellent knowledge of small businesses in their profession. Consequently, it is argued that the participants were experts in the field of small businesses and the tax issues surrounding them, as required for the Delphi technique.

Table 2: Demographics of participants

Participant no	Gender	Current employer or position	No of years in profession	Knowledge of small business
Academic (A1)	Male	University	>10	Yes
A2	Female	University	>10	Yes
A3	Male	University	>10	Yes
A4	Male	University	>10	Yes
Australian Taxation Office (ATO1)	Male	ATO	>10	Yes
ATO2	Female	ATO	>10	Yes
ATO3	Female	ATO	>10	Yes
Industry (I1)	Male	Accountant	>10	Yes
I2	Male	Accountant	>10	Yes
I3	Male	Accountant	>10	Yes
I4	Female	Lawyer	>10	Yes
I5	Female	Lawyer	5-10	Yes

⁹⁶ Theodore J Gordon, 'The Delphi Method' in Jerome C Glenn and Theodore J Gordon (eds), *Futures Research Methodology* (AC/UNU Millennium Project, 2009).

⁹⁷ Kozak and Iefremova, above n 76.

⁹⁸ Guglyuvatyy and Stoianoff, above n 88; Okoli and Pawlowski, above n 78.

Treasury (T1)	Male	Treasury	>10	Yes
T2	Female	Treasury	>10	Yes

The industry experts' (I1 to I5) small business client base extended over a number of industries:

- Retail trade: I2, I3, I5;
- Professional: I2, I3;
- Rental, hiring, real estate: I3;
- Education and training, health care, art: I4; and
- Construction, finance and insurance: I5.

VI RESULTS

Below the results are discussed in terms of business structure choice in relation to important considerations, major tax issues and tax neutrality.

A Most Important Considerations

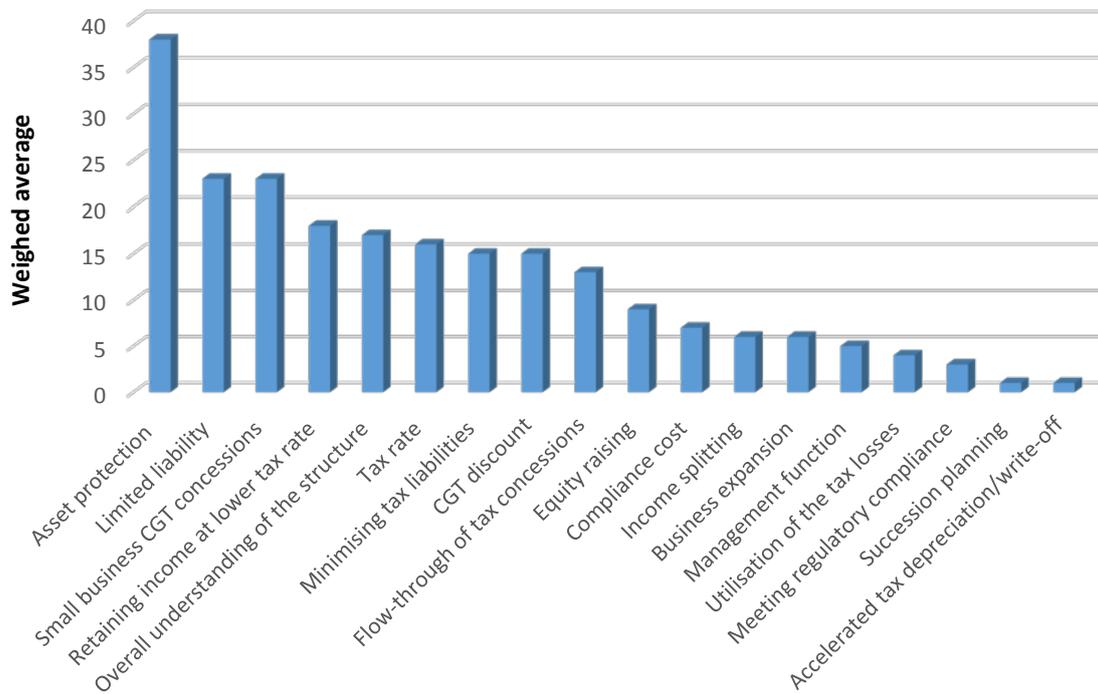
Expert participants were given a list of 18 factors that may influence choice of business structure, and they were asked to rank the top 10 most important considerations. These factors were collated from prior research,⁹⁹ literature in the area,¹⁰⁰ and those raised in submissions.¹⁰¹ These individual rankings were then aggregated to give a weighted average of the factors, illustrated in Figure 1.

