

# Factors That Effect Taxation of Small and Medium Sized Enterprises (SMEs)

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**Abstract**— Small and medium sized enterprises (SMEs) are important for their contribution to employment, innovation, economic growth and diversity. Ideally, taxes should be neutral with regard to the business decisions of SMEs, including decisions related to their creation, form and growth.

The taxation of SMEs is an important issue given their importance to the economies of countries. Careful design of government programs for SMEs, including special tax rules can address market failures and disproportionately high compliance burdens faced by SMEs. Consideration of the heterogeneity of the SME sector and the different challenges faced by SMEs and their owners need to be considered in the design of the taxation rules as governments endeavor to promote the creation, innovation and growth of SMEs.

This study examines the tax policy and tax administration arrangements affecting SMEs compared to large enterprises, earnings and the increase of own equity shortly.

**Keywords**— Taxation, Tax Policy, SMEs.

## I. INTRODUCTION

**S**MALL and medium sized enterprises (SMEs) make up the vast majority of business entities and contribute strongly to employment and economic growth, spanning the full breadth of industries and sectors, and differing in their propensity to innovate and grow. At the same time, SMEs face particular challenges in relation to their access to finance. The tax system plays a dual role: at times, as a tool to assist in overcoming these challenges, and at others, as an obstacle.

Studies about taxation of SMEs in OECD and G20 countries finds that rather than being neutral in their impact on SMEs and their decisions, tax systems often provide incentives for SMEs to incorporate, and to distribute income in the form of capital, particularly in the form of capital gains, which is often lower-taxed. In addition, some tax systems can disproportionately affect SMEs relative to large enterprises, to the extent that they treat profits and losses asymmetrically, have a bias towards debt over corporate equity, and impose relatively high compliance costs. Governments take many measures to reduce these impacts, providing tax preferences and simplification measures targeted at SMEs. Tax preferences are also intended to assist

with other challenges faced by SMEs, and to support their creation and growth.

The taxation of SMEs, and provision of SME-specific tax rules can, if carefully, designed, play a useful role in addressing the challenges and disproportionately high tax compliance burdens faced by SMEs

## II. DEFINATION OF SMES, TAXABLE INCOME AND TAX STATUS OF SMES

There is no single agreed definition of a SME, nor there is a role criterion that determines SME status. A variety of definitions are applied in OECD and G20 countries, though almost all make references to SMEs as non-subsiary, independent economic entities that are not controlled by large or medium sized enterprise. Common categories used in definition, however, include the number of employees, annual turnover and the size of balance sheet (net assets). A commonly-used categorization for SMEs is provided by European Commission (Recommendation 2003/361/EC of 6 May 2003). The commission classifies micro, small and medium sized enterprises based on their number of employees and either turnover or balance sheet total, stating that SMEs are “enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million”. Within this definition, a small enterprise is defined as having less than 50 employees and turnover or balance sheet of less than EUR 10 million; and a microenterprise as a firm with less than 10 employees and a balance sheet or turnover below EUR 2 million. The definition of a SME may also vary for tax purposes. For example, eligibility for the reduced SME tax rate in Luxembourg is based on the level of taxable income, whereas in Canada and Japan it is based on the capital of the business. France and Spain use a gross turnover test to determine eligibility for their concessionary SME rates. Businesses in Belgium, on the other hand, are only eligible for the reduced SME rates if they meet requirements relating not just to taxable income, but also to the activities of the company, the shareholding, the dividend yield and remuneration of managers of the business. Taxable business income at the entity level includes taxable income from single-taxed entities (reported as personal income) as well as business-level income from double tax entities. It does not include personal income from double-taxed entities in the form of dividends or capital gains, to include this would be double-counting.

However taxable income at the entity level will not necessarily include all SME income paid as labor income to the owner. The labor income of the owner of a SME, whether single or double-taxed, will typically be deductible against business income and treated as taxable personal income of the owner.

The income of SMEs may be taxed at the personal level only, or at both the entity level and again at the personal level when the income is distributed to the owners or investors. In many but not all cases, the tax status of a SME follows its legal form, with unincorporated entities generally being single-taxed and incorporated entities generally being double-taxed although this assumption is not true for all countries. Incorporation may offer a number of advantages to business, including in many cases limited liability of the shareholders, improved access to capital markets and increased ease of business continuity. However, the formation of an incorporated business is generally more costly in terms of legal fees in establishing and registering articles of incorporation, compared with setting up an unincorporated business, and typically has higher on going costs.

