ENTREPRENEURS AND MALPRACTICE IN TAX MANAGEMENT: AN EMPIRICAL INVESTIGATION IN GERMANY

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ABSTRACT

Nascent entrepreneurs face multiple challenges after starting their business. One is dealing with obligations from taxation. Entrepreneurs suddenly need to take care of taxpaying themselves, including the duty of implementing and running various tax relevant systems. Germany is known for one of the most complex legislations on taxation. In this explorative study, we try to identify the most challenging areas the field of taxation. Therefore we have analyzed several web forums for entrepreneurs and questioned 56 tax consultants and eight tax inspectors. Descriptive results are presented. Entrepreneurs with no vocational training have more problems with taxpaying than all other educational groups. Migrant entrepreneurs do not face significant more difficulties than German entrepreneurs, according to the tax consultants. Tax officer have a different point of view, they state that handling taxation is a bigger challenge for migrant entrepreneurs. Entrepreneurs in the gastronomy industry are most likely to get in conflict with tax legislation. Entrepreneurs need more advice on certain areas of taxpaying than on others. Entrepreneurship education should pay close attention to those areas.

1. INTRODUCTION

Nascent entrepreneurs at the edge of starting their business face multiple challenges. One rather unpopular burden is the one of taxpaying. Different from what it was in their earlier occupational life (in regular employment), entrepreneurs suddenly need to take care of taxpaying themselves, including the duty of implementing and running various tax relevant systems: bookkeeping and drawing up balance sheets, calculating depreciations, paying taxes on wages, filing preliminary turnover tax return and declaring actual sales taxes to name just a few. Besides, some businesses require the design of an elaborated taxation model to avoid unnecessary taxations. Others apply for aid from the tax office, designed as governmental support for start-ups (e.g. virtual accelerated depreciation on future acquisition costs of tangible fixed assets or booking incorporation costs as an asset) – or fail to apply for such benefits. The area of potential wrong doing and mishaps ranges from filling in forms to more challenging tasks of managing taxation on a more strategic CFO-level.

Some entrepreneurs ask for advice from tax counselors during the planning process and have tax accountants and advisors ready to support them during the startup process and thereafter. However, especially small business start-ups often fail to pay sufficient attention to taxation and do not reach out for counselors’ tax advice in the first place. While mid-sized and large scale start-ups must frequently employ the services of chartered accountants and tax counselors, small business owners – who are not subject to such legal requirements – sometimes go for a “do it yourself”-approach, ending up in unprofessional mishaps.
The aim of our study is to reveal empirical information on such mishaps. What kinds of errors in the field of taxation occur frequently with small business start-ups? What kinds of mishaps are dangerous hazards for young companies? How many companies fail due to mishaps in the area of taxation? How many small business owners stick to the “do it yourself-approach”, how many get counseled during business planning and start-up process? Where do they get information and advice from: online forums, official governmental web pages and citizens’ advice bureaus, or (costly) tax consultants? Does the lack of professional tax counseling necessarily result in mishaps? Are certain groups of entrepreneurs more likely to get involved in wrong doing than others, e.g. less educated individuals, or migrant and ethnic entrepreneurs?

2 METHOD

To address these research questions, in a first step we have studied discussions on the internet, monitoring relevant online forums and web based discussion boards. This approach generated first inside about what areas are addressed by entrepreneurs seeking for advice on the internet. In a second step we have conducted expert interviews with tax counselors and academics in the field of taxation. In addition we have analyzed information on taxation provided by official governmental web pages designed to support start-ups (www.existenzgruender.de). Based on the results of this exploratory approach, we have designed a questionnaire. After pre-testing, one questionnaire was distributed among tax counselors and tax inspectors. Thus, our empirical assessment on entrepreneurs’ mishaps in the area of taxpaying does not rely on entrepreneurs’ self-reporting.

Both questionnaires allow distinguishing the most frequent and the most dangerous mishaps. They also allow for tracking some potential influential factors, such as the entrepreneurs’ background (education, migration, ethnicity, age, experience, industry). The questionnaires were sent to a representative number of tax counselors and tax inspectors in a German county called “Bergisches Land”, an urban area with approx. 1 Million inhabitants. We received answers from 56 tax counselors and 10 tax officials. More than 50% of all counselors have advised more than 100 start-ups. Only 3% have dealt with less than 20 start-ups. We therefore assume that great knowledge and experience has accumulated in those individuals who answered to the questionnaire.