The results indicated that asset protection (weighted average 38) was the top consideration. Limited liability (23) and small business CGT concessions (23) were indicated as the next most important considerations, whereas succession planning (1) and accelerated tax depreciation/write-off (1) were the least important considerations for the choice of business structure.

⁹⁹ For example, the prior research of: Hicks, Drury and Smallcombe, above n 13; Freedman and Godwin, above n 13; Freudenberg, above n 9. 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* 81.

¹⁰⁰ 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.

¹⁰¹ For example, Brett Freudenberg, 'Re:Think: Small Business Proposed Tax Reforms' (submission to Tax Discussion Paper, Griffith University, 2015).

Figure 1: Choice of business structure considerations

Overall, this would conclude that asset protection and limited liability appear to be driving motivations for the choice of business structure, as their aggregated weighted score was 61. However, tax does appear to be a strong consideration as well – tax characteristics were 6 of the top 10 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, the findings would indicate that access to small business concessions is seen as very important (3rd), as well as retaining income at low tax rates (4th). In this regard, a DIT and its interaction with the small business CGT concession needs special consideration. It should be noted that, in their submission, Pitcher Partners suggested that Division 152 of the *Income Tax Assessment Act 1997* (Cth) would be altered to allow for the introduction of a DIT, in particular, in the removal of the current threshold eligibility requirements and to allow all capital gains derived from an active asset to be tax free to all individuals up to a set cap (\$1 million).¹⁰² A reduction of the Division 152 concessions may not be politically acceptable, given that access to them may have been a large consideration in the establishment of businesses over the last few decades.

In terms of retaining income at a lower tax rate, a DIT would not necessarily allow for retained income to be taxed at a lower rate, as only income attributed as capital income would be taxed at the corporate tax rate, with labour income taxed at the marginal tax rates. It is suggested that retention of income is a critical factor for small business

¹⁰² Pitcher Partners, above n 16.

structure choice. Indeed, the Pitcher Partners' submission raised concerns about the financing difficulties caused by the interaction of Division 7A with unpaid distributions to other corporations and corporate beneficiaries of discretionary trusts.¹⁰³

This would suggest that for a DIT to be favourable the tax features that need consideration are the effect on small business concessions, retention of income, tax rates, minimising tax liabilities, CGT discount and flow-through of tax preferences. If the DIT model applies to the members of closely held corporations and trusts then it could allow for asset protection and limited liability, although it should be acknowledged that in overseas jurisdictions the DIT model is applied when the corporation is closely held (with an active owner, owning more than two-thirds of the firm), and the utilisation of trusts as a business structure is largely absent.¹⁰⁴

The 5th factor is 'overall understanding of the structure' (weighted average 17). In terms of the DIT, particularly as a new model of taxing small businesses, it is important that both advisors and small business operators understand it. In later interview questions, concerns were raised about the complexity surrounding a DIT model – which is discussed below.

In terms of tax rate, which ranked 6th (score 16), the DIT model allows for a low tax rate on capital income, with the other component labour income taxed at marginal tax rates. This means that for capital intensive industries (depending upon how capital is defined) income should be taxed at a lower rate. However, for businesses with low capital input they will be potentially taxed at higher marginal tax rates. Consequently, this means that the 7th consideration of minimising tax liabilities will depend upon the businesses' characteristics in terms of DIT. It is not clear how the 9th ranked characteristic of the flow-through of preferences (score 15), would apply to a DIT model.