Double level taxation of businesses is increasingly common as business is increasingly common as business size increases whether measured by employment or by turnover. Generally large entities are more likely to be double-taxed than smaller entities whether according to OECD survey this likelihood increases, whether measured in terms of number employees or turnover, where all countries except USA report that %60 of large firms are taxed at both the entity and personal level.

### III. INCOME TAXATION OF SMES

In this section the income taxation of SMEs considering personal and corporate income taxes. In addition to personal and corporate income taxes, social security contributions may also apply to SME income. In most countries, the taxation of SME under personal and corporate taxes will depend on its business form; typically, unincorporated SMEs are taxed only at the personal level whereas incorporated SMEs are taxed first at the corporate level and then again when profits are distributed at the personal level subject to any integration measures between these levels of taxation.

In single level taxation of income for SMEs income is subject to tax only at the personal level of the owner or owners SMEs taxed only at the personal level are typically unincorporated business. They include both sole proprietors with or without employees and business with two or more owners for example general or limited partnership structures. In both cases, net business income typically flows through to the owner and is taxed at the personal level according to the relevant personal income tax structure. By the way; double taxation most commonly applies to incorporate SMEs, where the separate legal status of the entity confers a separate status for tax purposes. In both single level taxation and double level taxation, the most important actor is tax rate for SMEs. In most countries net unincorporated business income taxed together with other personal taxable income including employment income, according to the graduated personal

income tax rate schedule applicable in that country. In this context, three major variant for single level taxation can be accept important. The level of average wage, the marginal tax rate social security contributions. According to OECD survey fourteen countries have lower corporate income tax rate for small businesses. In addition to this a number of approaches are used in applying small business corporate tax rates;

- Lower tax rate on first tranche(s) profits, regardless of total income level
- Withdrawal of tax relief at higher profit levels
- Reduced CIT (corporate income tax) rates for corporations with income below a certain level
- Eligibility for small-business rates determined by non-income criteria instead of or in addition to income criteria.

After taxation at the corporate level, the income from incorporated SMEs may be subject to a second level of taxation at the individual shareholder level when they are distributed to the owner. Taxation at the personal level will depend on the form in which the income is received and on any available integration mechanisms between corporate and personal level taxation.

There are three possible forms in which the income can be received. Distributed after-tax corporate profits are normally subject to shareholder-level dividend taxation, while capital gains on shares that result from the retention of after profits may be subject to capital gains taxation upon the disposition of shares. Finally, the wage income of an owner for hours worked in the business, deductible for corporate income tax purposes, is subject to personal income tax.

The owner or owners of a small business can receive post corporate tax income from the business in the form of dividend income. How dividend income is taxed at the personal level will differ depending on the degree of corporate and personal integration in the country concerned. Under a classical income system, dividend income is included together with other income and is taxed at personal rates, with no integration relief for corporate tax paid. Under this system, there is double taxation. Reducing this, modified classical systems apply in several OECD countries, which apply a lower rate of taxation to dividend income than to other forms of personal income. Another method of reducing double taxation is tax only a portion of the dividends received at the personal level. Several OECD countries use a final withholding tax rate to apply a lower rate of taxation to capital income than to other forms of personal income. Finally, a group of countries apply imputation credits, taxing individual taxpayers on the grossed up value of the dividends but allowing tax credits to offset corporate tax paid, thus reducing or eliminating the amount of double taxation.

These forms of integration also affect the benefit of reduced corporate tax rates on small business income. To the extent these methods double tax business income, any benefit from the reduced rates on small business income will be partially reduced by taxes at the personal level, so that the amount of the reduction in small business rates is reduced by the net of shareholder tax rate. The form of integration between the corporate and personal levels will affect the resulting tax rate

on dividend income and therefore the difference between tax rates on single and double-taxed entities. Where a full classical system applies, corporate tax will add a second level of taxation to the owner, increasing the marginal statutory tax rate on business income. Different forms of integration may, however, have the opposite effect, where lower taxes on corporate income combined with lower withholding or capital rates, and the removal of social security contributions reduce the marginal statutory rate on business income.