3 RESULTS

As this paper reflects work in progress, it will basically focus on displaying descriptive results. Analyzing web forums has indicated six areas. On web forums, entrepreneurs seek advice most frequently on:

1. Implementing tax relevant accounting systems
2. Handling and calculation of Value Added Taxation (VAT)
3. Interacting with legal officials from tax offices
4. VAT allowance for small businesses
5. Calculating and handling income taxes
6. Writing invoices according to the guidelines provided by tax legislation

We expect to find these areas reported in our first question of our questionnaire for tax officials and tax accountants. We asked: “In which areas of taxation need entrepreneurs advice most frequently?” The first diagram displays the results. A five interval Likert scale was used to indicate frequency. In diagram 1, the answers from tax officials and tax consultants follow almost the same pattern. The insights from the web forums are supported empirically. In addition, some more areas are indicated as frequently challenging to entrepreneurs, including the pre-payment of taxes (T), the taxation on private use of company cars (K), and the registration of new businesses (H). Consultations on how to interact and communicate with fiscal authorities was the most frequent issue for entrepreneurs. In the internet, this issue was on third rank. Both positions indicate that the communication between entrepreneurs and tax authorities is not functioning at its best.
Diagram 1: How frequently do entrepreneurs need advice in the area of... (see legend A to W; light gray line represents opinion poll from tax officers, dark grey line represents opinion poll among tax consultants)

We asked to indicate areas in which entrepreneurs have done wrong before contacting a tax counselor for advice. Results are displayed in Diagram 2. Not installing appropriate accounting systems, failing to issue correct invoices and a lack in proper start-up planning are the most common critical areas.

Diagram 2: In what areas do entrepreneurs make mistakes before contacting a tax counselor? (see legend A to W; light gray line represents opinion poll from tax officers, dark grey line (with “Xes” at data points) represents opinion poll among tax consultants; broken line indicates areas were entrepreneurs seek for advice most frequently (from diagram 1))
According to diagram 2, almost for each item under examination (A to W), tax officials are more critical than tax consultants are.

Not every mistake will lead to situations which put a new company on risk of further existence. Some mistakes can be corrected, but others may lead to serious situations. Not paying taxes of course can seriously harm a company. But also a lack of planning that is leading to unexpected costs (J), not declaring income statements (E), and a lack of accounting systems (Q) are among the most serious threats. Tax officials are especially much more critical than their counterparts (tax consultants) regarding a lack of professional accounting systems in new businesses (Q) and the handling of VAT by new businesses (V).

Again, for almost all areas relevant to taxation, tax officials were more critical about the consequences of mishaps. Only the pre-payment (or the failure to execute such pre-payments) was evaluated much more critical by tax consultants (T). The reason might be that for tax officials, problems in liquidity which can occur from such pre-payments are not transparent. Fortunately, none of the critical areas scored 4.0 or higher on average.

We had an additional open question about the most common errors of entrepreneurs; consultants addressed a lack of entrepreneurial mindset, passion, and energy in some small business owners.

**Diagram 3**: In what areas are mistakes threatening the existence of the start-up? (see legend A to W; light gray line represents opinion poll from tax officers, dark grey line (with “Xes” at data points) represents opinion poll among tax consultants).

70% of tax consultants believe that there are no distinct industries where entrepreneurs run into problems more frequently than in other areas. The other 30% ranked gastronomy and construction first among those industries where entrepreneurs run into problems with tax authorities more often. To our surprise, even consulting businesses are named among those industries which typically have problems in tax management (see left hand column of table 1 for a full list).

Different from tax consultants, tax officials agreed in 100% that certain industries or trades are more likely to get into conflict with taxation. They named gastronomy, construction, internet retailers, and car repair garages, followed by others (see right hand column of table 1 for a full list). To some surprise franchise start-ups were also mentioned. We would expect franchise systems to set strict quality standards, to train new franchisees in necessary administrative tasks, like handling taxation, and to select franchisees who are capable to execute their obligations with the care of a prudent businessman. This seems not always to be the case. We would also expect a franchise system to help entrepreneurs with tax management, but this also doesn’t seem to be the case for each and every franchise system.
Except for gastronomy and construction business, the perception of tax consultants and tax officers differ heavily.

