

ITD Global Conference on Taxation of SMEs

Conference Topics Paper

Wednesday, 17 October 2007

Plenary Session I: **Setting the Stage—Key Considerations in the Taxation of SMEs**

In this opening session, three presentations will provide the broad context within which the essential context needed to design and implement taxes for SMEs in a way that recognises both their distinct characteristics and their role in the wider economy. Overviews will be given of:

- **The nature and importance of SMEs.** This presentation will provide an overview of the key features of SMEs and their economic and social significance, addressing such questions as: What is known about their wider importance to economic performance, in terms of innovation, growth, employment, and trade? What are the trends in the scale and importance of such firms? What is the relationship between size and informality? What role do SMEs play in the adjustment of the economy to various shock? What are the central political economy considerations shaping policy towards SMEs?
- **A business perspective on SME taxation, policy and administration.** How does the SME sector see its own role in the wider economy, and what particular challenges is it likely to face in the coming years? What does it look for in a well-designed tax system? How important to its development, relative to other factors, is taxation? What are the key respects in which SMEs differ from one another, both within and across countries? What are the essential realities that tax policy makers and administrators need to keep in mind?
- **Tax policy and administration for SMEs—key issues.** This presentation will introduce key issues to be taken up in the remainder of conference, such as: Is there a case for ‘special’ taxation of SMEs, and if so, what form might it take? What exactly is the relevance of size for tax design and implementation? What kind of criteria might one usefully think about dividing taxpayers into distinct groups for tax purposes? What is the evidence on the effects of SME taxation on economic performance?

Plenary Session II: **Current Practice in Taxing SMEs, Trends and Challenges**

In this session, the background paper prepared by the ITD partners—which will be distributed to participants in advance of the conference—will be presented. Drawing on the partners’ experience, the existing literature and a special country survey conducted for this conference, it will provide an overview of current practice in a wide range of countries, seek to identify lessons that may be of some general applicability, and point too to open issues requiring further analysis and discussion. Topics to be raised—and pursued further in the parallel sessions—include:

- What are the arguments for differential treatment of SME—such as the regressive nature of the administrative burden on SMEs, the importance of the SMEs for the economic growth and job creation—and are they persuasive?
- What kinds of differentiation are implemented in practice, both in terms of the partitioning of taxpayers into distinct groups and the tax treatment extended to each such group?
- How important is the tax treatment of SMEs in terms of the revenue collected? What, beyond any revenue raised, is the importance of proper tax treatment of SMEs?
- What is meant by presumptive taxation, what types do countries use—and is there any evidence on which kind works best?
- Is there are a role for levying withholding taxes on transactions as a means of reaching smaller or informal firms? How extensively and effectively are such taxes used?
- What is the importance of the tax treatment of SMEs in relation to policies towards poverty alleviation and income support?

Parallel Session 1, Stream A: **Special Regimes and Thresholds for SMEs**

Practical considerations, on the part of tax authorities and taxpayer alike, point to treating different taxpayer groups under somewhat different tax rules. The questions addressed in this session are that of how precisely taxpayers should be

partitioned into such distinct groups, and how tax treatment should vary across these groups. This will involve discussion of:

- What criteria should be used for setting the various thresholds between the various sub-groups—defining those subject to the VAT, for example, and the “real” income tax regime—be set, and how should they be aligned with each other?
- What should be the tax regimes for these various groups (below the largest)? What kinds of simplified or presumptive regimes might be used, and which taxes would they represent?
- What kind of book-keeping requirements is it appropriate to place on these taxpayers?
- Do social contributions present special challenges for this aspect of design?
- Is real simplicity really achievable?