#### IV. TAX PREFERENCES FOR SMEs

Providing tax references for SME is often justified by the special place of SMEs in the economy, particularly in terms of their contribution to employment job creation and innovation. In assessing the need for tax preferences for SMEs, the case in favor is generally based on arguments related to market failure and the positive externalities associated with SMEs. A second rationale for intervention is based upon the argument that the tax system may inherently disadvantage SMEs due to their size and, in the absence of intervention will unfairly disadvantage them against their larger competitors and may have distortive impacts on commercial decisions and between different business forms and different business activities.

Where a clear rationale for intervening exists, the advantages of doing so through the tax system as against other interventions should also be considered. If tax preferences are provided, they should be considered against the revenue and efficiency costs of doing so including the risk of creating further distortions or barriers to growth, or increasing complexity. Any tax preferences should, therefore, clearly identify the problem they seek to address and the SMEs to which the measure should be targeted, and should seek to avoid introducing new distortions or adverse consequences.

Tax preferences provided to SMEs act to lower the amount of tax payable by the SME or by an investor or owner of a SME. They can take many forms, including additional deductions, credits or exemptions targeted to SMEs or tax reductions and exemptions provided for SME owners and investors that are linked to their investment in SMEs. In most countries some form of tax preferences targeted to SME that seek to address a range of different goals most commonly to encourage SME investment, promote expenditure on research and development (R&D) and innovation, support employment, and encourage financing of SMEs by investors.

There are two main rationales put forward in support of tax preferences for SMEs. The first rationale argues that there are market failures that particularly affect SMEs due to their small size or age. The second rationale is that the tax system has a disproportionately adverse impact on SMEs, due to their small size, disadvantaging them relative to larger enterprises. SMEs account for a large share of employment and taxable business income. They also contribute significantly to value added and exports both directly and indirectly. One market failure argument in support of SME incentive is that SMEs

generate benefits over and above those accruing privately to investors. These benefits may include innovation that can be applied elsewhere, with positive growth consequences. Other potential benefits include labor training and skills development. As these benefits are not realized by SME owners or investors, under-investment in SMEs will result, relative to the socially optimal level. Therefore, tax incentives targeted at SMEs, and particularly at these activities, may encourage higher levels of investment in these activities. However, there is a question of whether it is only SMEs that generate these positive spillover benefits. There is lack of empirical analysis of whether SMEs are more likely than large companies to up skill workers or to innovate.

Another market failure argument for providing tax preferences to SMEs is affection about asymmetric information on markets or products and barriers to entry posed by larger firms or difficulties in accessing credit.(Freeman,2009)

Especially, SMEs are seen as more vulnerable to capital market weaknesses, making it more difficult for a new business or SME to obtain raise to finance or require them to pay higher interest rates. At the same time their small size may make it more difficult for them to attract and retain equity finance. Difficulties for SMEs in accessing finance have been exacerbated by recent financial crisis.(OECD,2009b) In these circumstances, it is argued that tax preferences supporting SME finance are justified. However except where information asymmetries affect access to finance, the more restricted access to credit or a higher risk premium of SMEs may not be due to market failures. But it is related to the inherently riskier and less profitable because of the nature of some SMEs or it may be connected with general lack of investment.

The second rationale used to support tax preferences for SMEs is that the tax system is inherently disadvantageous for SMEs due to their small size. This is a specific instance of more general issue of higher fixed costs for SMEs. Underlying this argument is the principle that the tax treatment of businesses, including SMEs, should not distort their commercial decisions and should be neutral between different business forms and activities, unless for considered policy reasons. Some of the disadvantages posed by the tax system to SMEs include:

- The asymmetric treatment of profit and losses under the tax system, profits are taxed when they occurred, however, losses typically are not refunded at the time they occur, but are carried forward to be used against future income. This may disproportionately affect SMEs who are more likely to have losses in their early stages of development, posing cash flow problems at a critical stage in the firm's growth.