In terms of the 10th ranked characteristic, equity raising (score 9), it is not clear how a DIT model would impact on it. However, it appears that, in terms of corporations that facilitate equity raising through issuing shares, a DIT is only available for closely held companies if the owner is active (works in the business) and owns more than two-thirds of the firm.¹⁰⁵ This could mean that a DIT may limit the capacity for closely held companies to raise equity through issuing more shares as it may result in the business structure moving out of the DIT system into another system.

Table 3 shows the results in order from the top considerations to the least important, with the shaded area representing the overall top 10 considerations. In comparing this study to Freudenberg's study in 2013, it appears that asset protection was highlighted in both studies as the most important consideration when providing advice. The **bolded text** in Freudenberg's result column indicates those considerations that are the common top 10 considerations for both studies; the *italic text* represents results that were identified in this study but were not in Freudenberg's top 10. Lastly, the considerations in the ***bolded italic text*** were not identified in the top 10 of this study but were in

¹⁰³ Ibid.

¹⁰⁴ Genser, above n 54.

¹⁰⁵ Ibid.

Freudenberg's. It is suggested that the current results are largely consistent with Freudenberg's study, although with more factors it appears that succession planning falls to a lower importance.

Table 3: Top 10 considerations regarding the choice of business structure¹⁰⁶

Rank	The top 10 most important considerations	Weighted average	Freudenberg's results ¹⁰⁷
1	Asset protection	38	Asset protection
2	Limited liability	23	Tax benefit/saving
3	Small business CGT concessions	23	<i>Business expansion</i>
4	Retaining income at lower tax rate	18	Level of risk
5	Overall understanding of the structure	17	Limited liability
6	Tax rate	16	CGT concessions
7	Minimising tax liabilities	15	Succession planning
8	CGT discount	15	Compliance costs
9	Flow-through of tax concessions	13	Equity raising
10	Equity raising	9	Prestige
11	Compliance cost	7	
12	Income splitting	6	
13	Business expansion	6	
14	Management function	5	
15	Utilisation of the tax losses	4	
16	Meeting regulatory compliance	3	
17	Succession planning	1	
18	Accelerated tax depreciation/write-off	1	

The interview revealed a number of things in terms of business structure choice. While asset protection was highlighted as an important consideration for choice of business structure,¹⁰⁸ the responses did show that tax does indeed play a role. It is not necessarily the level of tax imposed that was a key consideration, but also how the tax law can influence complexity and thereby compliance costs:

When you recommend to your clients what business structure to use, the most significant criteria is tax consideration, because every business structure has a different tax outcome. This differential in tax outcomes leads to a large amount of complexity and compliance costs. There is a lot of complexity in our tax system, and in fact people are structuring their business based on tax consequences. (I3)

It was seen a DIT model may improve tax neutrality and thereby reduce complexity in this regard:

¹⁰⁶ A weighted average method was used with the top (no 1) consideration taking the value of 10 and the least important (no 10) taking the value of 1.

¹⁰⁷ Freudenberg, above n 9.

¹⁰⁸ Freudenberg, above n 9.

This DIT model will reduce complexity and tax consequences between different business structures, and that's a good thing. (I3)

In terms of a DIT system, it is important to consider how it may influence the complexity of a tax system. There have been reports that a DIT is likely to lead to increased complexity, both for advisors and the small business operators.¹⁰⁹ This complexity is especially acute at the time of implementation of a DIT system, as well as in ongoing compliance.¹¹⁰

