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**BUSINESS CLIMATE
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Small, Medium, and Large Enterprises

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SMALL, MEDIUM AND LARGE ENTERPRISES

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The Georgian Personal Income and Profit Tax Laws do not conform to International Best Practice. In the EU, tax law provisions are divided into 4 separate categories: the Micro, Small, Medium and Large enterprise. However, in developing countries, it is difficult to implement 4 categories due to the size of the business community, and therefore, tax laws generally have only 3 categories.

1. Micro Enterprises pursuant to EU Directive 2003/361/EC. The micro enterprise is often referred to as the small enterprise in a developing country.
2. Medium Enterprise under the Profit Tax Law, which would be the small enterprise in a developed EU country, is the difference between a micro enterprise threshold and the Large Taxpayer Unit in a developing country.
3. Large Enterprise.

The Georgia Tax Law, however, only has one category of enterprise, the large enterprise.

The standard provisions of the EU Tax Laws for Micro and Small Enterprises include:

1. A separate flat tax rate for micro enterprises, which is not a presumptive taxation system, since the tax is computed on gross turnover, not occupied space or other forms of operation measurement. In addition, the presumptive tax system is not recommended, since it is discriminatory.
2. Simplicity of compliance for a micro enterprise.
3. Simplicity of transition from a micro to a medium enterprise under the Profit Tax Law.
4. Simplicity of compliance as a medium enterprise moves into the large size enterprise.
5. Incentives to promote expansion from micro to medium to large. This also enhances the correct disclosure of economic activity.
6. The VAT qualification threshold and Micro enterprise thresholds should be the same.

It is difficult to establish a unified, Best Practice, definition of Micro and Small enterprises, since the qualification for such definition varies on a country-to-country basis. In some jurisdictions, turnover, number of employees and capital invested are used as criteria,



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especially for statistical purposes. But for tax purposes, business turnover is the most widely used criteria to define Micro and Small enterprises. The gross turnover criteria allow for better target tax incentives and simplified tax regimes to businesses requiring special treatment. But, the gross turnover definition is also not a fixed amount in every country. For example in the USA a company having gross receipts less than 5 million USD, which would be a large company in many other countries, is a small company. In other countries the threshold gross turnover for micro enterprises are: Bulgaria 52,000 USD, Hungary 120,000 USD, France 76,300 euros, Brazil 103,000 USD, Ethiopia \$11,000 USD, Laos \$11,000 USD, Tanzania \$16,000 USD, Armenia currently at 80,000USD with discussions to reduce the threshold to approximately 30,000USD. It is, therefore, necessary for Georgia to first compare its GDP with other countries more similar to its GDP in order to define micro enterprises. Once the threshold is established for micro enterprises, then a threshold may be established to separate a medium enterprise from large enterprises.

The VAT threshold is a typical example of the gross turnover approach to determine the micro criteria. The VAT threshold defines up to what level of turnover a business is not required to register for VAT without necessarily mentioning that the businesses below the registration threshold are to be qualified as Micro enterprises.

It is noted, however, Georgia's current threshold for VAT qualification is 100,000GEL, which appears to be a high gross turnover threshold amount for Micro Enterprises based on other countries with a similar GDP to Georgia. It is recognized there are political consequences in reducing the threshold amounts to establish equal threshold amounts for the micro and the VAT qualification. However, this political concern may be offset by the following practical business considerations:

- Small taxpayers under the regular system of taxation are discriminated against, since the compliance requirements, cost of compliance and tax rate are the same for both small and large enterprises. Reducing the compliance costs and tax rate increases the small enterprises profit margin. It also increases the Government's tax revenue, since the simplified provisions for a micro enterprise historically reduce the size of the shadow economy and the number of non-complying registered taxpayers.
- The Small enterprises would benefit from a reduced flat tax based upon gross turnover as opposed to the profit tax rate based upon the computation of a tax base. Its profit margin would, therefore, increase.
- Small taxpayers would not be discriminated against by the VAT system, since the threshold qualifications for both micro and VAT are the same. The profit margin of the small enterprise would, therefore, increase. The loss of VAT revenue should be insignificant as reported by IMF studies in most countries, since small taxpayers contribute minimally to the VAT system.
- The simplification of the tax and VAT system generates additional Government revenue, since compliance is historically increased.
- Simple annual micro enterprise tax return, one page, encourages registration and compliance.



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I. THE MICRO (SMALL) AND MEDIUM CATEGORIES OF BUSINESSES:

1. MICRO BUSINESSES.

The Income Tax (IT), Profit Tax (PT) and VAT should uniformly establish thresholds for micro enterprises.