- Greater reliance on equity finance may result in higher tax for some SMEs subject to entity level tax. Corporate income tax systems generally provide deductions for interest expense which result in that capital income being subject to tax only at the lender level. To the extent that SMEs rely more heavily on equity finance, they have more of the SMEs capital income subject to entity level tax.

-The tax system imposes compliance burdens on taxpayers who must comply with record keeping, filing and payment processes. These burdens involve a large fixed component and are typically for SMEs than for larger enterprises.

Different tax preferences in OECD and G-20 countries applied by different levels. If we try to categorize them simply; tax preferences provided at the entity level (whether incorporated or unincorporated), considering deductions, tax credits and exemptions and tax preferences at the investor level for income received from the investment and on the disposal of SME assets (e.g. gift and inheritance tax preferences, capital gain tax preferences)

#### V. TAX COMPLIANCE AND SMEs

In addition to the direct cost of taxes, the tax system also imposes a burden on all taxpayers, including SMEs, in terms of the costs of complying with tax laws. These form part of the broader regulatory compliance costs faced by SMEs, which also encompass compliance with other regulations, for example labor, environmental or safety regulations. Tax compliance costs typically have a significant fixed cost component, tending to impose a relatively higher burden on SMEs than on larger enterprises which can benefit from returns to scale in complying. Tax compliance costs may affect a number of economic margins faced by the owners and operators of SMEs, notably, whether to become self-employed, whether to employ others and whether to operate in formal economy.

A number of factors influence tax compliance costs. These include number of taxes that must be complied with, the frequency of changes to the tax laws, the complexity of the tax system, the existence of different tax administrations, the difficulty associated with interpreting unclear tax laws, multiple deadlines for tax payments throughout the year, cost of external tax service providers as well as internal staff or owner time spent complying, and tax registration procedures. SMEs are subject to a number of taxes not filed or paid by an employee, notably obligations related to VAT and social security contributions.

Simplification measures can assist SME taxpayers to more easily meet their legal obligations under the tax system. Central to these measures will be the ability of the tax administration to facilitate compliance by delivering efficient procedures, good services, adequate guidance and taxpayer education. Tax policies and tax administration service delivery with streamlined regulatory arrangements and tax policy simplification measures is essential in addressing the compliance burden faced by SMEs.

Effective regulatory and administrative arrangements should recognize the specific circumstances of SMEs. In this sense, delivering a tax system that is tailored to some of the particular needs of SMEs is a challenge for many tax administrations. The heterogeneity of SMEs makes it difficult to administer the tax system in a way that effectively responds to the needs of SMEs. Many businesses, especially SMEs, find it difficult to grapple with the complexity and the

relatively high compliance burden imposed on them when they enter the tax system. Equally, tax administrations face many challenges as they seek to provide services to reduce SME compliance costs and maximize tax compliance. The tax system should be seen as the whole of regulations, processes and actors that are involved in the process of taxation: policies and legislation, administrative regulations and procedures, administrative processes and compliance activities delivered by the tax administration, the compliance activities of taxpayers, and services from tax intermediaries as well as from other service providers (such as accounting and filing software providers). Mechanisms to involve and engage the broader community are also part of the tax system. Supporting compliance by SMEs and preventing non-compliance will be the outcome of the interplay of all parties involved. In this context, the tax administration is responsible for its own service delivery, but also needs to act as a steward of the broader tax system.

Tax compliance imposes demands in terms of the procedures and tax laws which must be followed, such as correct registration or payment rules. In broad terms, there are four categories of tax compliant behavior (OECD, 2004):

- timely and correct registration;
- timely filing or lodgment of requisite taxation information;
- reporting of complete and accurate information (incorporating good record keeping)
- payment of the right amount of tax on time.

For SME taxpayers observing tax rules involves significant costs relative to their turnover or income and requires specific knowledge and capabilities to fulfil all obligations correctly. The compliance burden that comes with entering the tax system may be an impediment to businesses moving from the informal to the formal economy or to fully comply with the tax rules once they have entered the system. The more a tax administration can provide services that make it easier to comply, the better the outcomes will be, both in terms of lowering the compliance burden and in observed compliance. It is however important to bear in mind that tax compliance is the outcome of the interplay of many factors and therefore attempts to improve levels of compliance need a comprehensive approach. Effective compliance strategies need to be multi-faceted and systemic.