The small business sector is most likely dependent on personal savings and retained profits to finance growth and expansion.¹¹¹ It was also identified that Division 7A can impose a significant impediment to using retained profits of a private company to provide a loan at no interest to another related company.¹¹² The taxation of trusts can also impede the economic growth of the firm, because a top marginal tax rate is imposed on trusts for accumulating profits and they are required to distribute all income to beneficiaries.¹¹³ Division 7A and the tax treatment of trusts were some of the important considerations for Pitcher Partners in advocating for the introduction of a DIT system for Australian small businesses. From this perspective, the financial benefit of a DIT system was supported by the comments of participant A4:

Now one of the big things here is being able to reinvest retained earnings. This is a big thing. The question here is whether you can retain the labour income component? It's going to depend on what the rules are. The capital income can be retained, there is no question about that, it is a good thing, it allows for reinvestment that would be for sole traders, partnerships and those sorts of things. But the question will be on the labour income component; we don't know if the tax law forces that money to be distributed. (A4)

Given this, how a DIT influences retained income is an important consideration. It can be seen that a DIT system does not treat 'retained income' differently to distributed income, instead the specific allocation of the income as either 'capital' or 'labour' income determines the applicable tax rate, with capital income being subjected to a generally lower company tax rate. This means for low capital industries the DIT could result in a higher level of tax and could adversely affect the ability of small businesses to self-finance their operations.

Participants I1 and I2 suggested a lower tax rate may simplify the taxation of small business, particularly if there was greater tax neutrality:

My general overall comment is that if business income in whatever form is taxed at a company tax rate that will simplify things. (I1)

¹⁰⁹ Trad and Freudenberg, above n 73.

¹¹⁰ Ibid.

¹¹¹ Allen Berger and Gregory Udell, 'The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle' (1998) 22(6) *Journal of Banking & Finance* 613.

¹¹² *Income Tax Assessment Act 1936* (Cth) Div 7A, sub-div B, s 109C, the payment is made when the entity is a shareholder in the private company or an associate. As those funds can be treated as unfranked dividends, they can attract additional tax.

¹¹³ *Income Tax Assessment Act 1936* (Cth) s 99A.

It was identified that if the DIT system could replace the concessions and the different tax attributes it would have better outcomes:

I think there are too many concessions, too many choices and too many different tax attributes that make it complicated. If you could replace all of these things in this DIT model, then I think it would be much better, because adding extra choices on for small businesses where you can manipulate whether you are small or not, is just difficult. (ATO2)

B Major Tax Issues for Small Businesses

Participants were also asked to identify the major tax issues facing small businesses in Australia. This identification and the analysis of the tax issues may assist in analysing whether this sector could benefit from the introduction of a DIT system.

Many of the participants highlighted that complexity of tax legislation (9 participants out of 14) and compliance costs were major issues for small businesses:

The tax complexity, the compliance costs, the fact too that there is an uncertainty about tax laws, and that tax laws are changing all the time. (A1)

The compliance costs, because of the tax system and also small businesses don't have the time, and they use experts. So the biggest tax issue is dealing with the compliance costs. They are experts in what they do but they are not experts with tax. (ATO3)

Compliance is a big one for small businesses and if you are a small business you wouldn't have the money to comply with all the associated various taxes, with not just the income tax but all the others, especially GST, PAYG and BAS statements. For the new concessions that are directed to small businesses: the structure that you are operating through, that will dictate how much income tax you are paying and determine how much compliance cost you have. Lots of small businesses don't have finance to get access to expertise and that's why they make mistakes. (A4)

Another two participants identified payroll tax as an issue:

Payroll tax, because it is a significant additional cost for business growth, and it is probably impacting on the growth of the business. It is impeding for the small business growth, they refuse to grow because they don't like to pay the additional payroll tax. (I2)

The key tax issue for small businesses is payroll tax. Why is that important? It goes with your expansion and employment of people and it can clog in depending on the threshold, and quite often it goes with the nature of your business. If you were to operate across state borders it would become a bigger issue because you've got to go across two sets of payroll tax legislations. (T1)

Excessive red tape was identified as a big issue, concerning small businesses more than tax:

To me the biggest issue facing small business is excessive red tape. They tell me in Brisbane now a person needs 30 licenses to open a coffee shop! I do not see tax as a big issue, the big issue for most people in small business is not understanding the bottom line. (A3)

Overall this would suggest that complexity and compliance costs are big issues confronting small businesses in Australia. Consequently, this highlights the importance of considering how a DIT would influence compliance costs for small businesses. Comments by participants indicated that they think the introduction of a DIT system would, at least initially, increase complexity:

Initially complexity and compliance costs will go up dramatically for people to understand it; also the accounting system needs to be remodelled. It would be an initial dramatic increase in compliance costs too – no difference from when Australia first introduce the GST, there was huge cost. However, over a period of time, whether in five years or a decade, it will decrease. (I3)

Special concerns were raised about the rules required to split income between capital and labour income:

The distinction between capital income and labour income has to be done. You have to think of the best way for this to be done; my feelings: you are not going to get very simple and easy rules to do that. You also have to do the expense apportionment, in other words, you've got to work out what expenses go against the capital income part and what expenses go against the labour income component. Then, whether we like it or not, apportionment is a difficult issue, end of story; it's always a difficult issue: a lot of fights have happened over apportionment. (A4)

This means that it is essential to consider how a DIT could influence complexity and compliance costs.¹¹⁴ If it is poorly designed, then a DIT could have adverse consequences on the sector that it means to assist.

C Tax Rate Equality

Given that a DIT is supposed to increase tax neutrality between business structures, in order to consider whether there could be a relationship between tax and the choice of business structure, participants were asked:

If the tax rates were equal between different business structures, in your opinion what is/are the most preferable business structure/s for small businesses' choice?

In response to the question, some of those interviewed indicated that a combination of a trust and a company was a preferable structure:

The best structure by far is a description of the family trust with the trustee as a family company. This gives asset protection, the ability to stream income to beneficiaries, and to make deductible superannuation contributions. (A3)

Other responses to this question argued trusts were a preferable business structure:

Theoretically, if you remove the tax from the equation, it then becomes a commercial decision. The discretionary trust will be the most preferred structure, because no

¹¹⁴ For a more detailed analysis of the impact of a DIT on compliance cost in Australia see: Trad and Freudenberg, above n 73.

beneficiary owns the assets, therefore no one can be sued. Trusts can achieve asset protection inside the trust, and a higher degree in asset protection from outside creditors. (A4)

Such observations are consistent with the leading considerations for the choice of business structure being asset protection. What this would suggest is that it is essential to consider how a DIT applies to trusts, as trusts would still be popular due to their perceived ability to provide superior asset protection.¹¹⁵

The comment below illustrates why small businesses may choose the company structure:

If tax rates were exactly equal, including the losses and other stuff, a company is the best because it gives a limited liability. (T1)

Another interviewee suggested that having one entity as opposed to multiple entities could be preferable:

A partnership or a company is the simplest; a company has the ability to provide the protection needed. In terms of small businesses, I don't think you need a high level of complexity. In small businesses you need to be able to conduct the business within one entity; you don't need to pay a high marginal tax rate. The other structures enable you to split income between quite a range of people and decrease the tax, which makes it unfair. (A2)

For some participants this question was difficult to decide, as business structure depends on other variables:

You start looking for non-tax reasons, then it will depend on the personal circumstances, so you might choose a partnership because it is easy to set up for you; a company for other reasons than tax because you have limited liability. I think good things of having an equality of rates because it can remove some structuring around the tax system. A trust can be popular too; I wouldn't say which one is the best. (AT03)

Table 4 illustrates the findings from the interviews regarding the preferable business structure: two of those interviewed were undecided; the other participants on the whole demonstrated a diverse range of choices including a combination of trust and a company, a trust, a company, or a partnership.