Parallel Session 1, Stream B: Tax Administration Strategies to Respond to SMEs, Including Risk Management and Organisational Design and Overall Resources Devoted to this Group of Taxpayers

Tax administrations must make difficult strategic planning decisions to best allocate their limited resources across different organisational functions and/or taxpayer segments. SMEs pose particular challenges because they: (1) generate disproportionately low revenue relative to their number; (2) have lower compliance rates than larger, well-established enterprises, and often operate on largely cash basis; (3) undergo a particularly dynamic process of firm creation and destruction; and (4) face proportionally higher tax compliance costs than do large, established firms. This session will provide an overview of strategic approaches to cost effectively increase SME compliance. Issues expected to be addressed include:

- What are the specific challenges posed by the SME sector for effective tax administration?
- How do SMEs’ characteristics affect tax administration strategies?
- What resource allocation strategies do tax administrations use to best respond to the SME sector?
- What types of organisational design or structure (such as functional vs. client segmentation, or the use of specialised offices) best support improved taxpayer services and increased compliance levels?
- How can risk management techniques support a strategic approach towards resource allocation, and improve SME compliance?
- What types of intergovernmental cooperation do tax administrations use to best respond to the SME sector?

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Plenary Session III: Addressing the Different Tax Policy and Administrative Challenges of Micro, Small and Medium Businesses

The SME population is very diverse. At one end of the spectrum, micro businesses encompass activities such as street vendors, wage earners with side businesses, artists, and craftsmen. At the other, medium-sized firms may employ several hundred people and undertake sophisticated international transactions. This diversity affects tax policy and tax administration in important ways. For example, patterns of noncompliance differ within the SME population: micro and small business noncompliance is frequently related to problems arising from the informal economy, and manifested in non-filing and stop-filing behaviours; medium-size taxpayers’ non-compliance is typically aimed at underreporting income, sometimes by quite sophisticated schemes. Micro, small and medium taxpayers also have different service needs and methods of communication. Such differences need to be recognised in developing both tax policy design and tax administration strategy. This session will identify and discuss effective approaches to addressing the specific needs of these widely different classes of taxpayers:

- What are the distinctive and common characteristics among micro, small and medium taxpayers (such economic capacity, business structure, type of transactions, patterns of noncompliance, and level of understanding of tax laws) that affect tax policy and tax administration designs?
- How should tax design, including such aspects as penalty regimes, take these differences and similarities into account?
- How do they affect appropriate tax administration strategies, both in terms of service and compliance? In what ways can tax administrations adapt their structures and/or processes to better address these taxpayer segments?

Parallel Session 2, Stream A: Tax Impediments/Distortions to SME Growth and Development

SMEs are widely argued to be at a competitive disadvantage relative to larger enterprises. Some of the reasons for this go beyond tax considerations: they may, for example, face tighter credit market constraints, or simply suffer from the large fixed costs of doing business (especially in the formal sector). And taxes may distort too: the taxation of dividends, for example, may be especially disadvantageous for start-ups reliant on new equity finance.

This session will review the way in which taxation does and should impact the growth opportunities faced by SMEs:

- What are the main non-tax distortions to growth of, and risk-taking by, SMEs?
- Are there better ways of addressing these distortions than through the tax system?
- How might one expect alternative tax regimes for SMEs to affect their growth and willingness to take risk—and is there any evidence that such effects have been significant in the past?
- Do SMEs tend to face higher or lower effective tax rates than larger enterprises?
- How does the tax system affect decisions to incorporate—and should that be a major concern for tax design?

Parallel Session 2, Stream B: Identifying and Registration of SMEs and Methods to Reduce the Informal Economy

Studies consistently support a high incidence of informality and unreported income by small, cash-based businesses. This is caused by a number of factors, such as, high start-up and compliance costs; complex and costly accounting requirements; limited understanding of complex tax laws; ease of underreporting resulting from the prevalence of cash transactions; and illegal-sourced income. Given that the non-registered – largely understood as the informal sector – is an important part of the tax gap, tax administrations need to identify both service and enforcement solutions to bring these potential taxpayers into the tax net. This session will explore cost-effective ways to expand the tax net through the identification and registration of non-registered SMEs. The discussion is expected to include:

- What are the main challenges for tax administrations in bringing the “non-registered” into the tax net?
- What low-cost methods or strategies are available to identify and register this particular group (e.g., the use of a unique taxpayer identification number; third-party information and external databases; communication and educational approaches)?
- Which enforcement approaches (such as visits of starting business, on-the-spot checks and business closure) have proved successful, and what appeals rights should be afforded the taxpayer?
- Do these methods or strategies vary as a function of the country’s institutional capacity, tax system, or by industry segment? What tailored strategies have met with success?
- How can improved coordination and information sharing with other government institutions assist in reducing the informal economy?