Compliance refers to taxpayers' behavior. This behavior is the outcome of a wide array of variables, including the effect of deterrence; personal and social norms, opportunities for compliance or noncompliance (e.g. low compliance costs, easy rules or alternately, opportunities for evasion); fairness, related to outcomes and procedures, and trust, both in the government or the tax authority and in other taxpayers; and economic factors, including macroeconomic conditions, factors related to the business or industry and amount of tax due (OECD,2010)

To develop processes and interventions that effectively monitor and influence compliance, tax administrations need to follow a structured approach, which helps them to assess the strengths and weaknesses of the tax system and identify the relevant compliance risks for individual taxpayers or

groups of taxpayers, such as SMEs. The OECD Forum on Tax Administration has a well-established framework, referred to as Compliance Risk Management Model, which provides guidance in implementing such a structured approach (OECD, 2004). Compliance risk management systematically assesses risks and opportunities in relation to specific tax laws, segments and industries, taxpayer behavior and different tax processes. Strategies are designed to address those risks and include both upstream and downstream activities. “Upstream” refers to more preventive measures, such as taxpayer services, pre-filing audits, education and community outreach activities. “Downstream” are those measures targeted at detection and correction of flaws in tax returns after filing and will be more repressive. These strategies reinforce each other. Downstream activities such as audits have a direct effect in terms of revenue raised, but in SME sector the indirect effects may be even more important: reinforcing social norms supportive of compliance and protecting fair competition by showing that the tax administration will deal with cases of deliberate non-compliant behavior.

The compliance risk management model enables tax administrations to focus their attention on these domains and groups of taxpayers where non-compliant behavior is more likely to occur. Interventions should take a systemic approach, looking at the causes for particular behaviors, if possible trying to adapt the processes and services, or the legislation, in such a way that they encourage desired future behavior

## VI. CONCLUSION

In most countries, small and medium sized enterprises (SMEs) represent more than 95% of all firms. SMEs account for a large proportion of total employment and contribute significantly to national and global economic growth. As a large and important part of all national economies, SMEs often face challenges to their viability and growth, some of which are created by market failures, capital market imperfections and compliance costs.

Ideally, a country’s tax system should be neutral with regard to its impact on business decisions, including the creation, form and growth of SMEs. However; OECD reports show that many of the tax systems examined provide incentives to incorporate and distribute income in the form of capital, particularly as capital gains.

One of the important issues effecting SMEs is the disproportionately high impact that regulatory requirements and costs of tax compliance have on them. Even though many tax requirements may appear to be relatively “neutral” for businesses of all sizes, the significant fixed costs associated with compliance represent a higher cost for SMEs as a percentage of sales and income, and consequently have greater adverse impact upon SMEs than larger businesses. Another important issue effecting SMEs is, limited access to finance for growth and expansion. With limited access to equity financing, SMEs also face considerable constraints in relation to debt financing. Availability of debt finance and

term upon which it is granted to SMEs means that they are more finance-constrained and generally face greater costs in accessing finance than their larger competitors. Against this backdrop, many governments provide support to SMEs through non-tax programs, such as credit programs, as well as through special tax rules, including both tax preferences and simplification measures for SMEs. These measures include reduced corporate tax rates, more generous tax deductions, tax credits or tax exemptions; preferences that apply directly to the owner or investor of the SME, providing relief for initial investment ongoing income, or on disposal of the SME’s assets; and special simplification rules, including special presumptive tax regimes for small enterprises.

While many of these special SME tax rules are designed to support the growth and profitability of SMEs, their design and introduction can have distortive impacts by giving business an incentive to remain small or split up into different businesses to continue benefiting from the preferential tax treatment. These preferences need to be carefully targeted and designed to overcome the specific economic or tax difficulties identified or to provide support to companies providing positive spillovers to the economy

The taxation of SMEs is an important issue given their importance to the economies of countries. Careful design of government programs for SMEs including special tax rules, can address market failures and the disproportionately high compliance burdens faced by SMEs. Consideration of the heterogeneity of the SME sector and the different challenges faced by SMEs and their owners need to be considered in the design of the taxation rules as governments endeavor to promote the creation innovation and growth of SMEs

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