¹¹⁵ See, Dale Boccabella and Brett Freudenberg, 'Who Bears the Burden for Business Losses: To What Extent are Liability Issues of Business Structures Taught in Australian Accounting Degrees?' (2017) 35(4) *Company and Securities Law Journal* 235.

Table 4: Preferred business structure and the reasons behind choice

Participants	Business structure	Reasons
A1	Combination of company and trust	Flexibility and asset protection
A3	Family trust with trustee as a family company	Asset protection, ability to stream income and make deductible superannuation contributions
A4	Discretionary trust	Asset protection from outside creditors
AT02	Discretionary trust	Family needs, succession planning, asset protection and flexibility
AT01	Trust	Asset protection
I3	Company	Perpetuity and limited liability
I2	Company	Limited liability and commercial dealings
T1	Company	Limited liability
A2	Partnership or company	Simplicity
I1	Unincorporated for micro; trust or company > micro	Depends on the size of the business
T2	Partnership, incorporate or trust management	Depends on the business
I5	Company or trust	Asset protection
AT03	Undecided	
I6	Undecided	

Recurrent themes in the interviews were that the choice of business structure depends largely on asset protection and limited liability. In Australia, the discretionary trust is seen as having greater asset protection than a company.¹¹⁶ This means that, if a DIT model was to be introduced, it would need to apply not only to sole proprietors, general partnerships and closely held companies, but also to trusts.

VII LIMITATIONS AND FUTURE RESEARCH

This study has a number of limitations that should be considered when evaluating the analysis of the research.

As only a small number of expert participants were interviewed, it may not be feasible to generalise the findings. However, the validity of this study is based on the knowledge of the expert participants. Thus, the aim of this study is to deliver a truthful representation of the expert participants' perceptions, in terms of assessing what they consider are important considerations in the choice of business structures. The semi-structured interview approach was employed in an attempt to discover findings that are crucial to the study. This research design is anticipated to explore whether small businesses may benefit from introducing a DIT system.

¹¹⁶ Ibid.

Future research could build upon this study. First, it could be valuable if further research was conducted on a larger scale to determine what factors are taken into account when choosing a business structure. Research could also examine the relationship between tax-driven business structure choice and later commercial satisfaction. Future research could consider how an Australian DIT model could be designed to ensure that it applies to all current business structures: sole proprietors, general partnerships, corporations and trusts. Also, it could be valuable if further research was conducted to determine the effectiveness of lowering the top individual marginal tax rates to be more aligned with the corporate and capital tax rates.

Second, a further study could assess the impact of small business concessions, if they were to be removed, on the complexity for the Australian tax system for small businesses. Another area for further research is the introduction of a business tax scheme, which would see business income taxed at the same rate regardless of the business structure.

VIII CONCLUSION

Tax neutrality is a commonly stated canon of good tax system design. However, attaining tax neutrality is problematic as any tax system will necessarily have the ability to influence decisions. In terms of the taxation of the various business structures used by Australian small businesses, it is evident there is a lack of tax neutrality between the different business structures. Prior research from Australia and overseas has provided some evidence that tax could influence business structure choice. A taxing methodology that is mooted as improving tax neutrality is a DIT system.

This article reported a pilot study about whether a DIT system would address the attributes desired in business structure choice. The findings indicated that asset protection and limited liability are two major factors in business structure choice. However, tax featured in 6 of the top 10 factors, including access to small business CGT concessions, retaining income at a low rate, and the tax rate. Concerns were raised about how a DIT may not address these desires, particularly how a higher tax rate could apply to the income allocated as labour income, as opposed to capital income.

It was also reported that, all things being equal between the business structures in Australia, the trust and/or corporation structures would feature prominently, due to non-tax attributes, especially asset protection. Consequently, if a DIT system in Australia was going to achieve greater tax neutrality, then how a DIT applies to trusts and corporations needs to be critically considered. It appears that the choice of business structure is a complex decision, but with greater understanding we can start to appreciate the factors taken into account.

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