Parallel Session 3, Stream A: A Closer Look at Presumptive Tax Methods

All taxes are presumptive, in the sense that they are levied on indicators of the thing one would like to tax—the capacity to spend, or consumption itself—rather than the thing itself. But some taxes are more presumptive than others, being levied on only very rough indicators. This session will consider the potential role of such taxes in relation to SMEs, as a compromise between accuracy of the indicator and ease of monitoring. Noting that presumptive taxes have taken a variety of forms—including patent systems that levy a uniform charge on all, taxes on turnover, and taxes varying by characteristics of the enterprise—it will consider too the experience with the various types. Questions addressed are thus expected to include:

- When should presumptive taxes be used, and what distortions might they create?
- Does experience suggest any particular form of presumptive tax to be genuinely simple and fair?
- How does the likely revenue from such taxes compare with the costs of administering and complying with them? Are some types more corruption-resistant than others?
- What is likely to be the incidence of these taxes—that is, who will bear the real burden—and what can be said of their distributional effects?

Parallel Session 3, Stream B: Taxpayer Service and Education Strategies for SMEs

Delivering high-quality taxpayer services and educating citizens and taxpayers are widely recognised as essential to encouraging voluntary compliance and addressing non-compliance. For this, tax administrations must: (1) understand taxpayer characteristics and needs; (2) build strong communication channels with taxpaying communities; and (3) tailor and deliver customer-segmented services in a cost effective manner. This session will explore the specific challenges and options that tax administrations should consider when designing a service and education strategy tailored for SMEs, including:

- What particular service challenges do SMEs sector pose for tax administration (arising, for instance, from their large number and lesser access to electronic communication)?
- What strategies and approaches can tax administrations use to best meet SME service needs (such as multi-channel communication and education programmes)?
- How should resources be allocated among the various strategies and approaches?
- How do successful tax administrations tailor services to the SME business lifecycle?
- What tools can be used to measure SME client satisfaction?

Plenary Session IV: Reducing the Compliance Burden for SMEs

The compliance burden created by the complexities of tax law and administration is of special concern to SMEs, since the fixed component of start-up and compliance costs can place them at a competitive disadvantage, and may also have an adverse distributional impact. In addressing this, governments must strive to find measures that reduce the compliance burden, without undermining the quality or availability of the information needed to enforce compliance. The challenge is to seek the minimum necessary information in the simplest possible way, reducing taxpayer costs yet still allowing for effective control of a tax system largely based on self-assessment. This session will address ways to simplify tax laws and reduce the administrative burden for SME taxpayers, and is expected to include discussion of the following:

- What are the major burdens that SMEs face in complying with the tax system, and how large are they?
- What strategies have been most effective in reducing the compliance burden for SMEs (such as simplifying tax legislation, improving forms and publications, streamlining tax administration processes, and encouraging intergovernmental co-operation)?
- How can tax administrations organise and adjust their internal processes to meet the goal of burden reduction?
- What role can information technology play in reducing the compliance burden?

Parallel Session 4, Stream A: Bringing Informal Sector Firms into the Formal Economy

Not all small firms are informal, nor are all informal firms small. But there is a link between the two, so that proper tax design and implementation are likely to be critical to reducing the extent of informality, which in many countries significantly erodes the tax base and distorts the structure of economic activity. Issues expected to be addressed include:

- How does the extent and nature of informal activity affect the proper tax treatment of SMEs—and vice versa? What is the evidence on the impact of taxation on informality?
- What do principle and experience teach us about the use of withholding and other taxes aimed at encouraging compliance by smaller and informal firms?
- What can tax administrations do to encourage compliance by informal operators?
- What kinds of schemes have been used to encourage enterprises to regularise themselves—and is there any evidence that any have worked?
- How should social insurance contributions be treated when designing tax regimes for small and potentially informal firms?
- What are the general equilibrium effects of extending the tax net to such sectors?