The provisions for a Micro Enterprise would include:

- (1)** In the IT and the PT, the micro is taxed at the flat rate of 5% of its total Gross turnover, paid semi-annually. Banks, insurance companies and investment firms do not qualify as Micro Enterprises. There must be 9 or less employees (to be defined in the IT and PT) and if a micro business is a legal person, there can be no more than 2 physical persons as shareholders, a company may not be a shareholder in a micro business, this precludes a large taxpayer from splitting activities to qualify for the reduced tax rate. When calculating the gross turnover to determine qualification as a micro business, the gross turnover of related physical persons and companies will be combined.

- (2)** There is always concern that a micro enterprise earning gross turnover close to the threshold amount between it and the medium enterprise of the Profit Tax Law, would fraudulently not report turnover. This is avoided by establishing similar, simple compliance procedures for a medium enterprise.

Solutions to this transition concern are:

- Establish record keeping standards requiring all micro businesses to simply maintain a basic, informal cashbook, which records daily cash receipts and payments as opposed to formal sales and expense journals required of the medium business in the PT. Many countries attempting to determine the correct amount of turnover when the micro business has a high volume of cash transactions with low record keeping standards use this requirement. If the micro exceeds the threshold, there is no transition difficulty, since medium businesses would have a similar record keeping standard.

- Some countries have established a flexible micro transitional amount prior to entering the medium business category. For example, if the micro total turnover exceeds the threshold amount by less than 20%, the micro for the current year may file a year-end tax declaration as a micro business, but in the following year it must become a medium business.

- An added incentive to keeping adequate records would be to allow a micro business operating at or near the threshold amount (70% of threshold amount) the option of becoming a medium business under the PT. Therefore, instead of a tax at the rate of 5% of gross turnover, the taxpayer would compute the tax base and be taxed at the rate of the Profit Tax. In some instances, where the micro has a low profit margin due to large expenses, the full calculation of tax base would produce a lower tax burden, and if there were a loss, there would be no tax. If this option were chosen, the micro business must have maintained the



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same bookkeeping records as required by a medium business and the micro business would lose its micro business status for future years (or at least 2 years provided the taxpayer requests cessation from the IT or PT and proves that in the prior two years it has never had gross turnover over the micro threshold).

- The micro business pays its estimated tax semi-annually as will the medium business enterprise. Therefore, if the micro threshold amount is exceeded during the year and the micro is required to maintain simplified record keeping standards, the transition to a medium business would be natural with no difficulty.
- Two of the many reasons for informal enterprises failing to join the tax system are concern over the tax rate and lack of ability or knowledge on how to comply with tax procedure. The above suggestions encourage registration.
- The new provisions for the medium taxpayer in the PT should have similar micro record keeping, simple tax forms, cash accounting and semi-annual tax payments, which is not different from the micro provisions, therefore, there would be no difficult transition process.
- Simplification of VAT reporting and payment system in coordination with the record keeping requirements and payment schedules of the small and medium size enterprises pursuant to the profit tax.

II. MEDIUM SIZE BUSINESS.

Medium Businesses are those whose gross turnover exceeds the micro threshold but falls below the threshold set for large enterprises. Since the tax rate for medium businesses is the same tax rate for all enterprises under the Profit Tax Law, there is no incentive, except for simplified record keeping and payment of tax, to avoid or evade taxes or to split-up operations to stay below the threshold. It should also be noted, while developed countries with high tax rates have lower rates for medium businesses, this is not necessary in developing economies, since such economies have much lower tax rates than rates in developed countries as reported by a 2007 International Finance Corporation Report of the World Bank. Therefore, having a progressive tax rate system for medium and large taxpayer units is not needed. Instead, the provisions Georgia should consider to give to medium businesses are:

- Simplification of record keeping by using the cash method of accounting. Large taxpayers would continue using the accrual method of accounting.
- Simpler record keeping using only cash and expense journals and profit and loss statement. Large taxpayers would continue under the present system.



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- Simplified year-end tax declaration (tax return) and semi-annual tax filing to reduce paper work, time involved in compliance and compliance costs. Large taxpayers will continue with the current payment system.
- Improved availability to credit by allowing tax-free interest income to Lenders providing loans to micro and medium business borrowers, if the loans are registered. (Netherlands). This is not an incentive given to large businesses, since credit is available to them.
- Encouragement to modernize equipment and simplify accounting and book keeping by allowing the option to choose regular depreciation formulas or an accelerated medium business method permitting 50% in year 1, 30% in year 2 and 20% in year 3. (Republic of Srpska (Bosnia)). In Australia, instead of separately depreciating assets, the medium business may establish a general simplified depreciation pool and deduct 30% of the value of the pool each year. Large taxpayers do not need either of these incentives, since modernization is a natural, competitive business purpose done on a regular basis and other more technical accelerated methods of depreciation and pools are available, which produce nearly the same result.
- Consideration of an incentive to modernize all businesses (micro, medium, and large) by re-investing profits into the business. The incentive may

provide a 10% reduction to taxable profit if depreciable assets having a purchase price greater than the value of the 10% reduction to profit are purchased during the year. (This is given in Austria).
- As is done in Hungary and the UK to encourage research and development greater expense deductions are given to medium businesses than to larger enterprises. For example, a 200% expense deduction is allowed for medium businesses, whereas large taxpayers receive 150%.