<table>
<thead>
<tr>
<th>Industries which are more likely to get into problems in tax management, according to tax consultants:</th>
<th>Industries which are more likely to get into problems in tax management, according to tax officers:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gastronomy</td>
<td>Gastronomy</td>
</tr>
<tr>
<td>Mom and Pop Stores</td>
<td>Construction</td>
</tr>
<tr>
<td>Craftsmen like plumbers etc.</td>
<td>Independent car repair garages</td>
</tr>
<tr>
<td>Creative industries (e.g. advertisement, design, arts etc.)</td>
<td>Independent car dealerships</td>
</tr>
<tr>
<td>Real Estate Businesses</td>
<td>Franchise system outlets</td>
</tr>
<tr>
<td>Construction</td>
<td>Small independent internet retailers</td>
</tr>
<tr>
<td>Taxi Drivers / Businesses</td>
<td>Care taker / handymen services</td>
</tr>
<tr>
<td>Transportation in general</td>
<td>Small private solar energy producers</td>
</tr>
<tr>
<td>Consulting Businesses</td>
<td>Insurance brokers</td>
</tr>
<tr>
<td>Part time entrepreneurs</td>
<td></td>
</tr>
</tbody>
</table>

Table 1: Are newly founded businesses in certain industries or areas more likely to become involved in bad tax management?

The level of education is seen as an influential factor. The lower the education the more likely mistakes occur in handling taxations. Both, consultants and tax officials reported this. While this result was expected, it was found that immigrant entrepreneurs are not reported by consultants to have problems in the area of taxation more often than non-migrants. Tax officers have a different perspective; they pronounce that immigrant entrepreneurs have more problems to handle taxation.

A German governmental website (www.existenzgruender.de) gives advice to entrepreneurs. In a section that addresses taxation, the authors of the web site address certain areas. Tax consultants find these areas well chosen, except for inapt legal forms. In practice, this area seems to be less relevant.

In an open comment section consultants pointed out that for many nascent entrepreneurs problems occur in their private life, because of all the unforeseen impact of such a career movement, and that there is no support addressing such issues. It was commented that consulting a tax adviser may not make a company necessarily more successful, but at least it will open the entrepreneur’s eyes for problems that so far had not been recognized by the entrepreneur. Programs that encourage unqualified necessity entrepreneurs (in order to deal with the issue of unemployment) are blamed for an increase in problems with tax authorities. A lack of general business administrative knowledge and the need to run formalized procedures are addressed. Both demands often remain unfulfilled by necessity entrepreneurs. Tax officers point out that most “entrepreneurs” who get into conflict with tax authorities execute only a small side business, so mistakes in taxation have no big impact and can be corrected easily. Full time entrepreneurs with reasonable businesses could act much more professional. The quantitative measurement of how frequently and to what consequences mismanagement occurs therefore does not tell the whole story. Additional information on the quality of businesses under conflict with tax authorities should be taken into account. Newspaper reports for instance mention that 20 or something percent of newly founded ventures had to go out of business because of conflict with tax authority, this usually consists of a very large portion of very small side businesses.

4 DISCUSSION OF RESULTS AND IMPLICATIONS

Results address all interest groups of entrepreneurship research: educators, researchers, practitioners, and policy makers. Educators and researchers gain insights from real world activities. In the area of teaching, especially German and Austrian educators find insights that can help to adjust contents of courses designed to practically educate small business entrepreneurs. Courses in Entrepreneurship Education should focus on a small area of relevant tasks in tax management. Results seem to support our view that most courses are not designed in a “hands on manner” according to the empirically measured need for very basic and practical advice and lack of awareness.

Academics will furthermore be provided with an empirical “point of origin” for further research, e.g. addressing questions like: Why do tax consultants and tax officers name different critical industries? What is wrong with franchising? Is there a special need of migrant entrepreneurs for support in handling taxations?
Practitioners are provided with check lists of areas others have failed in. Results can create awareness and thus help to avoid replicating mishaps that have already occurred to others.

Policy makers gain insights in how complicated tax systems occur to small business entrepreneurs, especially the less educated ones. From the viewpoint of policy makers, the tax system may seem to be inherently logical, well crafted, and very detailed serving a broad set of distinct cases individually, but it still (or outright therefore) overstrains many small business owners, especially less educated and inexperienced small entrepreneurs in the start-up stage. A less distinct and detailed framework but more general rules to follow instead, a longer validity period of rules which have once been established, and a simpler approach in communication between taxpaying entrepreneurs and tax office are only three implications drawn from our results. It seems that simplicity could be the best way of governmental tax support for small business start-ups. Tax officers should be aware, that some of those small side businesses that have come into conflict with tax legislation probably one day would have grown into full scale ventures. Not the amount of taxes which have to be paid are critical to entrepreneurs, but rather the administrative task of handling taxation.

References: A list of literature can be provided by the authors.