Parallel Session 4, Stream B: SME Audit and Verification Strategies and the Use of Risk Management Techniques

Balancing scarce audit resources across different taxpayer segments is always challenging, and particularly so for the SME segment where the immediate return on investment may be low in comparison to large taxpayer audit results. Nevertheless, there are many reasons that justify investments in SME audits, including fairness across different categories

of taxpayers, positive external effects on overall “tax morale,” and the reduction in the informal economy. This session will focus on audit strategies tailored to SMEs, and the identification of cost-effective approaches to best respond to their unique challenges (such as the refusal to keep records, high-rates of non-filing, and tax avoidance and evasion facilitated by cash-based businesses). Issues to be explored are expected to include:

- What challenges does the SME sector pose to auditing and verification activities (such as poor records, cash based, and low level of reliable third-party information)?
- What strategies can tax administrations use to cost effectively manage the SME audit programme and optimise results? How do risk management techniques support this effort?
- How can tax administrations identify and control for “fiscal dwarfism”—the incentive of medium-to-large firms to operate as small entities to avoid the “spotlight” and/or to benefit from favourable tax schemes and treatment?

Friday, 19 October 2007

Parallel Session 5, Stream A: Tax, Small Business, and Growth: Effects of Taxation on Investment and Cross-Border Trade

The world is changing, for SMEs as for all enterprises. With capital, commodities and labour all becoming more mobile across international frontiers, what are the implications for tax design and implementation if it is not to disadvantage smaller enterprises? Issues addressed are expected to include:

- Are these trends likely to make tax obstacles to cross-border activity more burdensome for SMEs than for others (because of fixed costs of doing business in different countries or perhaps because they have less access to transfer pricing and similar devices)?
- Or, on the other hand, might these trends ultimately ease some of the non-tax distortions said to be faced by SMEs, for example by providing them with easier access to capital?
- What are the main concerns of SMEs in this area, and what can be done to alleviate them? Do such companies, for instance, systematically find it harder to obtain VAT refunds than do larger enterprises?
- Is this an area in which countries have proper incentives to adopt good policies, or might some degree of cross-border collaboration be appropriate (for example, in relation to registration requirements under the VAT)?

Parallel Session 5, Stream B: Management of Tax Debt Collection

Large stocks of arrears, beyond their obvious revenue implications, can jeopardise a system of voluntary compliance by undermining its ultimate fairness. Effective debt collection management is, therefore, key to increasing the relatively low rates of voluntary compliance among the large and diverse group of SME taxpayers, who pose distinct challenges for cost effective debt collection: for example, rapid firm dissolution within the SME sector increases the likelihood that even relatively new businesses will become defunct and responsible parties hard to locate without quick action by the tax administration. So in designing SME debt collection systems, tax administrations must consider both cost and timeliness of action. Issues to be discussed include:

- What challenges do tax administrations face in collecting SME arrears (such as lack of distrainable assets, no formal place of business, and small individual tax arrears balance)? What is the typical SME taxpayer’s debt profile and what are the implications for debt management?
- What strategies can be used to cost effectively reduce or prevent SME tax debt (for example, use of data analytics and risk models to support debt management, identification of optimal treatments—letters and call centres, the use of third party sources of information, such as banks and credit bureaus, and the adoption of “pay as you earn” systems)?
- What types of negotiation schemes are useful in dealing with SME tax arrears (granting extensions of time to pay, special payment arrangements, and so on)?
- What powers does a tax administration need to effectively recover SME arrears (collection from third parties holding taxpayer assets, seizure action, waivers and debt write-offs)? What appeal rights should taxpayers have during the debt collection process?
- What are effective and sound interest and penalty regimes for SME?

Plenary Session V: **Challenges Ahead**

The purpose of this final plenary session is to bring together what has been learnt from the conference discussions and to identify next steps. What do we know about good practice, and what remains to be learned? What directions for future reform in the tax treatment of SMEs have participants identified—and how can we help each other to realise them? What role can the ITD organisations take and how do we continue to identify and share good practice?