2. A PRESUMPTIVE TAX

The tax system should be simply two direct taxes, the Income Tax for sole-proprietors and the Profit tax for legal persons. However, presumptive taxation is accepted for only those industries that are either impossible to audit or have mostly cash transactions, such as the casino industry where the tax is based on number of gambling machines or tables.

III. INCENTIVES TO ENCOURAGE MICRO ENTERPRISE COMPLIANCE

During discussions with members of the Ministry of Finance, it was brought to my attention that in the past Georgia had a simplified system of taxation for small business, but the system was ineffective.



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In the past, I have recommended the following suggestions to encourage small business expansion, compliance and the correct reporting of turnover.

- 1. Investment.** In certain circumstances, the new definition of Micro Enterprises 2003/361/EC permits investment into micro enterprises without counting the investors as a shareholder for purposes of exceeding the two physical person rule. The investors must be investment companies or a group of investors joining their funds for the sole purpose of investing in companies. The investors may not be members of the company, founders, employees or decision makers and their total stockholder interest may not exceed 20% ownership. In order to facilitate the accurate reporting of income I recommend for your consideration That such investment into a micro (small) business without exceeding the 2 physical person shareholder threshold be limited to micro enterprises whose total turnover is 70% or more of the micro threshold amount. This encourages accurate reporting of receipts.
- 2. Research and Development.** The new definition of micro enterprises encourages the promotion of research and development. Universities and research centers are permitted to have up to a 20% ownership interest in a Micro without exceeding the 2 physical person ownership requirement. I would limit this incentive to micros whose total turnover is exceeds 70% of the micro threshold amount.
- 3. Loans.** In the Netherlands lenders limited to financial institutions and regional development grant institutions receive tax-free interest income for loans to small businesses, if the loan is recorded with the Registrar's Office. I would recommend the following incentives to encourage loans and correct reporting of turnover:
 - a. 25% loan interest income exclusion to micros having total turnover between an establish amount.
 - b. 50% loan interest income exclusion to micros having total turnover between the subpart (a) amount and another amount.
 - c. 100% loan interest income exclusion to micros having total turnover between the amount in subpart (b) and the total threshold amount.
 - d. The amount of total turnover must be maintained during the entire term of the loan.
 - e. If the micro exceeds the turnover amount in which the loan was granted, the Lender is permitted to use the exclusion amount attributable to the excess so long as the micro has maintained the additional turnover amount for a period of 9 months or longer during the current year.
- 4. Credit Cards.** Small businesses should be encouraged to accept credit cards. Consideration should be given to providing a discount against the total turnover received from credit card purchases prior to computing the flat tax on gross turnover.
- 5. Exceeding Threshold.** If the micro exceeds the threshold amount of employees or total turnover, rather than immediately becoming a standard tax regime taxpayer, the micro will retain the micro status so long as the excess amount does not continue beyond two



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consecutive accounting years. As a result, the micro having turnover, which would jeopardize its status for the current year, should not evade reporting the income in excess of the threshold amount for the current year.

Regarding employees, part time employees as well as independent contractors should be counted as $\frac{1}{2}$ unit toward the 9-employee threshold. For example, a company employing 5 full time and 4 part-time and 3 contractual persons would have a total of 8.5 employees.

- 6. Equipment Purchase.** Micro (Small) businesses having in excess of 70% of the micro threshold amount that reinvests profits into the purchase of new equipment are allowed a 10% reduction to total turnover if the cost of the new equipment exceeds the 10% reduction to total income. (This is given in Austria).
- 7. Audits.** It is cost ineffective to audit micro enterprises. However, to assure compliance spot inspections have been implemented in Australia. Since a micro enterprise reports only gross turnover, an inspector performs an unannounced spot check of the micro's gross receipts records. Failure to keep records allows the inspector to impose a predetermined fine and collect the fine on the spot. The inspector is also permitted to close the micro-enterprise until such fine is paid.

IV. CONSLUSION

It is strongly suggested that the Georgia Tax Code sections on Individual Tax, Profit Tax and VAT be revised to resemble the treatment of smaller enterprises of developed countries. If this is accomplished, Georgia will become even more attractive to Foreign Direct Investment.

It is also noted, that simplicity results in compliance, compliance as well as a tax system encouraging expansion results in increased Government revenue.

The USAID Business Climate Reform Project is ready and looks forward to assisting the Government.